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TIC Shakeout Accelerates

The tenant-in-common industry is facing a painful contraction marked by a sharp decline in deal flow and a dwindling pool of sponsors. TIC transaction volume has slowed considerably in the wake of the economic and financial crisis that has made accessing both debt and equity sources extremely difficult.

Even sponsors that are successful in securing financing to buy quality properties are stymied because far fewer TIC investors are willing to commit to new deals, a stark contrast from two years ago.

The TIC industry is fueled predominantly by investors who are pursuing replacement properties as part of a tax-deferred exchange under Section 1031 of the Internal Revenue Code. The investment vehicle enables investors to own a fractional interest in institutional-quality real estate while deferring capital gains by exchanging one property for another.

But activity in this investment niche of commercial real estate has stalled. Many property owners have opted to hold onto their real estate assets in a volatile economy. Others are opting to pay the taxes on what capital gains—if any—they are able to realize in a sale.

The TIC industry raised nearly \$1.4 billion in equity last year—half the \$2.8 billion raised in 2007 and less than 40% of the \$3.7 billion raised in 2006, according to data from Omni Consulting & Research in Salt Lake City. Omni tracks data from sponsors that structure TICs as securities. Fourth-quarter numbers saw the biggest drop with just \$256 million in new equity raised—about 25% of the quarterly volume the industry was generating in its heyday in 2006.

“The paralysis in the capital markets has caused the decline in transaction volume in the TIC industry as it has throughout the commercial real estate industry,” says Patricia DelRosso, president of Inland Real Estate Exchange (IREX), a TIC sponsor based in Oak Brook, Ill. “Once credit starts to flow again, it will have a direct impact on boosting TIC activity.”

When the capital markets will recover and what the shape of recovery will look like is anyone’s guess. In the meantime, the drop in deal flow has caused some sponsors to exit the business, while the remaining firms are focused on survival in what many anticipate will be another rough year. “I would venture to say that in 2009 the equity raise could be as low as \$500 million if things don’t change,” says Greg Paul, CEO of Omni Brokerage, a broker-dealer firm that specializes in TIC sales.

Survival of the fittest

The field of TIC sponsors has already narrowed considerably. Among firms that sell TICs as securities, 50 sponsors reportedly raised at least \$1

million in investor equity in 2008 compared with 63 sponsors who had raised at least that amount the previous year, according to Omni.

At the end of January, there were 63 available TIC properties issued by 37 sponsors. “Going forward in 2009, I expect that there won’t be more than 15 to 20 sponsors that will put a deal on the street,” Paul says.

The TIC industry has traditionally been split into two sectors. On one side are sponsors that sell TICs as securities, and subsequently follow Securities and Exchange Commission (SEC) rules for the marketing and sale of those securities. On the other side are those sponsors that follow a traditional real estate model in which they package and sell TICs as fractional ownership.

Real estate-based TICs have been able to avoid SEC oversight, thereby giving them greater flexibility in marketing real estate to potential investors. But the future of real estate-based sponsors is now in doubt.

The SEC recently issued a letter that effectively reinforced its opinion that TICs are securities. That letter is giving many real estate sponsors pause because continuing to sell TICs under the real estate model could leave them vulnerable to legal action for not following SEC rules and regulations.

That letter, coupled with lawsuits filed against Idaho-based sponsor DBSI Inc. and its entities for alleged securities fraud among other charges, will likely force real estate sponsors to curb their activity—at least in the short term.

“You’re going to see a lot of consolidation at many levels in terms of who is syndicating new equity, who remains in business, and who is still maintaining the asset management function over the portfolio of assets they currently have,” says Jeff Hanson, president and chief investment officer of Grubb & Ellis Realty Investors in Santa Ana, Calif. Grubb & Ellis is one of the top TIC sponsors in the industry. The firm raised \$181 million in equity in 2008.

TIC sponsors will face a tough road just to survive in 2009. “Those sponsors that have the staying power are going to take whatever steps they feel are necessary to ride out the downturn in the market,” says Robert Johnson, president of St. Paul-based AEI Fund Management.

“It looks like it could be a three- to five-year situation with the national economy, and sponsors are going to do what they can so they will be around in the future,” adds Johnson.

One factor that bodes well for the staying power of the TIC industry is that a number of sponsors are not dependent on TIC sales. AEI, for example,

is a net-lease investment fund manager with about \$500 million in net-lease properties under management.

AEI offers TIC deals as an exit strategy for properties it is selling from its portfolio of net-lease real estate. The firm has completed some 82 TIC transactions valued at \$215.8 million since 1992.

A short list of sponsors will dominate transaction volume in the coming months. The top 10 most active securities-based sponsors in 2008 were responsible for raising nearly \$884 million—65% of the equity that was placed.

That figure is up from 56% in 2007, according to Omni. The disparity is likely to widen even more in 2009 as the big firms take advantage of the loss of key competitors such as DBSI.

DBSI had been one of the industry giants until its business model began to unravel in late 2008. The sponsor reportedly raised about \$120 million in equity in 2007. The firm filed for bankruptcy protection in November and is facing civil lawsuits from investors, as well as the state of Idaho.

However, TIC industry observers emphasize that the woes of DBSI stem from a unique situation due to the company's master lease structure, and not an indication of problems with the TIC structure itself.

"What is going to differentiate those who survive and continue to thrive and those who do not is their fundamental business model," says Hanson.

Sponsors need to have other services or business units to fall back on, and they need to have a top-notch asset and property management program to keep properties performing amid challenging market conditions, he adds.

Grubb & Ellis, for example, has a number of other business lines to draw from—including its involvement in the publicly registered, non-traded REIT sector where it is currently raising an average of about \$3 million per business day for its healthcare and multifamily REITs.

The Tenant-in-Common Association (TICA) plans to diversify its member base to survive the downturn. The organization says that it will widen its focus to include the broader real estate investment securities sector, including publicly registered, non-traded REITs and funds. Targeting low-risk deals

TIC sponsors are focused on deals that are attractive to wary investors. For the most part, that means focusing on Class-A real estate in major metros. "There is a lot of trepidation in the minds of investors today, and absolutely they are opting toward more conservative investment strategies," Hanson says.

As an example, Grubb & Ellis recently closed on a 109,000 sq. ft. industrial building in Costa Mesa, Calif. Federal Express occupies the building on a 10-year net lease basis, and the property is generating an annual return of 6.5%.

The deal was attractive to investors because of the lengthy lease term, the strong creditworthiness of the tenant, and a favorable location near the John Wayne Airport. "Many investors are less concerned with yield and more concerned with preservation of principal," Hanson says.

Inland Real Estate Exchange hopes its new strategy of targeting apartment properties will help the firm boost market share in 2009. The firm successfully raised nearly \$180 million in 2008, and has a goal of \$300 million in 2009 as the pool of competing sponsors shrinks.

"It appears that the tenant-in-common investor definitely has an appetite for apartments," DelRosso says. "We think it's a good time to buy apartments. With economic conditions the way they are, we expect occupancies to go up."

A rise in capitalization rates, the initial returns for investors based on the purchase price, may help to spark investor interest in TICs. Depending on the tenant credit and location, cap rates range from 7.25% to 8.5%. Once fees are factored into the mix, investor returns today range from 7% to 8%, about 50 to 100 basis points higher than two years ago when premium property pricing kept yields low. "Those are attractive returns in this market," DelRosso says.

Many TIC sponsors, along with individual TIC property owners, are preparing for major operational challenges in the coming year related to refinancing and tenant retention issues. What that means for TIC owners is that there will be a greater risk of capital calls, lower yields or suspended yields as cash flow disappears.

Real estate owners with maturing debt face major hurdles in the refinancing arena due to the severely constrained capital markets. Traditionally, the majority of TICs were financed with commercial mortgage-backed securities (CMBS)—a capital source that is virtually non-existent today.

"There will be a significant number of CMBS loans coming due in 2009, and the ability to refinance those loans will be a big challenge," says Duke Runnels, CEO of Fort Properties Inc., a Los Angeles-based TIC sponsor.

An estimated \$171 billion of commercial and multifamily mortgages held by non-bank lenders and investors are expected to mature in 2009, according to the Mortgage Bankers Association.

Although Fort Properties does not have any loans coming due in its portfolio, Runnels estimates that the TIC industry will need to refinance up to \$3 billion in maturing loans in 2009.

Given the fact that traditional lenders such as banks have tightened their purse strings, which in effect means higher equity commitments and tighter underwriting standards, difficult questions remain as to where that refinance money will come from, and how much it will cost.

In addition, it will become increasingly difficult to retain tenants as more corporations battle to stay afloat in this deep recession. One of the vulnerabilities of TIC properties is that they are typically leased to a single tenant.

"In a market like this, we have redoubled our efforts just on tenant relations—staying in front of tenants and helping them with their issues," says Runnels. "The last thing we want to happen is for a tenant to leave."

Last year, Fort renewed many of its leases early to avoid any potential vacancies. The company is now reaping the benefit of that action with a 98% occupancy rate across its portfolio.

Clearly, sponsors will continue to face a number of challenges in the year ahead as they struggle to retain tenants and maintain yields at existing TIC properties, as well as put new TIC deals together that appeal to wary investors.

"It's survival of the fittest," Hanson says. "In a market environment that is this volatile and unpredictable, whether you're talking about the TIC industry or any other sector, you're going to have consolidation. Those [sponsors] with the better business models will win out."

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