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The TIC industry: What to expect in 2008

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The current year, 2007, has presented unprecedented challenges to the TIC industry, including:

- * A declining base of anxious sellers of appreciated real estate looking for exchange opportunities.
- * Confusion and concern in the real estate debt capital markets.
- * Continued pressure on cap rates for quality real estate.
- * Rising costs associated with offerings.
- * A higher incidence of problem real estate.

Despite all of these challenges, the TIC industry appears likely to finish 2007 roughly equal to 2006, with about \$4 billion in equity raised. This is no small accomplishment given the sometimes chaotic market conditions. But what about 2008? Will market conditions improve? How will the TIC Industry respond? Here are a few preliminary thoughts:

Sponsors

Sponsors are on the hot seat: decent real estate is too expensive, debt is less available and more costly, costs are rising and investors want higher returns! An increasing number of sponsors will find these challenges too daunting and they will leave the industry. However, the strong will survive and will benefit from the pruning out of sponsors who over-promise and under-deliver. Some of the strategies that the better sponsors will use will include:

- * Selling track record: Relatively few sponsors have a meaningful track record. The industry is still only 12 years old, with most of the growth in the last five years since rev. proc. 2002-22, and with more than half of the sponsors appearing in the last two years. A fierce debate is already going on among TICA members as to how track records should be presented in PPMs. Sponsors who can demonstrate that they have consistently performed as well or better than promised should have a meaningful advantage as market conditions continue to be challenging.
- * Selling appreciation: Sophisticated real estate investors understand that real estate always has appreciation as a significant component of the overall return, and that too much focus on initial cash flow can be counter productive as to the quality of the asset, and put real stress on the investment structure. Look for this message to be delivered with increasing emphasis in the coming year.
- * It's the real estate: Bubbly market conditions over the past few years had pushed the focus from risk to return. However, the events of the spring and summer of 2007 in the real estate capital markets may have changed the balance. Look for the deals to sell in 2008 that have lower risk, not higher return. Important factors will include location in primary markets, high quality tenants, acquisition cost below replacement cost. TIC leverage will still be in the 50% range, which translates to 60-65% of seller price, but interest only features will probably not extend beyond two-five years.
- * Broaden distribution channels: TIC offerings are shown to a relatively small percentage of available like kind exchange investors, particularly east of the Mississippi. Sponsors simply cannot afford to leave those investment dollars on the table. Look for sponsors to increasingly search out financial

joint venture partners with meaningful securities distribution channels, e.g. Ameriprise, and to build their own internal distribution team.

* Broaden products: Is it possible to sell fractional interests in real estate directly to investors without a built-in tax incentives? Sponsors have been bringing out a greater variety of real estate investment products in the past year which are sold through the TIC distribution channel but which do not have like-kind exchange treatment as their central feature. In addition, an increasing number of TIC offerings have gone back to the former practice of a double, or piggy-back offering, simultaneously offering TIC and non-TIC interests.

To be continued in the October 12th, 2007 Financial Digest edition of the New England Real Estate Journal.

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Broker dealers

I have had a number of conversations with broker dealers over the past year who wonder why anyone would want to be a broker dealer. Regulatory scrutiny is increasing, costs are rising, successful sponsors circumvent them, fees are being squeezed and the broker dealer is in the cross-hairs if anything goes wrong. As with sponsors, some weaker broker dealers will leave the industry. The better ones will survive, increasing their efficiency and broadening their mix of products.

* Better Due Diligence

As with all financial intermediaries, time is money for broker dealers. They simply cannot afford trying to bring out marginal sponsors and marginal projects. The third party due diligence available to broker dealers was never intended to be a substitute for due diligence by the broker dealer. Expect the broker dealer gatekeepers to the TIC Industry to raise the barriers to entry for new sponsors and to weed out marginal performers more quickly.

* Broaden Product Lines

Just as the sponsors need to wean themselves from exclusive reliance on TIC products, the broker dealers need to find alternative products to sell when the TIC market is slow, including funds, note-offerings or other products suitable for qualified plans, raw land, permitting or development stage deals and energy products. There is a fair amount of risk associated with bringing out new products, including up-front costs and the distraction. Successful new products will have to be carefully thought out, with quality sponsors and appropriate pricing.

* Training

The generally accepted bottleneck in the TIC Industry is the relatively small number of properly trained registered representatives. If the broker dealers do not train the registered representatives, who will? Now that the low hanging fruit is gone, the need for well-trained registered representatives

has never been greater. Sponsors and broker dealers will continue their efforts to improve training of and communication with registered representatives.

Registered Representatives

The registered representatives are on the front lines. They have to find qualified investors, establish a relationship with them, understand their needs and gauge their suitability, and understand the increasing complex products that are available to them. The good news for the better representatives is that it is very difficult for most representatives to do all of these things effectively, so if you can do it you can be very successful. It is sort of like lawyers: there are too many lawyers but you can never find a good one. In the coming year expect the better representatives to focus on:

* Demanding Due Diligence

Representatives have enough to do without having to do the sponsor's or the broker dealer's job. Expect representatives increasingly to refuse to look at offerings which are not accompanied by meaningful sponsor, broker dealer and third-party due diligence. The attitude will be don't just tell me the market and the rate, but rather show me why this works and will not embarrass me with my clients.

* Focus on Suitability

The turmoil in the poor credit home mortgage market should be a cautionary tale for all representatives. Nothing is harder than steering an apparently qualified accredited investor away from investment products based upon suitability. However, nothing is more likely to come back to harm a representative than an investment sold to an unsophisticated investor. Expect representatives to be more selective in who they show products to.

* Load

Representatives have more time to dissect offerings these days. One result should be a more critical eye on load, or the costs of the offering. This really isn't about how much money the sponsor is putting in its pocket. What it is about is how much are the investors paying for the asset. In times of modest or lower growth in the commercial real estate market, paying 125% of the fair market value to acquire a property may make it difficult to achieve the projected 12-13% IRR, or even get the principal fully returned, in 5-7 years.

* Pressure on Fees

There is increasing pressure on the fees paid to registered representatives. Can they hold the line at the current 7-8%? Can they avoid deferral of some portion of the commission into later years? Expect the better sponsors to refocus on this issue given the current tight deal economics.

Conclusion

These are just a few thoughts about the coming year. The underlying message is that in positive markets even the less skillful and less reputable can make money. When the market conditions deteriorate the smarter, more disciplined players will rise to the top. Expect that to be the fundamental trend in 2008.

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