



Financial Engineering in TIC Transactions

As cap rates continue to decrease, while interest rates increase, cash on cash returns for new offerings will decline compared with offerings that were available less than one year ago. Unfortunately, many investors are still hoping for the higher cash on cash yields from prior periods, rather than accepting current rates of return. This is known in the industry as yield chasing and it often leads to un-happy conclusions.

Equally unfortunate is that some sponsors of TIC offerings are assisting investors in their yield chasing by the use of excess financial engineering. Simply put, financial engineering is the use of debt products, or the manipulation of reserves, to increase the cash on cash return above that which would be naturally produced by the property. The four most common forms of financial engineering are;

- Interest only financing;
- Bought-down interest rates;
- Irregular use of reserves, and;
- Master leasing of vacant space.

While none of these techniques are inherently bad and they can legitimately improve returns, an investor must understand the implications of each of these techniques in order to be able to determine their impact on a potential investment and, especially, the ability to exit the investment with a profit.

Let's take a look at each of these techniques and see how they impact risk and returns.

Interest only financing is the most common form of financial engineering used in TIC offerings. With interest only financing, a borrower pays only the interest charges on a loan, but does not make any principal payments. While interest only periods can extend until the loan matures, it is much more common for the interest only period to last from between three-five years, with principal payments (amortization) occurring for the remainder of the loan term (for example, a 10-year loan with interest only payments for the first three years and payments based on a 30-year amortization schedule for the remaining seven years of the loan term). Because of the math of amortization, the principal payments in the first year of a loan amortized over 30 years would equal about 2.3% of return for the property. Put another way, a property that returns 6.5% on a fully amortized basis would produce around 8.8% with interest only financing. The flip side is that a property which returns 6.5% using interest only financing would produce only about 4.2% if the loan payments were based on amortizing loan.

Many proponents of interest only financing make the point that you make your money on well located, leased and managed properties, not principal pay down. Another argument in favor of interest only financing is that, by retaining the money that would be paid to the lender as principal amortization, the investor has maximum flexibility in the use of the property's cash flow; they can spend it, save it, use it to improve the property or use it to invest in another property. Fair enough. But it can be very hard to have the discipline required to not just spend the money and principal pay down is the safety valve that can allow full return of investor equity, even if the property's value stays static or even drops a bit.

The technique of buying-down interest rates is well established in the new-home market, but seen much less often in the commercial markets. Essentially, buying down an interest rate consists of paying the lender an amount that effectively equals the present value of the interest rate reduction. In the new-home market, it is a technique used by builders to reduce the borrowing cost for their buyers, especially in a

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rising interest rate environment. In the TIC world, it is used for a similar reason; every dollar of reduced mortgage payment should drop straight to the investor's pocket. For example, if a deal is set at a given price with a 6.5% cash on cash return based on an interest rate of 5.60%, but the sponsor uses some of the proceeds to buy down the interest rate, the investors could see their cash on cash returns increase to, say 7.0% without an increase in price.

Unfortunately, in the real world, the technique is often used to increase the purchase price of the property because every extra dollar of cash flow can support many additional dollars of price (the math here is fairly interesting; at a cash on cash return 7.0%, each additional dollar of cash flow equals over \$14 of additional price). The way the math works (approximately 1.0% of loan value to reduce the interest rate on a 10-year mortgage by 0.15%) a sponsor can almost always make money on the spread between buying down the interest rate and the corresponding increase in price. In addition, of course, any increase in price will require a commensurate increase in the exit price in order for the investors to receive back all of their invested capital. Since the underlying income will not be affected by the buy-down, the exit cap rate will have to be lower than if no buy down occurred.

The irregular use of reserves is, like the two previous techniques, one that can be used to benefit the investor. For example, most investors believe that the economy will experience some level of inflation over the next five to ten years. They therefore naturally hope that cash flow will increase over the holding period of the investment. Unfortunately, cash flows can be 'lumpy'. Capital expenses are often the culprit, as even if a tenant renews their lease and continues to pay rent, the tenant improvements and leasing commissions required to retain the tenant can cause the cash flow to decline, or even go negative. Appropriate buildup and use of reserves can alleviate this problem. A common way to do this is to create whatever up-front reserves (especially from the loan proceeds) the property can support and then to use 'excess' cash flow in subsequent years to build the remaining amounts. While no amount of cash flow is truly 'excess', it is not unusual to set a linear rate of increase for the cash flow (say 0.10%, 0.15%, or 0.25% per year) and then to use any remaining cash flow to build up reserves. Even if cash flow is not projected to be lumpy, it may just stay flat. In this case, using declining reserves has the effect of increasing cash flow. For example, the sponsor may start at \$1.00 per square foot in reserves and then decrease it every year by \$0.10 per square foot, which will have the effect of increasing cash flow on an annual basis.

The problem arises if reserves are used for items other than capital expenses, or if reserves are inadequate to pay for actual capital expenses as needed. An example of the first case is to apply reserves in excess of actual capital expenses in any given year. This would have the effect of artificially inflating cash flow beyond the level actually produced by the property. This is not appropriate and may cause tax issues as that portion of income may be deemed to be unrelated to the business of renting property. The second case, however, is probably more dangerous. During the last big real estate downturn of 1990-1995, one of the largest reasons for foreclosure was the lack of capital to pay for building improvements and attracting new tenants (tenant improvements and leasing commissions). It could be disastrous to the success of a TIC offering if the property did not have adequate reserves to upgrade the property and attract new tenants.

The final form of financial engineering, the master leasing of vacant space, almost never benefits the investor in the long run. A master lease of vacant space is very simple. A seller wants to obtain a full price for their property, but the property is not fully leased. Since most buyers price their investments based on a return on existing income (cap rate), vacant space directly reduces the price obtainable for the property. A typical master lease would take occupancy up to about 95% and would typically last for 24 to 36 months. In addition to rent, the seller might also set aside some amount to pay for tenant improvements and leasing commissions for the space. If the space is leased sooner than the expiration of the master lease, the seller keeps any remaining money. Likewise, if the tenant improvements and leasing commissions are less than allocated, the seller keeps the remaining amount. However, once the master lease expires, the seller's obligation expires as well.

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Because of the leverage effect described in the interest buy down section above, it is always beneficial to a seller to master lease space. If we assume that the seller is going to master lease space at a rate that equates to a return of 7.0%, they will receive over \$14 in additional price for every one dollar of net rent paid. At that rate, it would take 14 years for the investors to recover the additional price paid to the seller. At best the investor can come out even, and, if the space does not lease as projected, the investors can lose big-time. The seller, on the other hand, always wins. First of all, they get the value for the vacant space. Second, we have never seen a master lease that extended so long as to return all of the investor's money. Third, if the space leases faster than projected, the seller retains that much more of the additional value, while the investor rarely gets more than the initially projected rent (why would the seller hold out for more rent than is necessary to eliminate the master lease payments?). We call that giving dollars to get back dimes. Our question to sellers in this situation is always the same; 'If it so easy to lease the space at those rents, why don't you do it and keep all of the extra value?' The answer is, of course, because it often isn't actually that easy.

In conclusion, it is clear that some forms of financial engineering can, when properly applied, benefit the investor in a TIC deal (as they can in non-TIC deals). However, there are some forms of financial engineering that almost never benefit the investor. Even those techniques that can benefit the investor can be misused in ways that are very harmful to the success of an investment. The watch word is caution. Make sure that you understand exactly how debt service is structured, cash flows are generated and the sources and uses of reserves. Equally important, make sure that your representative fully understands the application, use and misuse of these techniques.

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