

## **1031 and TICs - Choosing Quality Pays Off** **by Don Meredith**

You have finally sold your property, now what? How can you get the best bang with your 1031 exchange funds in this economy? No matter if you have \$250,000 or \$5,000,000, you can own part of a fully managed institutional class property, better known as a TIC or tenant-in-common. TICs offer rewarding cash flow and no management on your part. That is a great combination, but the economy has been rocked and the housing market has been down for the count. So how have those investors fared who did a 1031 exchange into the now seven-year old securitized tenant-in-common industry? I checked in with some of the big five real estate TIC providers who get the bulk of my investors' 1031 business and here's the bottom line as I see it.

### **Returns Worthy a Cover Story**

Jeff Hanson, president and chief investment officer of Grubb & Ellis Realty Investors, said this, "Despite the constant negative press on the economy, commercial real estate fundamentals are extremely favorable. For example, if you take each of the five major assets classes (general office, medical office, retail, industrial, and multifamily) and look at the weighted average occupancy on a national basis, four of the five are in excess of 91 percent occupied. The fifth, general office, is still at a healthy level of 86 percent. Additionally, due to the exponential increase in raw materials and construction costs over the past few years, the development pipelines in each of the five asset sectors are very thin in most major markets, significantly reducing the risk of over-building."

Keith Lampi from mega giant Inland Real Estate of Chicago says, "Institutional grade property with national tenants do very well in a challenging economy, and are in balance with demand. We are seeing foreign investors, German pension funds, etc., coming heavily into the US institutional property market. We are basically back to core demographics and core fundamentals. Our primary market has been retail malls."

Tod Williams, a vice president for Argus Real Estate, put it this way, "Just look at the five-year trend graph of the S&P 500 versus the TIC industry performance. If you had a stock or a managed fund and turned in the kind of performance that TICs have in this economy you would be on the cover of *Time Magazine* and the *Wall Street Journal!*"

Another indication of how solid the strategy of owning institutional property is - consider that the largest American top performing endowment funds, such as Harvard and Yale, are largely invested in institutional real estate. Are TICs perfect? No, but my observation has been when a tenant vacates or the property has a problem, they have been impressive over all as to how quickly they have remedied the issue. This prompt action is just what you would expect for institutional grade property management.

### **What About Those Fees?**

A few financial planners may try to make the case that the fees on a TIC property could hamper the investor; but they have a very difficult time explaining the success year after year of this industry and the ensuing appreciation that occurs with many properties that have gone full cycle.

Institutional property is of a completely different scale than most planners have any real experience in. The big five TIC companies have demonstrated repeatedly that they have the investors in mind when they make a purchase and take into account the cap rates and all the fees involved in bringing the property to market. The TIC industry is a highly specialized field and few financial planners have any depth with real estate let alone TIC real estate. The big five TIC companies can leverage financing and have tremendous purchasing power.

Jeff Hanson of Grubb & Ellis Realty Investors explains, “We have over 6.3 billion dollars in our portfolio. Only five TIC sponsors raised over \$20 million in the second quarter of 2008. Any fees on a TIC property are offset by intensive management. We are very deep in that area. We have co-ownership involving almost constant communication with investors, 20-30 for the average property.

The economies of scale far outweigh the fees that are paid. With a 6.3 billion dollar portfolio, debt is just one type of savings for the investor, insurance is another. An investor can save probably 35 percent on insurance alone on a national portfolio. Escrow fees and other fees also deliver scale economies. Forty-two percent of acquisitions were sourced off market last year. Beware of a planner who suggests cashing out of 1031 exchange position using the fees on a TIC as a basis for the move. This is a very costly strategy when federal and state taxes are considered, let alone when recapture is factored in. Your financial planner may be suggesting cashing out only as a means to obtain access to your funds. Often this strategy boils down to the fact that the planner is competing for your dollars. Remember, many of these same folks just watched your stock and fund accounts decrease by 30 percent in 2007 and 2008. In contrast, the TIC has been an enormously successful and resilient option for investors. These fees are there for a reason. They have demonstrated tremendous value for the investor.

### **Waiting to Sell Could Cost You Money**

Several sources including the Fed “beige book” have made comments regarding the apparent strength of institutional and commercial real estate in the face of a cooling housing market. On July 10, 2006, the *Wall Street Journal* ran an article by Jennifer S. Forsyth entitled “Commercial Real Estate Maintains Its Strength.” It said despite a cooling housing market, the over-building and over-supply has happened only in the residential market and not in the commercial market. If we assume this means residential property will stay flat for another three years, there may be little benefit in holding on to a property you would really like to sell.

Conversely, because the commercial market is in balance we can probably assume it will continue to appreciate at three percent per year. If we take a typical TIC commercial property that is 50 percent leveraged, a three percent appreciation on the property would be a six percent appreciation on equity. For \$700,000 in equity, that’s \$42,000 per year. Waiting to sell could actually cost you money.

Thanks to a TIC investment option, you could sell your income-producing property at a less-than-peak selling price, complete a 1031 exchange, and still potentially make more money than if you waited for the market to turn around. A 1031 exchange into a co-owned TIC property offers the investor a thoroughly researched turnkey option together with critical financing already in place. The bigger the TIC company, the grander the scope, the bigger the footprint.

A few notables, Tufts New England Medical Center, the Mayo Clinic, Emerald Plaza in San Diego -- all TICs. It comes down to an option with a strategy in place versus often just guessing. Some might talk about the fees associated with a TIC; however, if you buy on your own you will have fees too. You have a real estate commission, appraisal fees, financing expenses, environmental costs, title work, closing fees, etc. The economies of scale on an institutional class TIC actually takes care of most additional fees and absorbs them quite efficiently. You are able to buy in an appreciating area regardless of where you live, and not worry about management. It is completely turnkey.

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