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TIC offerings have become an accepted form of investment

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Over the past five years tenant in common (TIC) offerings have become an accepted form of structured investment for like kind exchange investors. In each of 2006 and 2007 well over $5 billion in real estate investor equity has been placed in these structures, representing over $10 billion per year in total deal size. Although the majority of these investors are still west of Mississippi, each year produces more TIC investors in the northeast.

The characteristics of a tenant in common offering are fairly simple. A real estate company, or "sponsor," conducts a securities private placement offering to accredited investors which makes available to up to 35 of such investors a fractional interest in a designated piece of real estate. They are not partners in a partnership, rather a loosely affiliated group of direct investors in a piece of real estate. Each investor receives a deed of his undivided interest and signs the mortgage (on a non-recourse basis). Properly structured under Revenue Procedure 2002-22 (the Rev Proc), a TIC offering allows investors to qualify for like kind exchange treatment through buying a small percentage of a larger (and presumably better quality) piece of real estate than they could buy if they simply purchased a replacement property by themselves.

Has the TIC offering proved to be a desirable and reliable investment vehicle? The answer is a resounding yes. Since the Rev. Proc. was published by the IRS in 2002 some $20 billion in investor equity has been placed in these investments through over 1,000 offerings and involving over 20,000 investors. These investors are typically baby boomers now entering their 60s who no longer want to be involved in speculative real estate investments or real estate that they have to actively manage. They have capital gains realized from the sale of appreciated real estate, and they want to defer the resulting capital gains taxes until the taxes are actually eliminated for their heirs by the step up in basis upon their death. They are looking for passive, secure, cash flowing real estate investments.

Because of the restrictions of the Rev. Proc. and the nature of TIC investors the TIC offerings to date have been conservative, low risk investments. The properties are typically stabilized income properties, e.g. multi-family, fully leased suburban office or grocery anchored retail, which with low leverage (typically 50-60% of the fully loaded acquisition price) produce an initial cash return to investors ranging from 6% to 8%, and a projected IRR on disposition in the low double digits.

Given the conservative structure, most TIC offerings have performed exactly as projected or better. Although accurate statistics are difficult to find in this "private placement" environment, it appears that the vast majority of TIC offerings are performing at or above projections and only a handful of those that are below are sufficiently below to raise the specter of foreclosure by the lender.

Of course, the good track record of TIC offerings must be attributed in part to the positive commercial real estate market generally from 2002-2006. This year has been, and next year projects to be, more challenging. A few more TIC offerings, although still a very low percentage, have become distressed. Actually the most telling effect of the current market conditions is a slow down of the pace of growth of the TIC industry, partly as fewer potential investors are selling appreciated real estate, and partly because more costly and restrictive debt terms have squeezed margins too thin for TIC sponsors. This slowdown does not appear to be based on investor concerns about the viability of TIC investments.

Part 2 will appear in the March 4th edition of the New York Real Estate Journal.

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Having said that, one restraining factor on the growth of the TIC industry has always been investor concern that even if a workout was unlikely, if the worst came true and a workout was required it would be exceptionally difficult to produce a successful resolution given the involvement of so many different "stakeholders", i.e. lenders, sponsors, master lessees, property managers, broker dealers, registered securities representatives and up to 35 accredited investors. The most pressing concern relates to the fact that the 35 investors who own the property presumably do not otherwise know each other or even know how to reach each other. Coupled with that are the Rev Proc generated restrictions in the Tenant in Common Agreement the investors all sign at closing which require a majority or even unanimous decision by the investors before taking such critical actions as renegotiating or replacing the debt, replacing the property manager, triggering capital calls or selling the property.

All of this seems ominous and potentially a serious impediment to the otherwise increasing acceptance of TIC investments. However, now that we are starting to have some real world experience with a few TIC workouts, the challenges have generally proved manageable. I have been immersed in several TIC workouts, in some cases representing sponsors/master lessees (typically affiliates) and in some cases the investors. This experience has shown that if a few simple guidelines are followed TIC workouts do not have to be more difficult than any other commercial real estate workout. Here are some of the guidelines:

Communication. At the first sign of trouble the TICs need to be organized and start communicating. This can usually be coordinated by the sponsor/master lessee or by the managing broker dealer. Of course this may be impractical if the sponsor/master lessee is incompetent, dishonest or in bankruptcy, or if there was not managing broker dealer. Experience suggests that it is unusual for all of these conditions to exist, that is the problem that needs to be worked out is generally some unexpected event such as the loss of a tenant rather than, for example, misappropriation by the master lessee. There also typically is a managing broker dealer. At the first sign of declining performance some or all of the TICs should insist on the creation of an email mechanism which allows them to communicate with each other as well as the sponsor/master lessee and the managing broker dealer.

Improved Reporting. During any period of underperformance both the frequency and the depth of property level reporting must be increased and must be generated in a fully transparent manner.

Delegation of Authority. If the situation is or gradually becomes more serious, for example a potential default with a lender or a clear need to replace the master lessee, the TICs must delegate authority to a small group of them, ideally no more than three, who pursuant to powers of attorney can take all actions on behalf of investors other than those actions where the authority must be exercised by the TICs themselves under the Rev Proc.

Hire Experienced Advisors. As the situation deteriorates the situation may require hiring legal counsel experienced in both TIC offerings and workouts. This will require some group of investors to step forward and raise a retainer. There typically are mechanisms in the Tenant in Common Agreement allowing those who contribute to recover from those who don't.

Remove the Master Lessee. If the Master Lessee is incompetent, dishonest or distracted by other circumstances it may be necessary to terminate the Master Lease or arrange for its assignment to another, more reputable, TIC sponsor. A word of caution: any change in the status of the Master Lease or the identity of the Master Lessee without the lender's consent may trigger an event of default.

Stay Close the Lenders and the Tenants. It is critical that the confidence of the lender and any tenants be maintained. Communication with them by persons authorized to speak for the TIC investors is critical.

Be Patient. Take the actions that are necessary, but do not force the action out of fear of inaction.

Real estate moves in cycles. If you hunker down, keep the lender current and the tenants happy, make decisions on a timely basis, be careful to maintain the integrity of the structure under the Rev Proc so the like kind exchange benefits are not compromised, and wait for the market to come back a big problem should gradually turn into a minor annoyance.

TIC offerings are here to stay. Because of their conservative nature it is unlikely even in difficult market conditions that there will be a material increase in workouts, or that any substantial portion of the workouts that do crop up will turn into catastrophic events.