Why 2025 is poised to be a potential game-changer for 1031 exchange DST and 721 exchange UPREIT investors - by Dwight Kay

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As we settle into a new year, the landscape for 1031 exchange investors looks promising as they consider the strategies available to them to reposition their equity into a more diversified approach to real estate investing. Whether they utilize the Delaware Statutory Trust (DST) or the 721 exchange UPREIT strategy to potentially achieve their goals, there are several positive economic indicators ahead, and the recent election results have set the stage for a potentially fruitful year ahead.

Firstly, the election outcome has provided a sense of stability and clarity in the market. With policies that are expected by many to support economic growth and real estate investment, as investors we can look forward to an environment that is potentially conducive to making strategic moves. The continuity of favorable 1031 exchange regulations means investors can - for now, continue to leverage this powerful tool to defer capital gains taxes while reinvesting in income-generating and other like kind properties. In addition, there is strong support for extending the Tax Cuts and Jobs Act of 2017, which could benefit investors through the tax deferral benefits of Qualified Opportunity Zones and Bonus Depreciation schedules on certain asset classes.

Economic indicators further bolster this optimistic outlook. We are seeing a resurgence in consumer confidence, which typically leads to increased spending and investment. The job market remains robust, with low unemployment rates contributing to a healthy economy. Additionally, interest rates, while slightly higher than previous years, are still at historically manageable levels, providing opportunities for investors to finance new acquisitions or refinance existing properties.

Smart investors who can pinpoint and seize opportunities in mispriced assets or properties in out of favor asset classes stand to potentially significantly benefit in today’s evolving market. This is especially true on the equity side, where property prices are adjusting to the “higher-for-longer” interest-rate environment, potentially yielding favorable deals for strong buyers in today’s marketplace.

The investment picture is especially bright for all-cash DST investments that provide investors enhanced risk mitigation by avoiding high borrowing costs, lender foreclosures, and cash flow sweep scenarios. That being said we are also seeing many of the DST sponsor companies that we work with provide compelling leveraged DST products for those investors needing debt replacement in their 1031 exchanges. Likewise, 721 exchange UPREIT vehicles provide a positive outlook for investors searching for broad diversification and tax deferral as opposed to owning just one legacy property they may have purchase 20+ years ago.

At Kay Properties, we are committed to helping our clients navigate these promising yet still challenging times. Our team of experts is here to provide guidance and support, ensuring that you make informed decisions that align with your investment objectives whether you are considering traditional DSTs for your 1031 exchange, a 721 exchange UPREIT transaction and/or a direct investment into real estate investments with fresh capital – all strategies that we have helped thousands of investors nationwide execute on for nearly two decades.

With the new administration now in office, the stock market remains volatile, and the most recent round of interest rate cuts has yet to provide relief to borrowers. Amid these shifts, speculation continues about when the struggling commercial real estate market will hit bottom and begin its recovery.

There is no doubt that today's commercial real estate environment is exceptionally challenged, with elevated interest rates and an impending wall of debt maturities presenting clear headwinds to investors, lenders, and developers. Some commentators, though, have expressed optimism about entering a "new inning" in commercial real estate, one in which property prices will revert to pre-2022 levels and borrowing costs will stabilize. We believe this is a fundamentally misguided view, and one that will only delay the inevitable reckoning.

The era of near-zero interest rates is over and won't return for a long time, if ever. That extraordinarily friendly environment was the artificial result of a post-pandemic recovery, and the current, harsher environment is the new normal by every metric: As of this writing, the federal funds rate is steady between 4% and 5% (compared to 0.08% three years ago), the 10-year Treasury yield is hovering at 4.5% (up from 1.5% three years ago), and interest rates are expected to remain elevated for longer.

There is no reason to believe that these trends will reverse themselves any time soon. The difference between short-term and long-term interest rates, which serves as a market signal for investor caution, has been negative since 2022. Around $1.5 trillion in commercial real estate loans will come due over the next 18 months, exacerbating liquidity challenges. And on the national stage, the new administration seems poised to advance growth-centric policies that – while loosening regulations and driving new development projects – historically have had inflationary effects and will likely prolong "higher for longer" rates.

The reality is that commercial real estate isn't hitting a bottom – it's recalibrating to a new reality altogether. Investors and borrowers should adjust their perspective accordingly: The true worth of assets, based on cash flow and adjusted for risk, will need to be recalculated in this costly borrowing landscape. Commercial real estate professionals will have to acknowledge that property prices (which have fallen about 20% from their peak) aren't simply at a deep discount but are reaching "fair value" now that financing costs are higher. Banks will need to abandon their "extend and pretend" strategy for distressed loans so that the market can accurately price in the risk of defaults. Broadly, commercial real estate must stop burying its head in the sand.

Though the path to stability may be a longer one than some of the most bullish prognosticators suggest, this isn't necessarily bad news for savvy and patient players in the space. Smart investors who can capitalize on mispriced risk and out of favor asset classes can potentially reap the benefits of an uncertain landscape. Private credit may be a particularly attractive opportunity now, offering yields that align with recalculated intrinsic values and proposing a lending alternative to cash-strapped banks. On the equity side, it's possible that this year brings more favorable deals as prices more fully align with the “higher-for-longer” environment.

The commercial real estate landscape faces a great many unknowns over the next few years, but one thing is clear: there is no “new inning” in store for commercial real estate. We are in an entirely new game, and the first players to recognize this will be best positioned to navigate a challenging environment and come out stronger on the other side. For example, we’re seeing acquisition opportunities arise from buyers who overpaid for properties years ago and now face maturing loans they can’t refinance. These sellers are often forced to offload properties at significant discounts.

Additionally, we continue to leverage the 721 Exchange UPREIT strategy for investors concerned about over-concentration in a single property or market. This has allowed us to build relationships with leading 721 UPREIT sponsors, offering access to multi-billion-dollar portfolios for diversified 721 Exchange investments. As we look forward to the to serve each of you, our clients, we remain optimistic about the opportunities that lie before us. We are forever grateful for the opportunity.

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