



APARTMENT PROPERTIES versus NET-LEASED PROPERTIES versus TENANT IN COMMON INTERESTS

With the emergence of syndicated tenant in common (TIC) interests as an increasingly popular investment choice for smaller real estate investors, we are frequently asked to provide an objective comparison of the characteristics of TIC interests versus apartment and/or NNN-leased properties. This article will attempt to provide such a comparison.

First, we must remember that in order for these three property types to be evenly compared, all three must qualify as 'real property' under the tax code. NNN-leased and apartment properties generally qualify as real property as a matter of fact. TIC interests must be carefully structured in order to qualify as real property. Otherwise, they may be deemed to be a partnership or entity structure, which would be considered a security interest, or personal property. Most high-quality TIC offerings are carefully structured in order to qualify as real property.

Second, we must remember that we might buy these properties through different types of brokers. Apartment and NNN-leased properties will only be brokered by holders of appropriate real estate licenses. On the other hand most TIC interests are brokered by holders of appropriate securities licenses (although some TIC sponsors still sell their interests through real estate brokers). This is an area of great debate and uncertainty and both real estate and securities proponents can give many valid points as to why they are right. Regardless as to who is actually right, the fact remains that most TIC interests are sold through securities licensees, which means that an investor will typically deal with different types of brokers if they want to explore both NNN-leased/apartment properties and TIC interests.

OK, now that we have the caveats out of the way, let's begin with our comparison.

APARTMENT PROPERTIES

Apartment properties tend to be the most popular type of investment property for smaller investors. Everybody lives somewhere, so we all have some familiarity with housing. Many of us lived in an apartment at some point in our lives, so we have some familiarity with residential-income properties. Many people get their start as a real estate investor by converting their existing residence into a rental property, rather than selling it, when they purchase a new residence. Therefore, they also have some experience with the ownership of residential-income properties. By moving or trading up over time, these investors can end up owning either a series of small residential-income properties, or they may consolidate those individual properties into a multi-unit apartment property. Over time, and when well located and managed, these types of properties have experienced strong appreciation and relatively little downside.

These characteristics also cause apartment properties to be very attractive to the lending community, as they tend to have relatively lower rates of default than other property types. As a result, very attractive lending programs are available, which can dramatically increase an investor's purchasing power and can significantly increase the cash flow upon a refinance of the property.

Because of all of these factors, residential income properties, particularly apartment properties, have been the great wealth creator for the past several generations of individual investors and we see apartments as most suitable for investors who are still in the 'active-management' stage of their investing career.

APARTMENT PROPERTIES versus NET-LEASED PROPERTIES versus TENANT IN COMMON INTERESTS [Continued]

However, apartment properties have their potential downside. They are extremely management intensive. Anyone who has owned any number of residential units knows what it is like to receive a call at 2:00 in the morning about leaking plumbing, an electrical problem, a tenant locked out of their unit. Repair and maintenance can be very time consuming if done on a 'do-it yourself' (DIY) basis, or very expensive if outside contractors are used. Likewise tenant management is also very time consuming if done on a DIY basis, but is often too expensive to contract this function out to a third-party manager. Tenants themselves can be a problem. Residential income properties tend to be rented to individuals without tremendous credit. Like many, they live paycheck-to-paycheck, so the security of your rent payment is only as strong as their paycheck and money management skills. Many jurisdictions have strong tenant-rights laws or regulations, which can make evicting a tenant time consuming and expensive. On the other hand, many tenants look to leave the property just as soon as they find a residence that they can afford to purchase for themselves. Apartment markets throughout the nation were heavily impacted by this reality during the recent period of historically low interest rates.

Apartment properties also tend to provide lower cash flow than might be obtained for other property types. The very high degree of acceptance (and therefore demand) of apartments by individual investors, combined with ever more restrictive development requirements, combined with their strong historic appreciation, cause apartments to trade at capitalization rates (cap rates) that are typically 100 to 200 basis points below alternative real estate properties. This means that, in Southern California, we are currently seeing apartment cap rates in the 4.50% to 5.50% range. So, while they do tend to provide greater appreciation over time, an investor may have to wait a while to actually see that appreciation.

NNN-LEASED PROPERTIES

NNN-leased properties are almost the flip side of apartment properties. They tend to be leased on a long-term basis to highly credit-worthy tenants, who will then be responsible for all aspects of the management and expense of operating the property. In a true NNN-leased property, the tenant will be responsible for all operating expenses (utilities, maintenance, management, insurance, property taxes, etc.). In a bondable lease, the tenant will also be responsible for all structural aspect of the property, including damage and destruction of the property itself. In leases that are less than NNN, the landlord will be responsible for some or all of the operating expenses for the property.

NNN-leased properties are intended to be a passive asset for the investor. They are not typically expected to participate in the day-to-day operation of the property. They typically expect to receive a rent check like clockwork every month. If the tenant has an 'investment grade' credit rating, the lending community will look more to the lease than to the underlying real estate when establishing appropriate debt limits and interest rates. This may result in significantly greater loan proceeds and lower interest rates than for similar properties not leased to investment grade tenants, both of which will increase the purchasing power and/or cash flow available to an investor. Therefore, NNN-leased properties can be very useful in providing a long-term, passive investment with steady, predictable cash flow to the owner of the property.

However, like apartment properties, NNN-leased properties can also have their downside. The typical tradeoff for a long-term lease to a credit-worthy tenant is that the leases tend to be flat (no increases) for their entire term, or with minimal rent increases over the term. As a result, an investor will not enjoy any increase in cash flow over their holding period and will not receive any inflation protection through increasing rents. In this regard, NNN-leased properties are very similar to a bond (albeit, a bond where you own the underlying real estate).

A related potential downside is that the pricing for NNN-leased properties also tends to act like a bond. If interest rates go up, cap rates for NNN-leased investments tend to go up, which reduces prices. Conversely, if interest rates go down, cap rates tend to go down, which increases prices. As we have

APARTMENT PROPERTIES versus NET-LEASED PROPERTIES versus TENANT IN COMMON INTERESTS [Continued]

experienced historically low interest rates over the past few years (combined with record demand for NNN-leased properties) cap rates are also at or near record lows, which means that prices are at or near record highs. While all property types show some correlation to interest rates, NNN-leased properties show a much more direct correlation because of their great similarity to bonds (at least from an income perspective).

Our personal opinion is that it is much more likely for interest rates to go up over the foreseeable future than it is for them to go down or to stay where they are, which would result in reduced pricing and paper losses for many investors who bought NNN-leased properties over the past two years. Current cap rates for NNN-leased properties typically range from about 5.50%-to-7.50%.

Finally, NNN-leased properties are directly tied to their tenants. If the tenant succeeds, everything is fine. But, if the tenant leaves, you are left with an empty box. In many cases the box is generic and can be readily re-leased to another tenant. Frequently, however, the property was designed for that specific tenant, or has significant improvements that would not be usable for another tenant. In that case, finding a replacement tenant might be very difficult, time consuming and expensive.

Frankly, this is the area that worries us the most about NNN-leased properties. There are huge differences between the viability of various tenants. According to data supplied by Standard & Poor's, the risk of a default by a non-investment grade (or sub-investment grade) tenant may be many times the risk of an investment grade tenant. Unfortunately, the market does not come even close to adjusting for these differences. We constantly see properties leased to non-investment grade tenants sell for a fractionally higher cap rate (say, 25 to 50 basis points) compared to an investment grade tenant, when the actual difference should be several percent, not several dozen basis points. We don't want to be on a soapbox about this, but we do think that this issue is often overlooked by investors.

TENANT IN COMMON INTERESTS

Finally, let's look at TIC interests. TIC interests are intended to be a little like apartments and a little like NNN-leased properties. Like apartments, TIC properties tend to be multi-tenant properties, which require active management in order to appropriately operate the property and, hopefully, provide the appreciation expected of an actively managed property. In fact, larger apartment properties are a common and attractive property for TIC syndications.

Like NNN-leased properties, TIC interests are intended to be passive to the investor. The sponsor, acting on behalf of the TIC owners, will operate the property on a day-to-day basis. The big difference is that, unlike most NNN-leased properties, most TIC properties are leased to multiple tenants, so the cash flow is not wholly dependant on the success of one or two giant tenants and the cash flow can be expected to move over time in line with market conditions.

Tenant in common offerings are pre-packaged with all of the pieces put in place by the sponsor. The sponsor buys, or arranges to buy the property. They arrange or obtain the mortgage financing. They prepare the offering documents and arrange for the closing of the property. The investor need only review and fill out subscription documents, complete their due diligence and arrange for their equity to be delivered to escrow.

TIC offerings are structured to accommodate a variety of investors with different amounts of equity. While every offering has a minimum equity amount, an investor can invest any amount over the minimum (up to the maximum offering amount). This allows investors of various sizes to invest in an offering and it

APARTMENT PROPERTIES versus NET-LEASED PROPERTIES versus TENANT IN COMMON INTERESTS [Continued]

allows an investor to divide their equity among two or more offerings, depending on the amount of equity that they have to invest. Any debt placed on the property will be assumed on a pro-rata basis by the TIC investors. Typical debt levels range from 50%-to-70% and are almost always non-recourse to the TIC investors (except for standard recourse carve-outs). Because the debt is built into a TIC offering, TIC interests are priced on a cash-on-cash basis. Current cash-on-cash rates for TIC interests typically range from approximately 6.0% to 7.5%.

TIC interests are clearly not for everyone. While they emulate some of the positive characteristics of both apartment and NNN-leased properties, they probably will not provide all of the benefits of either of those two property types. If an investor wants total control over their real estate, they should probably not invest in a TIC interest. If someone needs a high degree of liquidity, they should probably not invest in a TIC interest. If someone cannot tolerate the risks associated with co-investing with others, they should probably not invest in a TIC interest. However, for a growing number of qualified investors, TIC interests meet their investment needs.

CONCLUSION

We have very briefly outlined the primary differences between apartments, NNN-leased properties and TIC interests. So, how do they stack up?

We would recommend apartments as an investment for someone who wants to control all aspects of their property, wants to maximize the appreciation of their investment and is willing and able to be actively involved in the management and operation of their investment.

We would recommend NNN-leased property for someone who wants a long-term passive investment with many of the characteristics of a bond, but with the advantages of owning real estate. We would caution this investor to carefully consider their ability and willingness to accept the tenant risk and lack of inflation protection.

We would recommend TIC interests to someone who wants a passive investment, wants to preserve capital and to receive a predictable cash flow from their investment, but who does not want the risks sometimes associated with NNN-leased properties. We would caution this investor to very carefully investigate the tax, sponsor and operating risks potentially associated with this form of investment.

CapHarbor has created a tool to allow simple financial comparisons of apartment, NNN-leased and TIC interests. To access this tool online, simply go to: www.capharbor.com/pdf/tool.xls.

CapHarbor is a real estate brokerage company serving the needs of 1031 investors who are seeking passively managed replacement properties (Single-Tenant, NNN-Leased properties by the whole through our real estate licenses and tenant in Common (TIC) interests on a fractional basis for accredited investors through our securities licenses). Visit us at www.capharbor.com or call 877-886-1031 to learn more about our services.

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