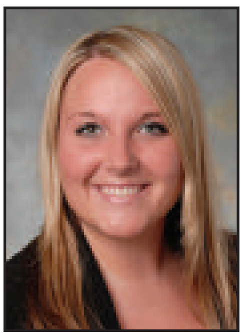
Lenders, TICs, and Bear Markets



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By Erin L. Hager

We are five and a half years into the tenants-in-common (TIC) market (since the IRS's Revenue Procedure Issue in March 2002). Sponsors now know that structuring a TIC investment correctly is probably the most critical step in bringing a saleable and long-term property to the market. This became painfully clear this summer as many conduit lenders, a long-time favorite debt provider for TIC sponsors, renegotiated loan terms and even cancelled funding for committed deals. Many sponsors are now scrambling to find properties that will perform favorably without the Commercial Mortgage Backed Securities (CMBS) debt they were securing in the not-so-distant past, and are refocusing on underwriting investments in a "worst case scenario" environment. Although this has caused the biggest roadblock in the history of the TIC market, the CMBS debt crisis may help TIC investors in the long run, as it will force sponsors to become even better at sourcing, underwriting, structuring, and ultimately operating TIC properties.

Financing Terms

Clearly, the financing component of the TIC structure is one of the determining factors of whether or not a property is suitable as a TIC. Issues such as: fixed terms versus interest-only terms, recourse versus non-recourse debt, and transferability of the property in the future are the first items on TIC sponsors' agendas when choosing a lender and financing package.

As the TIC industry developed, these issues were often overlooked and sponsors focused on the debt service payment only (to get to a good cash-on-cash return), and quickly signed up for loans that turned out to be impossible to work with as the market changed, or TIC investors wanted to re-sell their individual interests. Liquidity became a major problem and was found to be largely a result of terms in the mortgage which allowed for little or no flexibility. Now, established TIC sponsors and their legal teams are well aware of the specific loan terms that are amenable to a TIC structure, and are quick to determine whether or not a particular lender will be a good match for their project.

As soon as a property is on the radar as a potential TIC, sponsors must find a suitable lender with favorable terms to determine the profitability of offering the investment to the market. TIC investors are much more savvy about financing, and TIC sponsors, who in the past might have "glossed over" the debt terms as a side issue, are learning that those days are gone.

Lease Arrangements

Along with structuring the debt portion of a TIC property, the lease(s) will affect the operation and investor expectations as the property is held. Many TIC Sponsors prefer to structure their investments under a master lease. This allows for a blanket lessee (usually the original owner or TIC Sponsor) over the top of the entire property, which is especially helpful in a multi-tenant property. The master-lease structure aids in assuring consistent rent distributions, less decision making on behalf of the investors, and potential profitability to the master lessee if the property is managed well.

Master Lease Scenario

Master leased TICs perform almost exactly in the same way as a NNN leased single-tenant property: management-free, taxes and insurance paid by the lessee, and rent distributed (monthly) after debt service is paid. Master lease agreements also take away many uncertainties often associated with owning a multi-tenant property, such as monthly expenses and tenant turnover, which can drastically change an owner's return each month.

Since TIC investors are typically attracted to stabilized investments, the master-lease structure offers the ability to own a multi-tenant property without the headaches of managing numerous tenants, or feeling the impact of monthly changes in operation. A benefit of a master lease to a TIC Sponsor is the potential profit they can see if they manage the property well, keep expenses down, and the property fully leased. The master-rent payment to the investors is typically deleted in the master lease, so any "left over" cash (once all expenses, debt and rent payments are made) is kept by the master lessee as profit. TIC investors are usually happy to let the master lessee keep this profit to be assured of a consistent monthly distribution and the freedom from daily property management.

Rent Roll Scenario

Although it is common to see master-lease structures on multi-tenant TIC properties, it is also possible to structure a TIC purely on rent roll. This would mean that there may be variation in distributions from month to month, and a tenant move-out would negatively impact the investors' return until the tenant is replaced. But, it can also be a positive situation as the upside would belong to the TIC investors instead of a master lessee. It would be common to see a rent roll TIC structure on a single tenant property since many of the potential issues associated with this structure would not exist because of the number of tenants. In any situation, the TIC Sponsor will investigate the property and determine which structure is most beneficial to the co-owners, and the best fit for a seamless operation.

Property and Asset Management

The operation of a TIC property relies heavily on property and asset management. Since the TIC co-owners tend to be passive by nature, management plays a key role in operating a successful TIC investment and meeting investor expectations. Often, the original property management team will remain in place so that the tenants and vendors have continuity when new ownership (TIC) takes over. This tends to be a good choice and many sponsors favor this structure. Property management remains an important part of any real estate investment, so the TIC ownership documents allow for the TIC co-owners to change property management (annually) if they are not happy with the current management.

The asset management role does not exist before the TIC. It is set up specifically for the co-ownership group. Since the asset manager reports on property issues, distributes returns and financial information, and answers co-owners' questions, the sponsor must be very careful to choose an asset manager who possesses unparalleled organizational and communication skills. Many systems—such as virtual deal rooms which can be used to quickly and efficiently disseminate documents and information to co-owners—can help asset managers in this regard. The TIC ownership group is allowed to replace the asset manager if the manager does not meet investor expectations. Some TIC sponsors do their own asset management, but others hire this role out to an unrelated third party. Before buying into a specific TIC property, investors should investigate this issue and determine their comfort level with each approach. It has become clear when examining the history of the TIC market that asset management provides an integral piece of the operation of an investment.

Financing, lease agreements, and management stand as the three key elements of structuring and operating a successful TIC investment, and sponsors and investors have become more aware of these issues than ever before. Although TIC professionals understand the potential challenges that are associated developing a TIC investment, there are some obstacles that are impossible to predict or avoid, such as the CMBS debt crisis that has recently fallen on the real estate market. Over time, the market will correct, and TIC sponsors and investors will reevaluate the issues that are currently under pressure and come out of this tumultuous time better prepared for the "worst" than ever before.