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TIC deals follow industry standard for load fees

The 15 percent markup for the Minnesota Center building in a syndicated TIC deal was not unusual, according to industry insiders. But at least one real estate expert is preaching caution about the investment strategy.

By Burl Gilyard/F&C Real Estate Writer
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One of the larger local real estate deals of 2003 was the sale of the Minnesota Center building in Bloomington. The 14-story suburban office tower changed hands for $40.6 million in October. But the deal is perhaps more notable as the largest local tenants-in-common (TIC) deal to date.

The Dallas-based Behringer Harvard Funds acquired Minnesota Center from the Chicago-based REIT, Trizec Properties Inc.

Behringer Harvard retained a 14.5 percent interest of the property through its REIT fund, but ultimately syndicated the property for $46.7 million, a markup of 15 percent from the actual market price paid for the property.

While those numbers may make some traditional real estate investors blanch, it’s becoming business as usual in the burgeoning world of TIC deals.

Jason Mattox, senior vice president with Behringer Harvard Funds, said that his firm aspires to offer institutional-level investment to TIC investors. “There’s tremendous demand,” said Mattox. “Minnesota Center obviously fits that niche.”

Mattox said that 15 percent is a standard load for Behringer Harvard. “We generally try to make the load on our public funds and our tenant-in-common investments the same,” said Mattox.

Mattox declined to disclose the total number of investors in the deal. IRS guidelines cap the total number of TIC investors at 35.

Joe Atkin, a due diligence analyst with the Salt Lake City-based Omni Brokerage Inc., said that loads are a standard part of TIC. Omni has brokers throughout the country, some of whom were shopping the Minnesota Center deal.

“This is pretty standard of what we see in the market,” said Atkin. “It’s kind of like buying a pizza. You can buy a 10-slice pizza for $10, or you can buy a slice for $1.25.”

Loads can include closing costs, commissions, fees to brokers, reserves for building improvements and other costs. Atkin said that 13 to 15 percent of every dollar in equity typically goes to pay load fees.

Atkin said that the demand for good properties is robust. “In our market, the problem is the supply is not meeting the demand. It’s tough to find the properties that cash flow like investors want,” said Atkin. “We see $10 million to $15 million raises selling out in a day or two.”

The appetite for property is also driven by IRS guidelines, which state that investors who have sold a real estate property have 45 days to identify a replacement property and 180 days to close the deal. That means that the clock is always ticking for TIC investors. Failing to close within that window is a real risk for potential TIC players.

Tax-free exchanges, governed by section 1031 of the Internal Revenue Code, are old hat. But guidelines issued by the IRS in 2002 governing tenants-in-common exchanges for real estate have prompted something of an explosion in the TIC market.

TIC advocates argue that these investments offer numerous benefits. A TIC investment generally offers passive ownership, free from the traditional “tenants, trash, and toilets” concerns of landlords. TIC investors get regular cash flow from their pro rata share of the property’s rent. TIC investments are also touted as a way for smaller investors to get in large deals that they would otherwise never be able to access. Provided that the deal passes the smell test with the IRS, investors who are rolling over proceeds from another real estate sale are able to defer capital gains taxes.

Companies like Omni Brokerage serve as the middleman between TIC sponsors and investors. Greg Paul, president of Omni, said that graying boomers have driven much of the demand.

“Our market at this point is largely composed of aging baby boomers who’ve done the real estate thing for the last 10 to 20 years. They want to cash in their chips, but they don’t want to pay the taxes. They’re our primary market,” said Paul.

“The investors in this primarily look at the cash on cash return of a deal,” said Paul. He added that returns average 6 to 8 percent.

1031 and TIC Investments LLC, a branch office of Omni Brokerage, now has an office in Minneapolis headed by managing director Dan Werry.

TIC investments are often packaged as securities. A sponsor or promoter finds properties and packages or syndicates the deal for investors. The sponsor will typically retain a stake in the property and may also serve as the property manager. A network of broker-dealers finds investors for the deal. Deals are packaged with lengthy private placement memorandums, which offer detailed financials and a host of potential risks outlined for investors. The offerings also outline how long the sponsor envisions holding the property.

Gerry Reihsen, executive vice president of Behringer Harvard, was in town last week and spoke at a NAIOP (National Association of Industrial and Office Properties) forum on TIC investments.

At the forum, Reihsen spoke to the growth in the TIC market. He said that in 2001, nine sponsors syndicated $167 million in equity for TIC deals. By 2003, that had grown to 20 sponsors who raised $1 billion in equity.

“The projection is that by the end of the year, there will be about $2 billion in equity that has been raised,” said Reihsen. (Reihsen’s statistics only counted securitized TIC deals.)

Minnesota Center represented the first TIC deal for Behringer Harvard. The 276,425-square- foot Minnesota Center is about 90 percent leased. As it happens, the local office of CB Richard Ellis is one of the larger tenants, with nearly 33,000 square feet of space.

Minnesota Center, which opened in 1987, last changed hands in 1998 for $45.7 million at the peak of the local real estate market. That sale also included previously attached development acreage, which has since been parceled off. The 3.8 acre parcel was sold to Frauenshuh Cos. in December 2002 for $1.75 million. Per Hennepin County records, Minnesota Center is currently assessed at $32.34 million.

But given that the current top rate for capital gains taxes is now 15 percent, some question the value of paying a 15 percent load for an investment.

Gary Gorman, managing partner of The 1031 Exchange Experts, a Denver-based firm that serves as a qualified intermediary for 1031 deals, preaches caution for investors contemplating buying into syndicated TIC deals.

“Let’s assume that the building truly is worth $40 million and they’re buying it for $46 [million]. How long are these people going to have to own this building before the market says this building is worth $46 million. Five years? Ten years? And that gets them back to zero,” said Gorman. “How long do they have to hold this to get a 10 percent profit?”

“I firmly believe that more than 50 percent of these are not good investments,” said Gorman.

But for the moment, the demand for TIC deals appears unabated. Paul said that his network of broker-dealers will only shop deals that have been carefully scrutinized.

“We have to analyze not only the sponsor, we also look at the economics of the deal. The other thing we look at is just the structure of the deal,” said Paul. “The key component of a private placement letter is full disclosure. Every real estate deal has risk and issues associated with it. It’s laid out in all of its glory. We don’t want them to make a quick, uninformed decision.”