The TIC Industry Enters The Mainstream

The tenant-in-common structure has become a $3.7 billion per year business.

William Winn

The coming year brings high expectations of the tenant-in-common 1031 exchange (TIC) industry as it enters its 11th year. Across the board, the confidence of investors is rising, the volume of investments from existing investors is rising, and the entrance of new sponsors continues to grow. From the end of 2001 to the end of last year, the total deal volume for TIC 1031 exchanges blossomed from a mere $150 million to a robust $3.7 billion, according to Real Capital Analytics, a New York-based analytics firm and Omni Brokerage, a Salt Lake City-based broker dealer. Our own company, Passco Real Estate Enterprises, expects to acquire $600 million in assets in 2005, nearly twice the volume of the previous year.

These bright expectations are not entirely unclouded, however. The phenomenal growth of the TIC 1031 exchange industry has led to a boom mentality, with many new sponsors hurrying to create TIC investment vehicles.

From a historical perspective, the tenants-in-common 1031 tax exchange is based upon IRS code section 1031 that has existed for decades: the ability of investors to invest the sales proceeds of investment real estate into a new property, while deferring capital gains taxes. It is the strategy of choice to defer capital gains tax that would ordinarily arise from the sale of real estate. A successful exchange results in the taxpayer utilizing 100 percent of the proceeds from the sale of the property to purchase a new property. Real estate owners can accomplish virtually any investment objective with 1031 exchanges, including greater leverage, diversification, improved cash flow, geographic relocation, and/or property consolidation.

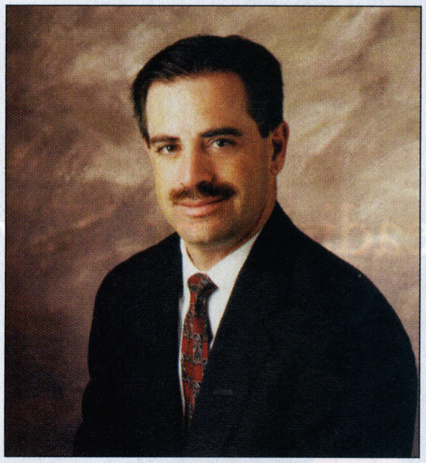
Passco arranged a TIC structure to purchase The Village at Orange, a regional shopping center in Orange, California, in October 2004.

As pioneered in 1994 by William O. Passo, the founder of Passco Real Estate Enterprises, the tenants-in-common 1031 exchange allows a group of investors to pool their equity from the sale of their investment real estate into a single property or asset, allowing them to buy a property jointly that they otherwise would not have been able to do alone.

Passco and other leading sponsors of TIC 1031 exchanges structure the investments as securities, rather than as a pure real estate transaction. TIC securities are regulated by the U.S. Securities and Exchange Commission (SEC), and the broker dealer that sponsors the offering must be licensed dealers approved by the National Association of Securities Dealers (NASD). Among other requirements, sponsors of TIC securities must issue a disclosure document, known as a Regulation D private placement memorandum, outlining the investment and its risk factors.

Some TIC sponsors choose to structure TIC investments as real estate transactions, rather than as securities. Among other things, that means that the investment sponsor is not regulated by the SEC and NASD, and that means a lower level of disclosure of the risks and less due diligence by those involved in selling the investments. Additionally, conflict of interest questions can arise because the broker representing the investor is not required to disclose risk factors or possible negatives outcomes of an investment. This is not to say that real estate TIC 1031 transaction cannot be structured in a way that minimizes the disclosure risks, only that there are no regulations requiring a sponsor to do so. A national trade group, the Tenant-in-Common Association (TICA), is in the process of providing clarity to the industry on appropriate structures that should meet the requirements of both the securities and real estate regulatory agencies.

In the 1990s, TIC sponsors were offering smaller assets of under $30 million in acquisition price, and limiting the number of TICs to no more than 15 in each transaction. With each investor contributing about $200,000 to $500,000 in equity to any given investment offering, and the number of the investors capped by lenders, the acquisition purchase prices were typically in the $7 million to $30 million range. Industry marketing tended to be more



Bill Winn, president, Passco Enterprises.

difficult and mostly by word of mouth, as investment sponsors slowly educated securities broker dealers about the opportunities of TIC 1031 exchanges that could be offered to their client investors.

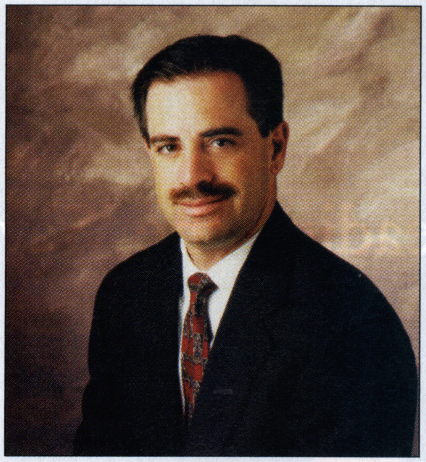
Revenue Procedure 2002-22 issued by the IRS in February 2002, significantly expanded the market by legitimizing the investment vehicle for many investors who were on the fence, and allowing up to 35 investors to participate in a tenants-in-common exchange, thus making it possible to buy larger and more expensive properties than before. Once the procedure was issued, many lenders increased the allowable number of investors per transaction from 15 to 20 to the 35 allowed for in the Revenue Procedure. After 2002-22, the TIC 1031 exchange industry has grown exponentially. Nowadays it is common to hear of TICs buying institutional-grade assets priced up to $100 million and higher. Last spring, Passco set an industry record by purchasing a $148 million asset, Puente Hills Mall, in Los Angeles County, in a tenant-in-common structure. That historical transaction marked the first of its kind, in that it was the largest tenants-in-common securitized loan transaction with more than 30 co-owners.

By carefully selecting assets with regard to cost per square foot, capitalization rates, location, class of the asset, strength of the cash flow and value added opportunities, some sponsors have been able to achieve substantial returns for their investors. In our experience, returns have ranged from 11 percent to 30 percent per year for a 3- to 7-year hold period depending on property type and risk profile. Rather than take profits, however, many investors are content to continue "rolling over" their proceeds into other TIC 1031 exchange offerings. Investors most often prefer to stay with a reliable and trustworthy sponsor.

The TIC industry is casting its net wider by acquiring a broader range of real estate assets, such as CBD Class A multi-tenant office buildings; single-tenant and multi-tenant industrial/flex centers; and multifamily apartments in excess of 500 units each. In recent years, TIC sponsors have been acquiring institutional quality assets, and as a result, compete with institutional buyers such as life insurance companies, pension funds and real estate investment trusts (REITs).

In the future, the TIC industry believes the IRS will issue additional guidelines and rulings, providing greater clarification, a higher level of acceptance and additional comfort to investors. The expectation is that the TIC 1031 exchange industry will continue to grow rapidly, and become as well known to investors as more common real estate investment vehicles such as REITs. While we are concerned about the possibility of a "bad apple" or a new and inexperienced sponsor tainting the reputation of our industry, even a conservative estimate sees big things — and big acquisition volumes — ahead for the industry. The most rewarding aspect of our business is extending to medium and small investors, the opportunity to invest in institutional quality assets and to help them achieve their real estate investment goals. **SCB**

William Winn is president of Irvine, California-based Passco Real Estate Enterprises, Inc.



Bill Winn, president, Passco Enterprises.

difficult and mostly by word of mouth, as investment sponsors slowly educated securities broker dealers about the opportunities of TIC 1031 exchanges that could be offered to their client investors.

Revenue Procedure 2002-22 issued by the IRS in February 2002, significantly expanded the market by legitimizing the investment vehicle for many investors who were on the fence, and allowing up to 35 investors to participate in a tenants-in-common exchange, thus making it possible to buy larger and more expensive properties than before. Once the procedure was issued, many lenders increased the allowable number of investors per transaction from 15 to 20 to the 35 allowed for in the Revenue Procedure. After 2002-22, the TIC 1031 exchange industry has grown exponentially. Nowadays it is common to hear of TICs buying institutional-grade assets priced up to $100 million and higher. Last spring, Passco set an industry record by purchasing a $148 million asset, Puente Hills Mall, in Los Angeles County, in a tenant-in-common structure. That historical transaction marked the first of its kind, in that it was the largest tenants-in-common securitized loan transaction with more than 30 co-owners.

By carefully selecting assets with regard to cost per square foot, capitalization rates, location, class of the asset, strength of the cash flow and value added opportunities, some sponsors have been able to achieve substantial returns for their investors. In our experience, returns have ranged from 11 percent to 30 percent per year for a 3- to 7-year hold period depending on property type and risk profile. Rather than take profits, however, many investors are content to continue "rolling over" their proceeds into other TIC 1031 exchange offerings. Investors most often prefer to stay with a reliable and trustworthy sponsor.

The TIC industry is casting its net wider by acquiring a broader range of real estate assets, such as CBD Class A multi-tenant office buildings; single-tenant and multi-tenant industrial/flex centers; and multifamily apartments in excess of 500 units each. In recent years, TIC sponsors have been acquiring institutional quality assets, and as a result, compete with institutional buyers such as life insurance companies, pension funds and real estate investment trusts (REITs).

In the future, the TIC industry believes the IRS will issue additional guidelines and rulings, providing greater clarification, a higher level of acceptance and additional comfort to investors. The expectation is that the TIC 1031 exchange industry will continue to grow rapidly, and become as well known to investors as more common real estate investment vehicles such as REITs. While we are concerned about the possibility of a "bad apple" or a new and inexperienced sponsor tainting the reputation of our industry, even a conservative estimate sees big things — and big acquisition volumes — ahead for the industry. The most rewarding aspect of our business is extending to medium and small investors, the opportunity to invest in institutional quality assets and to help them achieve their real estate investment goals. **SCB**

William Winn is president of Irvine, California-based Passco Real Estate Enterprises, Inc.