Naples Daily News
Business

The birth of a new investment method

By TERRY PRISTIN, New York Times News Service
September 22, 2004

NEW YORK — Since it was completed in 1990, Emerald Plaza, an office tower in the shape of five hexagons ranging in height from 20 to 30 stories, has been a distinctive part of the downtown San Diego skyline, especially at night, when it gives off a green neon glow.

Since June, when the building changed hands for nearly $101 million, the building has belonged to 30 investors — nearly all of them relatively minor players in commercial real estate.

The building was bought through a program sponsored by Triple Net Properties of Santa Ana, Calif., one of a growing number of companies that put together so-called tenant-in-common deals, which are now competing for prime office and apartment buildings and shopping centers with publicly traded companies, pension funds, and large private real estate companies.

Robert M. White Jr., the president of Real Capital Analytics, said that sponsors of these deals are helping to drive up real estate prices. "They are not the only ones aggressively pursuing real estate, of course, but they are some of the most motivated buyers and they are a huge topic of conversation," he said.

One of the newer ways of buying real estate, tenant-in-common programs, or TICs, offer fractional ownership of large properties and are primarily aimed at people who have recently sold other commercial property and seek to defer capital gains taxes. Under Section 1031 of the federal tax code, such taxes can be deferred if the property being sold is exchanged for one of the same value. But the seller has to find a new property within 45 days and complete the exchange within 135 days after that — a deadline that sponsors say is often hard to meet, particularly in a hot real estate market.

In 2001, there were $165-million worth of real estate deals involving tenant-in-common equity, but this year the volume is expected to approach $2 billion, according to Omni Brokerage Inc., of Salt Lake City, which tracks tenant-in-common properties sold as securities. The number of companies sponsoring such programs grew from nine to more than three dozen during the same period, said W. Rob Hannah III, the president and chief executive of TSG Real Estate of Chicago and the vice chairman of the Tenant-in-Common Association, a two-year-old trade group.

The explosive growth of tenant-in-common investments, which are sold through financial advisers, has attracted the attention of NASD, the securities industry regulatory body, which is looking into how these programs are organized and marketed. "Any time we see that kind of stunning growth in product sales," said Mary L. Schapiro, the vice chairman of NASD, "you have to be concerned about how it is being sold."

Unlike real estate investment trusts, which sell shares in portfolios of properties, sponsors of tenants-in-common investments sell interests in individual properties. The concept of tenancy-in-common as a way that two or more people can buy real estate together, with each having an undivided interest in the property, goes back to English common law. But it was only in 1994 that tenant-in-common properties were used as an investment vehicle for people who do not know each other.

Credit for this innovation is given to William O. Passo, the chief executive of Passco Real Estate Enterprises, in Irvine, Calif. Last year, in the biggest tenant-in-common deal so far, Passco bought the Puente Hills Mall, in City of Industry, Calif., for $143 million. More recent deals involving TICs include St. Louis Place, a 20-story office building in St. Louis, bought by Behringer Harvard Funds, of Addison, Texas, for $30.2 million; and Indigo Creek, a 408-unit apartment building in Glendale, Ariz., bought by Evergreen Development, of Santa Ana, Calif., for $34.6 million.

Although tenant-in-common deals have been around for a decade, their current popularity can be traced to a 2002 document issued by the Internal Revenue Service, which spelled out some conditions that had to be met before the investments could qualify for a so-called 1031 exchange, said William Winn, the chief operating officer of Passco. "That legitimized the industry in the real estate world," he said. Until then, he said, "some sophisticated real estate people were sitting on the fence," not knowing whether the investments would pass muster with the tax agency.

To qualify, the investment must have certain characteristics that differentiate it from a partnership: each investor must have the same ownership rights; no single owner or group of owners may have more control than any of the other investors; all major decisions have to be made by unanimous vote; investors must have the right to sell their interest but may have to offer it to the other investors first; and no more than 35 investors can participate.

Sponsors say that tenant-in-common investments appeal to sellers of small buildings — an apartment house, say, or a CVS drugstore — who may be nearing retirement age and no longer want the burden of managing a

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property. When TICs were first offered, Hannah of TSG Real Estate said, a minimum investment could be as little as $100,000. "Now the norm is $500,000 up to $5 million or $10 million," he said. Passco, for example, is about to complete its $100-million purchase of the Village at Orange, a shopping mall in Orange County, Calif., with $42 million of the equity from tenant-in-common investments, Winn said. The minimum investment was $1.6 million, he said.

Increasingly, tenant-in-common investments are drawing people who do not need a tax deferment but simply want to diversify their holdings, said Anthony W. Thompson, the chief executive and chairman of Triple Net Properties, which owns and manages 102 buildings. Of these, 65, valued at about $1 billion, were bought through tenant-in-common programs, Thompson said.

But there is a steep price for owning part of a high-grade office building or shopping center. Brokerage fees combined with the profit and transaction costs of the sponsors can total as much as 25 percent of the equity invested, Hannah said. Some sponsors are making a profit of 15 percent to 20 percent by buying a property and then selling it to tenant-in-common investors, said Dean Macfarlan, the chief executive of Macfarlan Real Estate Investment Management, a company in Dallas that has arranged more than $60 million in tenant-in-common investments. The sponsor's profit should not exceed 7 percent, he said.

Given these fees, investors need to calculate whether they are better off paying the capital gains taxes rather than buying a tenant-in-common interest, said Michael G. Frankel, the national director of real estate tax services for Ernst & Young. They also need to have their own adviser and not merely rely on the word of a broker, he said.

Another concern in the tenant-in-common industry, brokers and sponsors say, is that some of these investments are being sold as real estate transactions rather than as securities. Sponsors who do not register tenant-in-common investments could be putting themselves and their investors at risk, said David B. Bayless, a partner at the law firm of Morrison & Foerster, in San Francisco, and a former official with the Securities and Exchange Commission. "It's pretty clear," he said, "that these 1031 TIC exchanges are almost always securities."

Registering as a security requires sponsors to supply investors with thick documents with many disclosures, including how they keep records, how they are compensated, whether conflicts of interest exist. Such private-placement securities may be sold only to investors with a net worth of $1 million or an annual income of $200,000.

Cary Losson, the president of 1031 Exchange Options, a consulting company in Walnut Creek, Calif., said it was "terribly reckless" for sponsors to sell tenant-in-common interests as real estate. "They don't have to provide nearly the level of due diligence," he said.

Based in Boise, Idaho, 1031 LLC is one company that sells tenant-in-common investments as real estate. Pete Johnson, the vice president of marketing, said his investors get the same information his company executives see, including rent rolls, environmental reports, and loan documents. "We encourage them to visit every property," he said. "We want them to kick the tires." The company, founded in August 2003, invests mainly in office properties valued at $2 million to $20 million, Johnson said.

Macfarlan said investors need to ask a lot of questions before they buy tenant-in-common interests to make sure, among other things, that the building is not overpriced and that it has a stable base of tenants. "Whenever you have an asset class that is gaining as much interest as this one," he said, "there are always going to be a lot of Johnnies-come-lately who begin to flood the marketplace with poor investments. Some people will get hurt."