TIC TAC DOUGH

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As if there isn't enough competition for retail assets, a new crop of eager investors has found the way into the market. It's the tenant-in-common (TIC) structure, which enables individual investors to pool their resources to chase retail deals.

TICs aren't new — the structure has been around for about 10 years. But in 2004, it took off. More than 50 sponsors of TIC funds raised $1.5 billion, according to Omni Brokerage Inc. That's up from nine companies and $167 million in 2001. The retail portion this year was just $200 million, mostly on the West Coast. But as the trend moves east, brokers expect the TIC numbers to soar, especially now that the Internal Revenue Service has given its blessing to the structure's use. And retail could account for as much as 25 percent to 30 percent of the TIC market.

“The overall TIC industry has grown geometrically over the past three or four years,” says William Winn, COO of Passco Real Estate Enterprises Inc., one of the largest TIC sponsors in the country. “The investors we're dealing with are primarily those types that have built their own little real estate portfolio but want to get out of day-to-day management and get something with very low risk.”

The increased use of TICs has created a ripple effect on retail investment. By pooling funds, TIC investors get to play above the overheated market for single-tenant net-leased assets. These are the little properties that small investors — such as that dentist looking for better-than-stock-market returns — usually are restricted to. Those properties trade for $5 million or less and, with more of those dentists seeking yield, it is an competitive sector. Through the first three quarters of 2004, $11 billion in property in that price range has traded hands. It is on pace to exceed last year's total of $14 billion. The competition for these smaller assets is so intense that it is often difficult for 1031 exchangers to sell one property and buy another within the window of time allowed in order to retain their tax benefits. The TIC investors are not a factor in major Class A properties where the REITs and institutional players rule. But they are becoming a factor in the bidding for B and C malls in secondary markets. In October, for example, a group of 32 investors bought the 858,350-square-foot Village at Orange in California in a $100 million deal.

As is typical of TIC investments, Passco acquired the property on behalf of the ownership group, which purchased the Village at Orange looking for a well-positioned property with tenants with solid credit, steady income and long leases; they were not interested in a turnaround. 1031 Exchange Options, a real estate investment consultant, represented 45 percent of the buyers in the deal. It is currently working on another project in Dallas, valued at $77 million.

“Retail is starting to become more popular,” says Dave Laga, a due diligence analyst with Omni Brokerage Inc. “I think the determining factor of whether its popular in the marketplace or not is that cash-on-cash return and who the tenants are.”

In most TIC undertakings, the sponsor signs a master lease agreement with the TIC investors. The sponsor is responsible for managing and leasing the property and helping to secure any debt. TIC investors tend to be older, less risk-averse individuals that are looking for the same sort of security they get with net lease deals. The master lease agreement allows TIC investments to function much like net leases, even on properties with multiple tenants.

They are looking for passive investments that generate a stable yield. The typical hold is five to 10 years.

“Every property we offer is a little different hold, based on the dynamics, but [Village at Orange] is an A location and an infill area. The buyers don't want to come in and flip this. They want to come in and hold and when they do sell, get a good cash-on-cash return. Occasionally we'll do a buy that's a value-add where it may have a three-to-five year hold. But this was not one of those," Winn says.

While the trend toward bigger deals is clearly growing, TICs are still in the strip-center sector. SCI Real Estate Investments, for example, bought the 88,839-square-foot Country Village Shopping Center in Rancho Cucamonga, Calif., with eight TIC investors for $16.9 million, a 6.1 percent cap rate. But Christian Mirner, senior vice president of 1031 Exchange Options, says the economics favor investments in bigger properties. "Because neighborhood shopping centers are a more expensive property type due to the dynamics of supply and demand, there's been this gravitation toward larger property," he says. "There's an opportunity there to acquire properties with less competition and at higher cap rates, which allows them to generate the return they want."

The growth of TIC investments in the past couple of years also reflects the increasing credibility of such partnerships — and favorable tax rulings. With a short track record, it was difficult for TIC ventures to get financing. And even when they did, the terms were often less favorable than the individual investors could get. These days, lenders are more comfortable with TICs and are willing to finance at levels comparable to other investing vehicles.

"We are now getting CMBS and conduit loans with five- and 10-year terms," says Adam Bryan, vice president of sales and marketing for SCI.

Another step toward legitimizing the TIC vehicle is the formation of the Tenant-in-Common Association (TICA), a group of brokers, investors and sponsors that's trying to organize a lender base and expand the use of TICs.

"I feel that at this time we have worked through the issues with lenders for the most part. They have become more comfortable with TICs," says Patricia DelRosso, president of Inland Real Estate Exchange Corp. and a member of the TICA board of directors. "Lenders want to be protected." As a result, each investor must form a "single-purpose, bankrupt-remote entity," such as an LLC.

A crucial breakthrough came in 2002 when the IRS determined that up to 35 investors could participate in one deal. The agency also provided guidelines on how the relationship between sponsors and investors should work and directed that unanimous consent is required between all investors before a property can be sold or refinanced. Together, these rules helped take some of the uncertainty out of financing TIC deals, says Mirner.

"Prior to the IRS ruling we were topping out at 15 to 20 investors in a transaction," Winn says. That was partly because lenders didn't want to deal with more borrowers. "With the ability to bring in more investors [and subsequent IRS permission to structure the deals as trusts], we can buy larger properties."

With the rules clarified, individual investment amounts rose — to an average of $750,000 today from about $200,000 five years ago. The average investment in the Village at Orange was $1.25 million.

Another IRS ruling this year allows TICs to structure their investments through Delaware Statutory Trusts. The IRS said that owning part of a trust qualified as owning real property, meaning 1031 exchangers could participate in such agreements and fulfill their exchange obligations.

Also, structuring the investment as a trust creates a single entity that owns the property., enabling the TIC to work with lenders that have limitations on how many borrowers are allowed in one deal. Through this arrangement, the lender will work directly with the combined trust rather than with 20 different buyers.

Overall, the IRS has laid down 15 conditions on how to structure deals. But the conditions are not binding. In fact, TIC sponsors say that most deals do not meet all of the IRS's proscribed conditions.

"The guidelines have provided guidance and made the structures more compatible with one another. The IRS will tell you they know that people will not meet all 15 conditions. There's a give and take," DelRosso says.

Some concerns remain. For one thing, sellers resent that due diligence and closing takes longer because so many parties are involved; TIC investors, because of their conservative nature, tend to be more stringent than other buyers in reviewing a property's history. And TICs frequently need 60 days to line up their financing and want another 30 days to close the deal.

"A lot of sellers would much rather do business with somebody who can do their due diligence in 21 days and close in 30," says Brad Umansky, vice president with brokerage company Sperry Van Ness. "They are just not as impressive a buyer as some private capital is."

Another concern is that TIC investors seem willing to pay a premium for the tax deferral benefits that go along with fulfilling their 1031 exchanges. As a result, TICs generally bid more aggressively than other buyers. If they become more of a force, they could cause further inflation in real estate valuations.

“The question is going to be, ‘What price is too high for TIC buyers, making returns small?’” says Dean Halfacre, senior manager with Deloitte Tax LLP's national real estate tax services group. “We haven't see any deals fall apart yet, but it's definitely a concern.”

Back to Top

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