

**Using Exit Strategies in a Recessionary Market:  
Defer Taxes with 1031's and TIC Investments  
By Anne Baber, Investment Real Estate Broker**

***“Most bad government has grown out of too much government.”...Thomas Jefferson***

And too much government indeed! The huge stimulus packages that were rammed through Congress in the final year of the Bush presidency (\$700 billion TARP package), and by the Obama administration in February of 2009 (\$787 billion stimulus package) have created an unprecedented, expensive government ownership interest in many institutions. In addition, the enormous amount of debt placed on the backs of taxpayers will burden several future generations. And do I need to mention the proposed health care bill consisting of one thousand plus pages that the majority of congress members have not even read?

Most of the banks and financial institutions that received TARP funds have paid the funds back including interest. “What was supposed to be an emergency capital injection to thaw frozen credit markets has morphed into a revolving bailout fund” (Rep. Jen Hensarling, R-Texas). If not returned to the taxpayers, at the very least, these funds should be used to promote job growth in the private sector, not to grow government and/or save government jobs. The country needs significant, sustainable job growth in the private sector before we can achieve real recovery.

On a brighter note, housing is a leading indicator relative to economic activity and there are three market fundamentals that turned positive in 2009 which could be good indicators in 2010. First, home prices have fallen lower than replacement costs in many areas. This means that a home can be purchased for less than the cost to build it. What a deal for the buyer! Second, relative to rents, home prices (coupled with very low interest rates) are a lot more attractive than they have been in many years and third the inventory of homes for sale in some areas has dropped. All of the foregoing suggests that some markets have stabilized.

**The Southern California Economy**

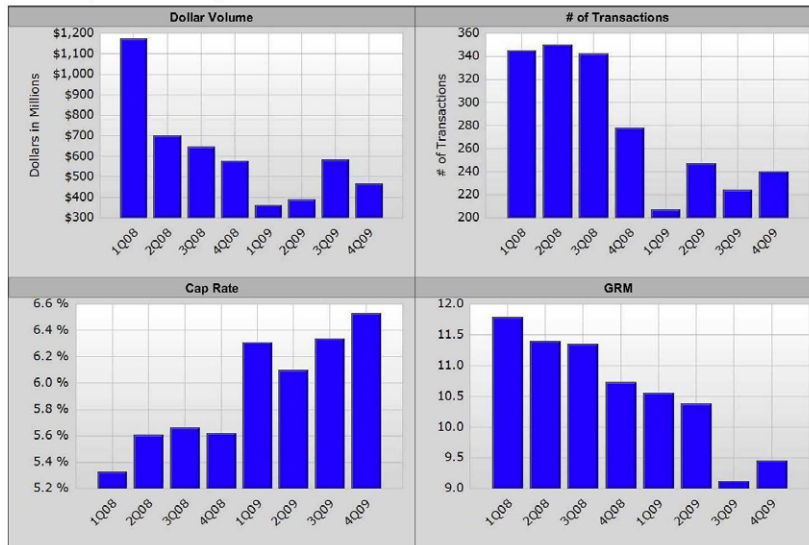
While the national unemployment rate fell from 10 to 9.7 percent in December, the rates in most regions of California are much higher. In the costal counties, unemployment is typically 10 to 11 percent and not exceeding 13 percent. However, in the Central California counties, unemployment exceeds 13 percent and is often as high as 15 to 16 percent. Los Angeles County did not fare much better having risen to a rate of 12 percent in December 2009.

The UCLA Anderson Forecast’s outlook for California calls for “slight” growth in 2010 and no new jobs generated which are needed before more normal growth rates return in 2011. Further, the Forecast states that “though the economy will be growing in 2011, it will not be generating enough jobs to drive the unemployment rate below double digits until 2012.

## The Southern California Multi-Family Market

The multi-family continues to soften. This market erosion is evidenced by the continuing decline in the number of transactions and the dollar volume of same. Cap rates are increasing and the gross rent multipliers (GRM) are decreasing (see chart below). Buyers are demanding a return on their investment, i.e. cash flow, as it appears that values are still declining in this market. Note that the fourth quarter of 2009 reflects an average Cap rate of 6.5%, a GRM of just under 9.5.

Trend Report; LA County; 5+ Units



Source: CoStar, Inc.  
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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., multi-family 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 well with respect to multi-family are Dallas, Austin, San Antonio, Colorado and the Mid-Atlantic region to name a few.

Many economist and lenders believe that multi-family 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 2010!

### **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.

*Anne Baber is a real estate broker with the Apartment Owners Association, Commercial Brokerage Division and has over 20 years experience in apartment house brokerage. She can be reached at (818) 235-1135 or [anne@aoausa.com](mailto:anne@aoausa.com).*

### **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

#### ***Seminar Dates:***

*(Principals only please; no real estate agents)*

- **Long Beach: Tuesday, April 20th**
- **Pasadena: Thursday, May 6th**
- **Van Nuys: Thursday, May 13th**
- **Culver City: Thursday, May 18th**
- **Torrance: Tuesday, June 1st**

- **Santa Ana: Thursday, June 3rd**

**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 at AOA Commercial Brokerage (818) 235-1127 or register online at [www.discoverysuccess.com](http://www.discoverysuccess.com).

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