

Cover Story

Maneuvering the Market

Discover how three industry sectors are navigating mixed economic signals.

By Jennifer Norbut, Daniel E. Herrold, Scott K. Lunine, and John Z. Barr, CCIM

"When one door closes, another one opens," said scientist and inventor Alexander Graham Bell. The problem for most of us is what he said next: "Sometimes we stare so long at a door that is closing that we see too late the one that is open."

In a market like today's, it's easy to miss an evolving opportunity. Everyone is focused on the fact that the economy and the credit crisis have slammed the door on commercial real estate transactions, particularly the net-lease and tenancy-in-common investment sectors. In the coming months, the year-end statistics will tell the final tale of a period most commercial real estate professionals would like to forget.

But in the darkness there are a few slivers of light. This year's groundswell of interest in green building, coupled with rising gas prices, has created a buzz about transit-oriented development. While not a new idea, TODs are gaining new respect from investors and brokers as they pave the way for future development in many markets.

And although net lease and TIC are two formerly high-flying segments that have been grounded by the credit crisis, both sectors are expected to pick up speed as the industry regains its strength. A look inside these three trends in different stages of evolution will help CCIMs be ready when opportunity knocks in the year ahead.

TODs Take Off

by Jennifer Norbut

Last year 10.3 billion trips were taken on U.S. public transportation systems — the most rides taken in 50 years, according to the American Public Transportation Association. "People have decided that taking public transportation is the quickest way to beat the high gas prices," says William W. Millar, APTA's president. Skyrocketing fuel costs, clogged highways, and renewed interest in urban living are contributing to what may be the biggest U.S. development trend since the 1950s suburban housing explosion: Transit-oriented development is one of the hottest topics in commercial real estate today.

"The pendulum is swinging from drivable suburban projects to walkable urban projects," said Chris Leinberger, a Brookings Institution visiting fellow and University of Michigan professor, at the International Council of Shopping Centers conference in May. And this shift is occurring for good reasons. Demand for housing adjacent to transit is expected to double by 2025, according to a Center for Transit-Oriented Development study. In addition, households without children — primarily baby boomers and the millennial generation — are a growing demographic in urban centers. In fact, 53 percent of 24- to 34-year-olds want to live in transit-rich, walkable neighborhoods, according to Congress for New Urbanism research.

Emerging TOD Markets

Well-established transit markets such as Washington, D.C., New York, and Chicago pioneered the TOD concept, evolving high-density mixed-use into its own class of commercial real estate. But today's hottest TOD opportunities are emerging in secondary markets, including Charlotte, N.C., Dallas, Denver, and Houston. These growing cities are devoting millions of dollars to light-rail commuter train systems to complement their other public transit options. And, where train lines go, commercial development follows.



Located in the gentrifying Cedars neighborhood in southern Dallas, Cedars Station connects two of the city's light-rail lines with bus service. Photo credit: Dallas Area Rapid Transit

Nancy Bowen Wiggins, CCIM, CIPS, of Nancy Wiggins LLC, in Charlotte, N.C., played an instrumental role as a local planning commissioner for LYNX Charlotte, the area's new light-rail commuter system. "We enacted zoning regulations to make the system possible and allow high-density development surrounding the corridor," Wiggins says. The 9.6-mile line has 15 stops between Charlotte's central business district and Interstate 485. "The success is in the numbers," Wiggins says of

LYNX, which launched late last year and exceeded five-year ridership projections in its first eight months of operation.

Commercial real estate opportunities are popping up all along the LYNX line, even in the most unlikely neighborhoods, Wiggins says. "Properties in dicey areas now sell for substantial sums.... The mixed-use element has been quite significant in making these corridors desirable locations for new development." LYNX's inaugural success has spurred development of two new lines, which are expected to be in service no later than 2010.

TOD opportunities also abound along the Dallas Area Rapid Transit, or DART, system, which serves 13 cities in the Dallas-Fort Worth market. For example, a developer purchased an older apartment complex in Richardson, Texas, when he learned a DART commuter station would be located adjacent to it. The property has been redeveloped into Brick Row, a \$140 million office, retail, and residential mixed-use project. Janice Peters, CCIM, principal of Hudson Peters Commercial in Dallas, assisted the developer in acquiring neighboring properties and currently is leasing Brick Row's office space.



Located in Dallas-Ft. Worth's Telecom Corridor, mixed-use transit-oriented development Brick Row is adjacent to the Spring Valley DART light-rail station. Photo credit: Winston Capital

But Peters' role began much earlier in the process: She attended local planning meetings and supported the city's efforts to rezone the area to allow for TOD. She also assisted in gaining local approval for Brick Row. "I was the liaison who introduced the developer to city officials," she says. Peters also has educated nearby property owners and brokered sales between them and the developer.

With more than five years invested, Peters says Brick Row, which should be completed by fall 2009, has been a complicated project. "The developer has spent many hours and dollars to revise the plans to appease the city council," she adds. These efforts have paid off: The development was the catalyst for a local tax-increment financing district, which is a source of funds for the project.

In Houston, the success of the light-rail system's first section, from downtown to the Texas Medical Center, coupled with high fuel prices "has people thinking public rail transportation can work in Houston after all," says Marshall V. Davidson Jr., CCIM, SIOR, a director at Cushman & Wakefield. The city recently approved a new rail section, the University Line, which will interconnect the Uptown/Galleria area with the existing line. Transportation authority Metro and the project's stakeholders hired EEK Architects to deliver a TOD "vision" at the intersection of the proposed new rail lines, and Cushman & Wakefield is marketing a tract of land that could eventually total more than 58 contiguous acres.

"There aren't enough of these projects planned to make an impact [right now]," Davidson says of TOD activity in the Houston market. "But logic would dictate the price of the dirt will be enhanced by the announcement of the proposed Metro station on the site we are marketing. We look at this opportunity as a singular moment in time when all the stars are aligned for a public-private partnership."

Overcoming Challenges

Financing can be one of the biggest obstacles for TODs, but the path may be getting easier to navigate. Though significant equity generally is required, debt financing is becoming easier to secure for TODs, industry experts say. Public-private partnerships drive many of today's TODs, and these groups can obtain financial leverage with TIF-backed revenue bonds, business improvement districts, federal and state financing programs, foundation grants, tax credits, and other programs.

In 2004, Denver passed a revenue bond measure to fund FasTracks, an area-wide rail-based transit system. Though plagued by cost overruns, commodity price increases, and development controversy, FasTracks' more than 50 planned transit stops are drawing interest from many commercial real estate developers, according to Bill James, CCIM, MAI, president of James Real Estate Services in Denver. For example, Cherokee Denver LLC is redeveloping the former Gates Rubber Co., a 50-acre industrial site along the rail line, into a new mixed-use village. "Though the credit squeeze has constrained transit-oriented development in the market over the short term, opportunities will certainly arise near transit stops in the future," James says.

In Seattle, "public sector-sponsored TOD development is challenging," says Blair Howe, CCIM, a real estate consultant with GVA Kidder Mathews who provides on-call consulting services for the region's two largest transit agencies. Howe helps the agencies in strategic planning, decision making, market analysis, project feasibility, entitlement, developer procurement, and property dispositions for sites located in proximity to transit hubs.

"Seattle is not like Colorado or Texas where land is available as far as the eye can see. Our transit systems are constrained by existing development, topography, and natural barriers," Howe says. These factors, combined with political

considerations, make TOD projects challenging. And due to the complexity of local and state financing mechanisms that "stipulate that the state may not lend its credit to private projects, public-private partnerships are more difficult here than in some markets," he notes. "The transit agency purchases just enough land to build a system and leaves the TOD to the private sector."

Despite their challenges, TODs fill a growing need for affordable, accessible transportation and the related commercial real estate in communities across the country. "The rise of transit villages nationwide is an opportunity for CCIMs to add value for clients," Howe says. "TODs can happen in any market as long as the projects are consistent with local demand and scaled accordingly."

TODs Tomorrow

From reduced traffic congestion to decreased environmental pollution to increased tax revenues, proponents are quick to point out TODs' many benefits. And plenty of research backs up their praise: Properties within a five- to 10- minute walk of transit stations sell for 20 percent to 25 percent more than comparable properties further away, according to a CTOD study. In addition, office rents in TODs run 20 percent higher than market rents in some regions, according to PricewaterhouseCoopers/Urban Land Institute's *Emerging Trends in Real Estate*.

Though zoning hurdles and financing are distinct TOD challenges, an estimated 100 transit villages exist nationwide with approximately 100 more in planning, says Robert Cervero, author of *Transit-Oriented Development in the United States: Experiences, Challenges, and Prospects*. And, patience pays off for developers and investors who can expect to see 20 percent or more return on investment, according to Marilee Utter, president of Citiventure Associates in Denver.

Many experts in both the public and private sectors think TODs are a win-win for everyone — residents, local governments, and private commercial real estate developers alike. "The city gets what it wants, developers and investors get what they want, and the community gets a brand new identity," Utter says.

Triple-Net Stays on Track

by Daniel E. Herrold

While not performing at the torrid pace of the last few years, the net-lease market continues to hold its own in this down phase of the commercial real estate investment cycle. While national commercial real estate transaction volume has dropped 50 percent to 75 percent compared to this time last year, many investors — net lease and otherwise — continue to watch and wait. Buyers who were accustomed to higher loan-to-value ratios, long amortization periods, and interest-only financing now remain on the sidelines because of the difficulty in achieving such attractive financing. Currently, 1031 exchange buyers remain consistently active in the net-lease sector. Even so, their criteria have narrowed and their participation in the market consequently has become much more conditional.

Hot Net-Lease Markets

Many of today's net-lease buyers are leaning toward primary markets with growing fundamentals and strong, dependable economies. Today, it's all about less risk and more stability. Texas, for example, with a growing population, steady employment market, and solid price points, is benefiting from investor interest in Houston, San Antonio, Austin, and Dallas. During the past 24 months, Austin's population grew more than most U.S. markets, and Houston remained one of the nation's strongest employment markets this year, adding 50,000 positions for 1.9 percent job growth.

Regional net-lease transactions reflect these strong fundamentals. For example, a 1031 exchange buyer early this year acquired a 90,000-sf industrial facility in Conroe, Texas, just outside of Houston. The investor sold a Midwestern asset and reinvested the proceeds in an asset in Texas because of the growing and attractive economy. In addition, markets such as Chicago and states such as New York, California, and Florida, with continued population and job growth, are seeing investor interest.

This movement back to quality real estate based on strong fundamentals could significantly reverse a four-year trend in which investors have been equally attracted to secondary and tertiary markets. While the market was on its way up, capitalization rates in secondary markets climbed as much as 100 basis points higher than their primary-market counterparts. But with continued investor demand, the cap rate spread between primary markets and secondary or tertiary markets continued to shrink to the point where it was almost negligible. At the top of the market, the cap rates of tertiary-market properties were similar to properties in primary and secondary markets.

Market readjustments over the last six months have initiated a return of that cap rate spread, resulting in investors and lenders who see less risk in primary- market properties and more risk in smaller markets. This is not to say that secondary markets are without a future, but secondary and tertiary markets may experience a lull in investor activity, at least until sellers realize that they won't be able to achieve prices similar to properties located in stronger real estate markets.



Stan Johnson Co. recently completed a net-lease transaction for one of Covenant Transport's trucking facilities located in Chattanooga, Tenn. Photo credit: Stan Johnson Co.

Sought-After Product Types

For some net-lease investors, equal — and sometimes even greater — importance is given to the tenants' creditworthiness and lease economics as opposed to the underlying real estate fundamentals. Net-lease investors primarily still seek retail product in strong local economies where they can invest in prime, high-traffic properties.

However, smart investors also pay attention to trends. In today's market, this includes growth in sectors such as drugstores, fast-food restaurants, auto-related companies, and sporting goods. As the strength of these sectors has developed, the market frequency of these investment properties also has increased and served to make these types of tenants very steady and attractive to net-lease owners.

Some investors also are leaning toward new niche product types because they see continued growth in these areas. For instance, over the past few years, net-lease medical facilities have been considered a promising sector among both investors and developers. People are living longer today and requesting specialty services beyond their general doctors. Continued growth is expected in this segment.

Keys to Net-Lease Deals

Getting deals done in today's market is not as easy as it has been in past years. Before, brokers could garner attention by marketing properties electronically to the net-lease buyer and brokerage communities. Today, the marketing process to identify ideal buyers takes much longer, and brokers must be creative when marketing their properties to capture motivated buyers' attention. Some tips for maximizing today's market include the following.

- Cash is king, and all-cash buyers are likely to provide the highest probability of a successful close.
- Tax-deferred exchange buyers typically are the most-qualified and motivated to purchase.
- Work with sellers who understand the current commercial real estate environment and are realistic with the prices they expect to achieve.
- Be creative in marketing your clients' properties.

Lending Climate. Additionally, all parties must understand the current lending market and the difficulties buyers face in obtaining financing today. There are fewer sources of money and the underwriting requirements are much tighter. The conduits are all but gone in 2008, with some estimates of only \$12 billion in commercial mortgage-backed securities issuances during the first half of the year — down almost 91 percent from the same point a year ago. Life insurance companies are selective, going after the best properties available, and continue to maintain a conservative approach in terms of deals they are willing to consider.

Overall, the lending climate has returned to pre-2003 levels, with capital sources focusing more on real estate fundamentals as part of their underwriting. Lenders now are underwriting deals with LTV ratios between 60 percent and 70 percent, shortening amortization periods from 30 years to 25 years, and requiring partial or full borrower recourse. Additionally, national, regional, and local banks are becoming more prevalent lending sources for buyers.

The net-lease market should gain strength in conjunction with the rest of the commercial real estate investment market, although it remains to be seen when transaction volumes will return to their 2005–07 levels. At some point, both buyers and sellers will reach a compromise on values, and cap rate spreads will continue to increase among primary, secondary, and tertiary markets. While today's conservative lenders will slowly regain confidence in the investment market, only time will tell if they will regain enough confidence to be as aggressive as they were in the market's most recent heyday.

Time Out for TICs

by Scott K. Lunine and John Z. Barr, CCIM

When the Internal Revenue Service created Revenue Procedure Code 2002-22, it drastically changed the faces of both the 1031 exchange transaction process and the 1031 exchange buyer. In 2002, several economic factors were

in play: Aggressive lending practices allowed for highly leveraged loans at historically low interest rates. Billions of dollars flowed into real estate investments from Wall Street and foreign countries and institutions. Additionally, strong fundamentals bolstered the value of all major property types.

In essence, the tenancy-in-common exchange structure leveled the playing field so small investors could compete alongside institutional buyers in one of the strongest real estate markets in decades. As many long-term investors looked for a way to protect capital gains, the TIC structure created strength in numbers by offering small investors access to the necessary equity to upgrade into higher- quality assets.



Fort Properties' tenancy-in-common portfolio includes the Chase Operations Center in Springfield, Mo., a 268,000-square-foot class A office property that serves as the company's largest U.S. call center. Photo credit: FORT Properties

TIC Investment Declines

2Q08	1Q08	2Q07
\$353 million	\$443 million	\$700 million

2008 TIC investment (through August)	2007 TIC investment (through August)
\$796 million	\$1.6 billion

Source: Omni Brokerage

These factors led to four years of double-digit growth, peaking at more than \$8 billion in 2006 with more than 100 sponsors offering some form of TIC investments. This pent-up demand for properties also resulted in many nontraditional offerings such as student and seniors housing, theatres, oil and gas, hotels/motels, and even unimproved land.

The Credit Squeeze

In July 2007, the TIC industry ran head first into one of the worst credit crises in U.S. history. The subprime debacle led to a severe tightening of credit availability for all investment real estate sectors. Many sponsors no longer were able to acquire properties due to rising capital costs, recourse, increasing spreads, reserve requirements, and lack of ability or desire of financial institutions to extend credit.

In addition, the velocity of 1031 exchanges plummeted by more than 60 percent, severely impacting sponsors' ability to place their properties. This resulted in huge carrying costs due to the mezzanine financing many sponsors preferred. In fact, the average number of days on the market for TIC properties has jumped to more than 150 from approximately 80 in 2007. These factors have created a new perfect storm, resulting in the demise of more than 50 percent of TIC sponsors in the past 18 months.

Additional Concerns

Even as the TIC industry flourished, there were many unanswered questions about issues such as liquidity, proper structure, the possibility of secondary offerings, and the ability to withstand market shifts. Concerns also surfaced about several sponsors' investment decisions. In July, The Wall Street Journal reported on a TIC investment that went awry. A joint venture of CB Richard Ellis Investors and U.S. Advisors acquired a single-tenant property anchored by LeNature, a privately held bottling company.

The tenant deliberately committed fraud by falsifying its financial records and eventually went bankrupt, leaving the property without a tenant. This property should have been a red flag from the start for several reasons: The strength of the tenant was hard to qualify due to the lack of publicly available audited financial information, it was a single-purpose facility that would be difficult to convert in the event of tenant loss, and the purchase price was well above market.

In addition to the LeNature deal, there has been a rapid increase in underperforming properties since 2007, mostly due to

overly optimistic sponsor projections. Some property types have been hit harder than others, specifically retail and those located in tertiary markets.

The master-lease structure presents another concern for TIC investors. Although most master-lease payments are maintained by the sponsor/guarantor, many of these properties are underperforming and co-owners could be left with a property worth substantially less than the acquisition price.

Yet among all this doom and gloom, some TIC sponsors and their properties continue to flourish. Well-capitalized sponsors using conservative underwriting standards and acquiring institutional-quality assets continue to meet projected returns and are able to obtain financing for new offerings.

TICs and the SEC

There are many positive signs that the investment real estate markets will rebound as financing becomes more readily available. In addition, an imminent ruling from the Securities and Exchange Commission may breathe new life into the TIC industry.

Since 2002, most TIC sponsors have structured their offerings as securities by filing their investments under Regulation D with the SEC; however several sponsors have structured their offerings as purely real estate investments avoiding this registration. This has been a source of an ongoing debate since the early days of the TIC industry. However, for the past several years the National Association of Realtors, the SEC, the Financial Industry Regulatory Authority (formerly the National Association of Securities Dealers), and the Tenant-in-Common Association have been working to create an exemption for real estate brokers to receive an advisory/referral fee for referring their 1031 clients to securities brokers. The exemption is anticipated by either fourth-quarter 2008 or early 2009.

After the exemption is in place, it is anticipated that most if not all real estate sponsors will convert to a securitized platform. The exemption will create a huge advantage for investors by providing access to a greater number of available offerings. Instead of going directly to individual sponsors, investors will be able to work through broker/dealers and review all available offerings from multiple sponsors.

The TIC industry will continue to mature and improve in concert with the rebounding market. And, sellers who want to defer capital gains will continue to execute 1031 exchanges. New sources of TIC equity likely will come from self-directed IRAs, Wall Street investors seeking diversification, foreign sources, and greater exposure to investors and brokers from the NAR/SEC exemption.

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