

WESTERN REAL ESTATE BUSINESS™

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LOSING THE LUNA-TIC FRINGE

Only the strong TIC sponsors will survive to once again thrive in western commercial real estate investment.

Michael Franklin

The past year has undoubtedly been the most challenging in recent memory for those involved in commercial real estate. Tenant-in-common (TIC) sponsors have felt the same pressures and, in some high-profile cases, have succumbed to the rapid changes in our economy.

As in all areas of the commercial real estate sector, however, there are TIC sponsors that are reacting proactively to the challenges facing us and there are those who will not survive this downturn. The question then becomes what are the major issues facing TIC sponsors in 2009—and who will live to see another deal?



Michael Franklin
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A Business Model Issue, Not an Industry Issue

The past year saw a few high-profile TIC sponsors fail completely or take to the sidelines. While it may be expedient to view this as an indictment of the entire indus-

try, those familiar with these firms recognize the reality—the stresses on this sector have magnified the fault lines of companies whose business models work only in the best of times.

For example, there were firms that guaranteed a high return on investment. Real estate, however, holds few guarantees. The only way this firm could honor its commitment to investors was to subsidize existing obligations with new deals. When the firm could no longer finance new deals due to economic conditions—and the returns guaranteed on the firm's existing assets were completely out of line with the investment's true yield—thousands of investors were left in a chaotic financial position.

The lesson in this situation mirrors that of the financial industry as a whole: transparency and skin in the game provide the incentive for sponsors to act with integrity. Each TIC investment must stand on its own merits, without the financial support from deals unrelated to that asset. Additionally, those who invest in the asset before selling it as a TIC inherently invest in more comprehensive due diligence and are more realistic about the property's prospects—after all, this sponsor is willing to own the asset.

Additionally, sponsors that previously structured TIC investments as real estate have been denied a no-action request by the SEC. This SEC writ essentially warns sponsors that they are vulnerable to SEC action if they do not structure these investments as securities. Input from the SEC has been long awaited by the industry and will certainly prompt some sponsors to abandon TICs and/or change their model.

Refinancing—The Elephant in the Room

The single most significant challenge facing all those in commercial real estate today is the financing issue, and this is equally true for those in the TIC industry. The majority of TIC investments were financed through CMBS vehicles. The reason? The structure of a CMBS loan typically fits the profile of a TIC investor. CMBS loans were less expensive, provided for a quicker transaction and were generally longer term. So, with an estimated \$40 billion in CMBS loans for the TIC industry alone coming due in the next 3 years, the choices available to these borrowers are clear: extend the loan, refinance the loan or possibly face a loan workout.

While new CMBS loans are non-existent today, lenders have shown a skeptical willingness to extend the existing term for select assets. There are certainly no guarantees for an extension and the ability to extend the term may cost the borrower dearly.

Borrowers can also turn to more traditional sources of lending to refinance a property, though they will face the same challenges as all commercial real estate borrowers in addition to the added burden of educating traditional lending sources on TICs. For TIC sponsors who have both strong relationships with traditional lending sources and also a proven track record in this field, this may still be an attractive source of financing and/or refinancing.

One challenge inherent in the TIC structure continues to prove difficult for all lenders: creating for the lender a comfort level in dealing with the multiple owners

of a TIC asset. In the coming months, there may be a number of TICs converting their structure to a DST (Delaware Statutory Trust) or an LLC, thereby creating one entity with which the lender can work.

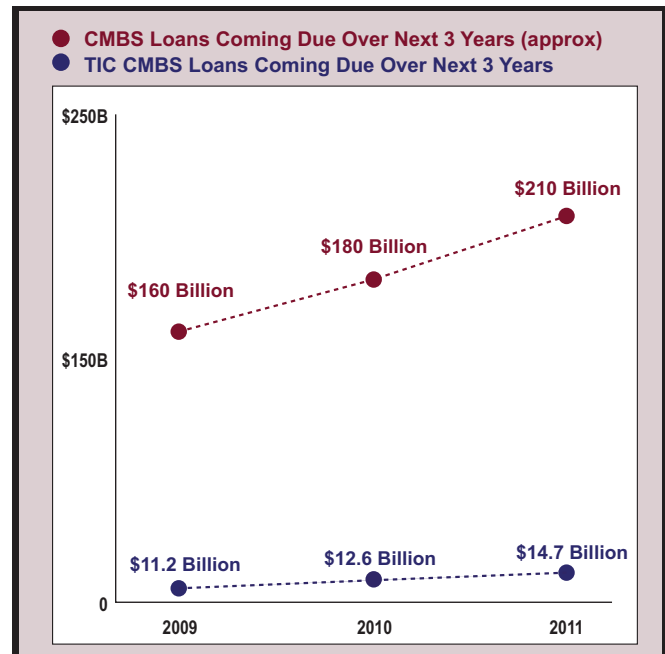
Ultimately, however, all commercial real estate transactions, regardless of the structure, have been paralyzed by the unwillingness of lenders to lend. Supply cannot be manufactured without debt, and fears within the market have made debt difficult to obtain. The TARP funds, while initially promising, are not making their way into the commercial real estate sector. TICs are particularly susceptible to this environment as investors hoping to utilize the strategy

in a 1031 exchange find it increasingly difficult to find a buyer for their property, thereby indefinitely postponing the exchange.

There is Good News

While the evolution of the industry will result in far fewer TIC sponsors, those that remain will have done so because their business model is investor-focused and realistic. These same sponsors will certainly have a history of strategic acquisitions and exceptional asset management or they would have been unable to obtain financing during these turbulent times.

TIC investments remain an outstanding investment strategy for certain inves-



tors. Well-capitalized, strong sponsors will ensure that this option remains viable and attractive long after the economic crisis has passed.

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