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REPRINTS

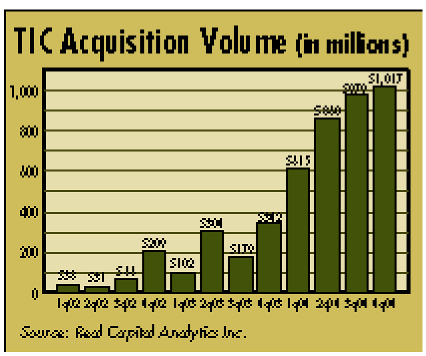
TICs Take Off

Enable Small Buyers to Compete for Big Deals

By Keat Foong, Executive Editor

APRIL 01, 2005 -- New York—As recently as just three years ago, few multi-housing players had ever even heard of tenant-in-common (TIC) entities—let alone crossed paths with one in a business deal.

But with the TIC approach to buying real estate exploding in popularity, the industry is quickly becoming infinitely more familiar with these ownership entities.



More and more multi-housing players will find themselves working with TICs in a myriad of ways, if they haven't already begun doing so: Participating in one as investors; competing against one for a deal; or selling a property to a TIC, perhaps for a handsome profit.

Indeed, the growth trajectory of this investment method has been nothing short of miraculous: Before 2002, TICs were not even a blip on most investors' radar screens; now, they are evolving into a major force in the industry, accounting for a rapidly increasing percentage of acquisitions.

"We've gone from not having an industry to an industry with $4 billion worth of acquisitions," said Dan Fasulo, a senior associate at Real Capital Analytics Inc., the New York-based real estate investment research firm. "If the growth continues at this pace, next year [TIC acquisitions] could be as large as that of private REITs."

Real Capital Analytics data shows that acquisitions by TICs (across all commercial

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property types) has rocketed from $344 million in 2002 to $3.5 billion just two years later [see chart]. This data includes the acquisition of properties and portfolios of $5 million or greater—which account for up to 90 percent of the total volume on a dollar basis, said Fasulo.

Ticking Off the Benefits

So for the uninitiated, just what are TICs? TICs are "undivided fractional ownerships" in real property, most commonly used by real estate investors to purchase replacement property in an IRS Section 1031 like-kind exchange

TIC investment vehicles essentially allow small 1031 investors to band together to bid against the big boys for large institutional-quality real estate whose price and size would otherwise have been beyond their reach as individual buyers.

What are the advantages to TICs that have made them so intensely attractive to certain investors? The benefits of investing in TICs vs. reinvesting sales proceeds directly in a real estate property are numerous, according to TIC advocates.

A major edge is convenience, according to Christian Mirner, executive vice president of real estate at 1031 Exchange Options, a Walnut Creek, Calif.-based consultancy which works with TIC investors and TIC sponsors.

Investing in a TIC eliminates the need for the buyer to first identify a suitable like-kind exchange property: At the acquisition stage, TIC sponsors scout out suitable properties and essentially provide turnkey real estate investment services, including performing due diligence and arranging financing (at institutional terms), Mirner said.

Going the TIC route also frees investors from the need to oversee the day-to-day management of the required property. "[The TIC investor] continues to receive the benefits of real estate ownership, but is removed from the day-to-day operation of the real estate," said Mirner.

Another crucial benefit, supporters argue, is that TIC deals give mom-and-pop players the opportunity to partake in the ownership of institutional-quality real estate—which is highly desirable to many investors as these super-sized properties are generally of "higher quality, in good locations and have professional management supported by economies of scale," said Mirner. Therefore, the risk-reward returns for these properties are generally better than what can be obtained in the typical small apartment building, Mirner argued.

And through TICs, the investor is able to obtain greater investment diversification—to spread dollars obtained from the sale of one property over a few different TIC-owned assets and/or geographic regions, added Mirner.

interest
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- apartment property

People
- Christian Mirner
- Dan Fasulo
- Tim Snodgrass
- TICA
- Mike Frankel

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The phenomenal growth of TICs in the past three years is attributed to a revenue procedure issued by the IRS on March 19, 2002, which provided guidance on what TIC sponsors needed to do for a TIC interest to be characterized as a real property interest eligible for a 1031 tax-deferred property exchange, explained Tim Snodgrass, president of the Tenant-in-Common Association (TICA), based in Sacramento, Calif. The IRS guidance opened the floodgates for the use of TICs for tax-deferral purposes since 2002.

(Most, but not all, TIC investors are 1031 exchange investors; TICA's Snodgrass ventured that about 20 percent of today's TIC investors are not participating for the purpose of a 1031 tax-deferred exchange. These investors simply like the particular piece of real estate being offered to TIC buyers, he said.)

The TIC Process

It is important to note that a good 90 percent of TIC offerings are issued as securities, as opposed to real estate, so these TIC transactions are subject to SEC disclosure rules and are regulated by the SEC.

"There are disclosure requirements that allow investors to have all the information necessary to make a suitable investment. Everything is disclosed upfront," said Mirner.

Typically, to begin the TIC process, an investor who has just sold or is about to sell a property and wants to defer capital gains tax on it by completing a 1031 exchange contacts a NASD-registered broker/dealer who will match the TIC investor with an appropriate TIC sponsor.

TIC sponsors—there are about 50 of them in the marketplace, with the number "growing everyday," according to Snodgrass—buy properties with the intention of immediately re-selling them (as securities, via a registered broker) to a pool of TIC investors.

The NASD-registered advisors will show the prospective TIC investor the private-placement memorandum for the TIC project concerned. Every TIC project is allowed a maximum of up to 35 TIC investors, and there can be some flexibility in the amount of capital invested by the different investors, he said.

According to TICA, after investing in a deal, each TIC investor receives a separate deed and title insurance for his or her percentage interest in the property. Each investor has the same rights as a single owner, getting one vote on property issues regardless of his or her percentage interest. Generally, decisions regarding the property have to be approved by a unanimous vote, said Snodgrass.

TIC entities that own apartment properties typically have a master-lease relationship to the TIC sponsor. Under the master-lease arrangement, the sponsor leases the apartment property back from the TIC sponsors who have purchased it.

The reason for the need for a master lease in apartment TIC deals is a matter of practicality. As property owners, TIC investors themselves would be required to sign leases with any tenants. But in the case of multi-housing properties, which can comprise hundreds of tenants, it is not really feasible for every TIC owner to sign leases with every resident every time someone moves in to an apartment. Hence the sponsor performs the task via a master lease.

According to Timothy Kemper, managing principal in the Atlanta office of the law and accounting firm Reznick Group, the details of the master lease can be a subject of intensive negotiation between the lessee and the lessor.

In some cases, the master-lease holder provides a guaranteed rate of return to the TIC co-owners. TIC investors also can get anywhere from 50 to 75 percent of the profits resulting from the future sale of the property, with the rest going to the sponsor, said Kemper.

Mirner added that total returns for TIC investors have ranged from 13 to 25 percent on an annual basis historically. Going forward, he projects annualized total returns of 11 to 15 percent.

Rates of Return

Houston-based Creekstone Partners, one of the country's largest TIC sponsors, is now guaranteeing a minimum total investment return of 11 to 12 percent IRR on multifamily properties. Creekstone additionally backs up all its master leases with a $500,000 note to cover any operating shortfalls.

Marc Goldstein, a Creekstone principal and its president, said the company will pay a guaranteed monthly rate of return, currently at a 6.5 to 7 percent annual yield, generally matched to the prevailing market cap rate at the time of the property's acquisition. If rent levels in the apartment community increase during the master lease, the extra income will be shared between the TIC owners and the sponsor company as a management incentive fee, said Goldstein.

As for the terms of the exit, Creekstone Partners typically has a purchase option after five years, at which time the co-investors are obligated to sell the property if Creekstone Partners chooses to follow that route.

Some observers caution that master leases may guarantee monthly returns, but limit the upside to the investor on rent increases and residuals on the sale of the property. But the New York-based Milestone Group, which was formed by the former principals of the private equity group at Insignia ESG, said that it structures its deals such that the rental upside and residuals are shared with its clients.

"We want TIC investors to be able to benefit from the appreciation of rents and improved performance of the properties," said Jeffrey Goldberg, a principal at the Milestone Group.

Deal Drawbacks?

Some investment advisors have cautioned their clients that the fees charged by TIC sponsors can eat significantly into the TIC investor's returns. There have also been criticisms that some TIC sponsors sell the properties to the TIC investors at a highly marked-up profit to what they have paid for it.

But TIC sponsors said that investors know—upfront before they invest—through the offering memorandum what the fees are, at least in the case of TICs that are sold as private-placement securities governed by SEC rules.

"The costs are disclosed. It is in black and white what the investor is paying for—where the [capital] is going to, the amount of money that is going into the ground and not going into the ground," said TICA's Snodgrass. "Nobody has compelled the investors who have placed billions of dollars into this industry to do so. Bottom line is, the investors reason that this is a good investment for their purpose. The market decides. If the fees are too high, nobody would be investing."

Mike Frankel, national director of real estate tax services in the Dallas office of Ernst and Young, advised that investors should make sure they are buying from sponsors that "dot all the I's and cross all the T's." Investors should also demand a very detailed private-placement memorandum that spells out what investors are getting and what the risks are. Investors should know what their exit strategy is, Frankel said, and what the secondary market is for TIC interests for those who want to sell their interests to other investors.

Frankel, who represents TIC sponsors as well as investors, also advises prospective TIC investors to obtain independent tax advice on whether to go ahead with TIC investments. For example, he said, they should perform a present-value analysis of whether it is preferable to defer capital gains tax—but pay ordinary income taxes at higher rates on the TIC cash flow.

TICs Shake Up Apartment Acquisition Market

New York—Tenant-in-Common (TIC) entities are aggressive new buyers of apartments—so aggressive, in fact, that many see them as frequently overpaying for properties. This, in turn, has led to complaints that the "TIC factor" has caused an overall escalation in the bids would-be buyers have to submit to compete in the superheated multi-housing investment market.

"My [limited] experience has found that [TICs] do overpay," said Brian Ward, CEO of the Seattle-based Orion Residential, an affiliate of Starwood Capital Group Global LLC and a major buyer of institutional-quality multi-housing assets. Ward said his company was recently "significantly outbid" by a TIC entity—by roughly $10 million—on an $100 million apartment complex asset in Southern California.

Tarak Patolia, head of acquisitions at Sterling American Property Funds in New York, observed that TICs are becoming increasingly prominent players in the multi-housing arena. "Although TICs are relatively new to the market, they are aggressive and they have rapidly grown in size and are absorbing a larger share of the market," Patolia said.

Experienced apartment players say that TICs appear not to be governed by the traditional return parameters that govern multifamily acquisitions. Patolia, for example, surmised that small investors' return expectations may be much lower than larger real estate players. "Smaller investors' return expectations are adjusted to stock-market returns," said Patolia.

Another possibility that accounts for TICs' aggressiveness is that with the tax benefits they are getting, TIC investors may be able to absorb lower yields and higher prices. "Their capital is motivated by tax [considerations] instead of investment yield," ventured Ward. "This smacks of the old days, when you had tax-motivated syndicates buying real estate."

Tim Snodgrass, president of the Tenant-in-Common Association and president of a TIC sponsoring company, Argus Realty Investors L.P., denied that TICs are muscling aside the competition with unduly aggressive bids. "Right now, as a TIC company, I lose lots of deals to REITs and institutions that can buy at lower cap rates," he said. "It is a wrong assumption that we all pay more for properties."

And even if TICs are driving up prices, this would be viewed as a very positive development by certain members of the industry—those owners looking to sell.

Having an aggressive new buyer in the market is always "a good thing for the seller because there are more options and a larger pool of buyers to choose from, and therefore you can have a better execution," observed Patolia.

Indeed, Sterling American has sold several properties to TIC buyers. "In some cases, [the TICs] were definitely the highest bidders," said Patolia.