



The Turner Top-10 Rules for TIC Investing

Over the past several years TIC real estate has become very popular among 1031 exchange investors, and for good reason. It is one of the few ways a person can own institutional-quality commercial real estate, earn a solid cash flow, and retire from day-to-day property management responsibilities. With all the potential benefits that TIC's provide, it is equally important to understand what can go wrong. As an advisor specializing in TIC transactions, I get the opportunity to review literally hundreds of new offerings. Over the years, I have seen what works and what doesn't. From these experiences, I have developed a list of things to look out for. I call it *The Turner Top 10 Rules for TIC Investing*.

Rule #1 - Avoid situations where a single tenant or a few very large tenants can hurt performance

You should always ask yourself "What would happen if the largest tenant stopped paying rent?" If a tenant occupies half the space in your building, the answer won't be pretty. You could be left holding the bag without enough income to pay the mortgage. The situation could be even worse with a single tenant. I cringe whenever a client suggests investing in a single tenant big box or drugstore chain. Those properties are usually billed as "safe" investments because they lease to national credit tenants, and require little or no management attention. Tell that to the investors with K-mart, Rite-Aid, Warehouse Records, and Montgomery Ward as tenants, all of whom filed for bankruptcy protection and walked away from their lease obligations. The bottom-line is, it's safer to have a property with multiple tenants and staggered leases than one with just a few large tenants.

Rule #2 - If the cash flow is too good to be true, it probably isn't

There is enormous pressure among TIC competitors to attract investors' attention. One way is by offering a high cash flow. This has led to a practice called "financial engineering." There are a few ways that TIC sponsors can tweak offerings to make them look better than they actually are. One way is to over-borrow and supplement the cash flow out of reserves. In essence, investors are being paid back their own money disguised to look like cash flow. Another way is through the use of a master lease. For example, let's say an apartment complex is legitimately generating a 6% cash-on-cash return. By master leasing the property, the TIC sponsor can pay a 7% cash flow, again drawing from reserves. Be careful, some master leases allow the TIC sponsor to keep a majority of the future rent increases rather than passing them on to the owners. Your best bet is to read the pro-forma income statement in the Private Placement Memorandum (PPM). It should project the income, expenses, debt service, and what is actually left over for the investors.

Rule #3 – Don't commit to a TIC offering unless fixed-rate financing is locked in

With all the turmoil in today's lending environment, it is essential that fixed-rate financing be secured before you consider an offering. Variable-rate financing with the intent to convert to a fixed-rate in the future exposes the investors to an unacceptable level of risk.

Rule #4 – Invest with the best

The TIC industry has approximately 65 TIC sponsors that are in the business of acquiring, syndicating, and managing commercial real estate on behalf of TIC investors. The 80/20 rule definitely applies here. A vast majority of all TIC offerings are done by a handful of top sponsors that have the ability to close on the real estate, obtain favorable financing terms, manage the property and properly service the investors. Many of the smaller and newer TIC sponsors compete by promising high cash flow and investment returns, but lack the management experience and service capabilities to deliver on those promises. Before investing, there are a few questions you should ask the TIC sponsor, including:

- How many TIC transactions have you underwritten?
- How many TIC transactions have gone full cycle, and what is your performance record?
- What is the background of your senior management team?
- Do you have any non-performing properties?

Rule #5 – Avoid development deals

Most TIC offerings involve the purchase of stabilized real estate, which is well suited to multiple owners who are mainly interested in predictable cash flow and long-term growth. Development deals may offer the promise of big gains, but there are many things that need to come together in order to make those gains a reality. Development deals in the TIC world face two important challenges. First, the co-owners must approve all major decisions, which can be cumbersome. Second, active participation by the TIC owners could cause the venture to be considered a partnership in the eyes of the IRS. This could jeopardize the TIC's status as like-kind property and trigger capital gains taxes.

Rule #6 – Go where the growth is

This may seem obvious, but investors sometimes focus too much on cash flow, ignoring the fact that a property is located in a slow (or no-growth) market. The prospect for job growth (which in turn translates into market growth) is incredibly important. Remember the three rules of Real estate, location, location, location. In case you haven't noticed, there is a major migration underway toward warm climate states including Arizona, Nevada, Texas, Florida, Georgia, South Carolina and North

Carolina to name a few. Rust-belt states may appear to be a good value, but absent specific job growth “drivers”, rents and property values are unlikely to achieve significant growth.

Rule # 7 – Make sure you don’t overpay

There are things you should check to make sure you are getting a good deal on transaction. First, compare the appraised value of the property to the offering price. If the offering price is significantly higher than the appraised value, it might take a long time to profitably sell the property. It is also an indication that the fees may be too high. Second, compare the offering price to what the TIC sponsor paid for the property. As a rule of thumb, syndication fees (also known as the load) should be about 6% of the property value. When calculating the “load” make sure to back out reserves, which is cash that has been set aside for emergencies.

Rule # 8 – Diversify

You’ve heard the rule “don’t put all your eggs in one basket.” This definitely applies to TIC transactions. We encourage our clients to diversify both geographically and by asset category. There are four major categories of commercial real estate, including office, apartment, retail and industrial. They each have different levels of risk. By investing in different categories and geographic areas, you can actually lower your risk.

Rule #9 – Kick the tires before you buy

I don’t believe in buying real estate sight unseen. Most real estate transactions are big-ticket items. You wouldn’t buy a car before test driving it, so why would you buy real estate without seeing it first. I usually tour a property before recommending it to a client, and I encourage my clients to tour properties before investing in them. Over the years, I have rejected many properties that looked great on paper, but didn’t look quite so good in person.

Rule #10 – Work with an experienced and trustworthy advisor

Most people have a sixth sense when it comes to knowing if an advisor is trustworthy and ethical. Always ask to see the advisor’s bio, and ask for references. A good advisor will ask a lot of questions in order to learn about you and your needs. Make sure your advisor learns what your needs are before recommending anything to you. Above all else, if that little voice in the back of your head tells you that something isn’t quite right, listen to it.