An Exit Strategy That Defers Tax Liability
Using the 1031 Exchange and TIC Investments in a Recessionary Market
by Anne Baber, Investment Real Estate Broker

Pigs get fed, hogs get slaughtered……..and so it goes on Wall Street.

A Truncated Version of Events
The perfect financial storm of 2008 was primed in 2007 by an avalanche of subprime home buyers unable to make good on their mortgage payments resulting in a national record number of foreclosures. Some of the elements that fed the crisis were a rapidly changing financial system and the innovation of new types of mortgage backed securities, an eroding sense of responsibility in the lending process by both lenders and borrowers, the explosive growth and commodity demands of China and other foreign markets, lax oversight of Fannie, Freddie and Wall Street by policymakers, incorrect ratings of securities, and the greed of Wall Street investors and entrepreneurs who could borrow cheap money and leverage their returns. No one was in control. This brought about a collapse of confidence in the world banks, mounting losses in the stock market (now at an eleven year low on 2/24/09) and ravaged the US economy and global financial markets. The resulting loss of jobs and continuing declines in the GDP has thrown the United States into a "nasty recession".

While events are still unfolding, many economists expect a national recession that will last throughout 2009 with an anemic recovery to begin in 2010. If the recession continues as expected and the job loss continues, the unemployment rate could reach the 1990-91 levels of nearly 10%.

The Southern California Economy
The UCLA Anderson Forecast's outlook for California calls for a very weak first three quarters of 2009, with a glimmer of recovery in the fourth quarter. They state that a key to look for will be a recovery in the rest of the country and in Asia, which will create demand for California goods and services.

We are probably going to have a "muddle through economy" over the next several years. The down economy has been fueled by the bursting of two bubbles: the housing bubble and the credit crisis. Also, it is going to take some time to work through the huge national inventory of foreclosed and overbuilt homes not to mention the considerable inventory in Southern California. We are probably talking 2011 or beyond before we finally work through this housing crisis and get back to a normal market where housing contributes significantly to GDP growth.

The Southern California Multi-Family Market
The multi-family continues to soften. This market erosion is evidenced by the continuing decline in number of transactions and the dollar volume of same. Cap rates are increasing along with cash flow.

Interestingly, while the overall real estate market has continued to decline, unlike the single family market (one to four units), there have been relatively few foreclosures in the multi-family arena. As our property values increased over the last several years, the buyer's down payments also increased per the lender's requirements. A down payment of 35% to 45% or more has been the norm. Therefore, since the property owners purchased their buildings in a cash flow position and have a vested interest (money) in the property, we see very few foreclosures.

TIC Investments and the Recession
While no sector of the Real Estate industry is recession proof, the TIC segment (under SEC regulations) appears to be weathering the storm better than expected. This is due in part to the historically low loan to value ratio (LTV) of 60%-70%, the transparent/comprehensive due diligence performed by both Sponsors and Lenders prior to purchase, experienced professional management, and the institutional quality of the properties. However, some asset types are fairing better than others - i.e., multifamily properties.

The multi-family sector has been far more resilient and in far better shape in terms of fundamentals than any other asset type - particularly office and retail and even industrial. The financing options are more favorable for multi-family properties than most other sectors in commercial real estate. That is because the industry is buoyed by Fannie Mae and Freddie Mac, which provide liquidity to the housing market. The apartment sector has always been viewed by lenders as having less risk than commercial retail or office properties.

While overall the multi-family TICs are performing well, in certain areas, the cash flow distribution of some of the TIC properties has decreased due to higher vacancy rates. This is being seen especially in areas that have sustained high foreclosure rates, such as the California's central valley, Las Vegas and Miami to name a few. In these areas, the multi-family market is facing the short term challenge of absorbing excess "shadow rentals" which is a phrase applied to foreclosed homes available for rent. Upon foreclosure, single family homes enter rental markets with comparable rents (or lower) to multi-family units. Thus, there are more tenants, less demand and higher vacancy rates. Also, many sponsors are setting aside some of the cash proceeds as reserves into a Rainy Day Fund. This seems to be a prudent response to better manage adverse and unforeseen market conditions (the State of California could take a lesson).

While there are fewer TIC offerings on market than in past years, they are perhaps more attractive with respect to their financials; higher CAP rates and cash flow. Also, because of the current lending environment, the properties are scrutinized closer than in previous years and the underwriting requirements have tightened. In addition, the LTV ratios are lower than previous years at a ratio of 50%-60%.

Using the 1031 Exchange and TICs as a Retirement Vehicle
The good news is that while the market has turned downward, historically, the multi-family market values are still relatively high while interest rates are relatively low. And

yes, there is financing available for multi-family properties. The process takes longer and the buyers must have good credit and financial strength. If you are looking towards retirement, it is still an excellent time to sell, take advantage of the 1031 Exchange into Tenant in Common Investments and position yourself for the next up-leg of the real estate cycle.

While the real estate market is cyclical, we are not in lockstep nationally and market fluctuations give us opportunities in various geographical areas that are better poised for growth. Some areas that have held will with respect to multi-family are Dallas, Austin, San Antonio, Colorado and the Carolinas to name a few.

Many economist and lenders believe that multifamily is well positioned for an early recovery ahead of other real estate categories. A significant portion of US households will return to multi-family housing as renters due to stricter mortgage loan requirements and the decreasing availability of consumer mortgage financing. In addition, increasing demand for rental housing will come from the 5,000,000 "echo boomers" entering the largest demographic of 18-24 year-olds in the US history. Another factor is that newly built apartment supply has dropped to an annual rate of less than 1% of existing inventory between 2005 and 2007 and will probably remain at the same rate for the next several years. All of these factors imply that select segments of the US multi-family market are poised to capitalize on surging demand combined with an aging supply of inventory. The U.S. multi-family properties will be dramatically more valuable in 2014 than 2009!

Advantages of Tenant in Common (TIC) Ownership

- Flexible size to match your needs
- Pre-arranged financing
- No management hassles
- Potential increased after tax cash flow
- Economics of scale
- Can be identified and closed in a timely manner
- Investment can be diversified into more than one property and/or location

As a tenant in common, one can reduce management responsibility, defer capital gains taxes, increase both cash flow and tax deductions, increase appreciation potential, have more safeguards with triple net, high-credit tenants and maintain direct ownership. The option of partial ownership gives buyers the opportunity to diversify their real estate holdings by purchasing TIC interests in multiple properties and various geographical locations. A TIC can get you more while you do less. Accordingly, this arrangement can solve several problems for owners looking to make their lives less complicated.

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Free Capital Gains Tax Planning

Seminar & Deli Luncheon
Hosted by Anne Baber of AOA Commercial Brokerage
(Principals only please; no real estate agents)

You Will Discover:

- How to Use the 1031 as a Retirement Vehicle
- A Proven Safety Net Mechanism for 1031 Exchanges
- The Intricacies of How IRS Code Section 1031 Works
- The Advantages of Tenant-In-Common (TIC) Investments
- An Easy Way to Get More Income While Doing Less Management

CALL TODAY AND RESERVE A SEAT!

- **Pasadena: Tuesday, April 21**
- **Long Beach: Thursday, April 23**
- **Culver City: Thursday, April 30**
- **Van Nuys: Thursday, May 7th**
- **Torrance: Tuesday, May 12**
- **Ontario: Thursday, May 14**
- **Santa Ana: Thursday, May 21**

Seminars will be held from 12:00 p.m. to 2:00 p.m. Registration will begin at 11:30 a.m. Seating is limited! For reservations and further information, please call Caelume Essence at AOA Commercial Brokerage (818) 235-1127 or register online at www.discoversuccess.com