NJPA Real Estate Journal

Tuesday, November 25, 2003 Covering the States of New Jersey and Pennsylvania

By Michael Houge, Upland Real Estate Group, Inc.

# Differences between triple-net and tenants-in-common investments

Real estate investors involved in 1031 Tax Deferred Exchanges, seeking single tenant, net-leased properties are facing the daunting reality of lower returns coupled with less opportunity. With the release of the private letter ruling, a new property ownership opportunity is emerging; the Tenants or Tenancy in Common (TIC) investment.

Although the TIC structure for ownership has been in use for decades, the structure has basically been "blessed" by the IRS as an approved investment type for those seeking replacement properties in a Section 1031 Tax Deferred Exchange, creating, in effect a whole new investment opportunity class. Make certain any TIC opportunity you are interested in complies with the fifteen points of the Revenue Procedure!

I will attempt to compare and contrast net-leased real estate (triple-net properties) with TIC offerings.

The working definitions of the triple-net property and a TIC investment are as follows:

**Triple-Net Leased Property:** This property has all of the expenses "netted out" and paid by the tenant. The true "triple-net" property has no property management or day to day involvement by the owner and all expenses including real estate taxes, insurance, CAM and utilities are paid directly by the tenant.

**TIC Investment:** The property ownership structure is a fractionalized, undivided interest including up to 35 investors . Most TICs, however, will have less. As a syndication, the property will have a sponsor who acts as the asset manager, and often as the property manager. The day to day management is "outsourced" to the sponsor or asset manager.

**Triple-net Advantages:**

· Little or no property management. These properties are very passive in nature, and except for slight variations in the definition of "net", triple-net properties require little, if any, involvement by the investor. This is a key characteristic to the unsophisticated buyer seeking a real estate investment, since they often have little or no property management experience.

· Simple "rent roll." Both savvy and unsophisticated investors appreciate the simplicity of long term net-leases, especially in the last days of an identification period for a 1031 Tax Deferred Exchange. The predictability of the rent roll combined with the strict time constraints of a 1031 make the net-lease investment the path of least resistance. The investor does not have to be as concerned with potential vacancies, tenant improvement allocations and other factors often underwritten in multi-tenant or multi-family properties. A net-lease is easier to get his or her arms around.

· Quality real estate-reasonable returns. Many net-leased properties are leased long-term to national and creditworthy tenants. The failure or default rate of investment grade companies is very low. An investor in a triple-net, credit investment property can expect reasonable returns combined with very low risk of tenant default.

**TIC Advantages:** TIC properties are emerging as another investment opportunity because they offer some of the same attributes of the net-lease with the added potential for upside.

· Little or no property management. TIC investments are usually offered with professional asset and property management services as part of the package.

· Bigger opportunities. An investor with $0.05 million can, by investing alongside other TIC investors, participate in properties that would normally not be reachable. This investor can invest into a property valued at $7 million assuming 35 equity investors each invest $0.05 million into a 25/75 debt to value ratio. Normally this investor can only leverage up to a property value of $0.2 million. Generally, the $7 million property is significantly superior in tenant quality, fundamental real estate factors, potential for upside and market attractiveness than the smaller investments usually available to this investor class. Using the same argument, the $5 million equity investor can, theoretically, real estate portfolio. The buyer can invest in differing property types (industrial, office, retail, multi-family, etc.), into varying geographical and demographical locations, into separate and distinct industries, and ultimately, into properties with various risk/reward profiles. Long-term this can be a very sound strategy for risk mitigation.

**Triple-net downside:** In a triple-net property, it is rare to find an investment with all of the value components perceived as perfect. There are no "unicorns". The value components are:

· The Tenant. The credit, competitive edge, net-worth, financial history, future prospects, reputation and name recognition of the tenant all impact triple-net property value.

· The Lease. The lease *form*, the degree of "net" or landlord responsibility, presence of rent increases, lease term and other conditions can significantly impact net-lease property value.

· The Real Estate. Demographics, geographics, building visibility, ingress/egress, building specialization vs. generic functionality and overall estimate of future and residual values all drive net-lease property values.

Any perceived problems in any of the aforementioned value components will influence investor appetite. These factors combined with the single tenant nature of a triple-net property are considered in any risk assessment. Most investors are concerned with the "all eggs in one basket" attribute of net-leased property. The impact of supply and demand, availability and cost of financing and skyrocketing development costs are also considerations.

**TIC downside**

· Multiple ownership. A TIC property, by definition, involves other decision makers. This makes for less perceived liquidity and nimbleness in reacting to changing market forces.

· Sponsorship risk. Sponsorship poses another layer of risk. If the sponsor and or its property manager(s) or leasing agent(s) are not qualified or competent, a quality TIC investment can suffer.

· No secondary market. A TIC investment has all of the other inherent risks associated with commercial real estate those considering this type of property should do their homework before investing. Since TICs have just recently hit the market, there has not been time to establish a secondary market for TIC units. The exit strategy is still cloudy.

Both triple-net and TIC investments have potential for good or bad results. An investor facing the prospect of either property type should consider the fundamentals associate with investing, obtain quality advice and proceed cautiously.

**Michael Houge is a principal at Upland Real Estate Group, Inc.**