



Texas Real Estate Business – June 2006

TIC Investments in the Texas Real Estate Market – Today and Tomorrow

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Rarely has the real estate industry seen such explosive growth as we've seen in 1031 exchanges, primarily utilizing a "tenant-in-common" (TIC) ownership structure as a source of equity for the acquisition of income properties. TIC investments have more than doubled each year from 2001 (\$166 million) to 2005 (\$4 billion). Many in the industry have watched to see if this source of equity would be a fleeting trend or something more long lasting. After five years of steady growth, most investors and real estate professionals agree that the TIC form of ownership, as a vehicle for a 1031 exchange, is here to stay.

The last four years have shown very favorable conditions for property acquisitions. Interest rates have been at historic lows and, up until very recently, loan capital has cost less than equity capital.

As 1031 exchange investments have become more popular, competition for good properties that provide the necessary investment returns have made it increasingly difficult for most sponsors to maintain the frenetic pace of

acquisitions enjoyed in the recent past. Additionally, in the last 12 months, interest rates on long-term debt started inching up and the spread between cost of debt and cost of equity has narrowed. We are also starting to see a disconnect between what sellers expect for their properties and what buyers are able to pay. Despite these changing market conditions, 1031 exchanges remain a strong force for the foreseeable future.

The key to any successful real estate transaction is not just location and quality of the asset, and supply and demand factors, but also the professionalism and ability of the sponsor behind the transaction. Defaults often result from the inexperience or unprofessionalism of the sponsor, so lenders and broker dealers will take into serious consideration the sponsor's track record. This is important for an investor to keep in mind because the number of TIC sponsors has grown from approximately 10 in 2001 to more than 45 in 2005.

The explosion of the TIC form of ownership was not immediately welcomed by all in the commercial real estate industry. Lenders, for example, did not fully embrace this type of ownership. Today, lender acceptance, while not universal, has been gradual and steady. Most conduit lenders are accepting them as viable borrowing/ownership structure, however, most life insurance companies have been slow to underwrite TIC ownership – at least on the same terms and conditions as conduits.

In July 2004, the IRS issued a ruling that, under certain conditions, a Delaware Statutory Trust (DST) is as acceptable as a TIC structure to effect a 1031 exchange. This structure, utilizing a master lease of the property back from a DST to the sponsor (in the case of an apartment property), eliminates many of the concerns that lenders have with the TIC structure. Many of the life insurance companies that were hesitant to underwrite a TIC form of ownership immediately recognized the advantages of a DST. As a result, most of our multifamily DST loans have been financed by life insurance companies.

Conduit lenders have been slow to recognize the advantages of a DST multifamily loan because of the reluctance of the “B” piece buyer to purchase these loans. However, this appears to be changing as a result of a series of meetings between Harbor Capital Group, a leading sponsor and several active purchasers of “B” pieces. As evidence, within the last six months we have closed two DST loans totaling almost \$30 million with two separate conduit lenders, and Harbor Capital’s Josh Chambers has four more properties under loan application with conduit lenders for DST loans.

Texas remains a solid investment market for TIC/DST sponsored acquisitions, predominantly because of the strong job growth in its major cities – Houston, Dallas, San Antonio and Austin. In 2005, Texas had a 2.7 percent increase in job growth, while the rest of the country had a 1.5 percent increase. This job growth should bode well for all income-producing real estate in Texas.

When looking forward, I believe we are going to start seeing some sponsors selling their TIC/DST-owned properties into Real Estate Investment Trusts (REITs). This would actually protect the TIC/DST investor because they can exchange their ownership interest in a single property into an ownership position in a portfolio of properties, thereby decreasing the investment risk.

Despite slower growth this year, the 1031 exchange – utilizing a TIC and DST form of ownership – will continue to thrive as a source of equity for commercial real estate acquisitions.