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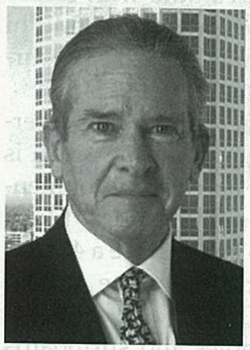
NUMBERS GOT U DOWN?

Navigating challenging times for IRC 1031-1033 buyers.

Sean O'Shea

These are indeed challenging times by any objective review. Net lease practitioners and investors, who have actively participated in the 1031 exchange sector, now face a number of new challenges in the current market:



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• Challenge No. 1: Years 2002 to 2008 must be filed into the professional archive as being nothing but a memory. This requires a paradigm shift.

• Challenge No. 2: The spread between sellers' expectations and buyers' assumptions are about 100 to 250 basis points apart. That makes it tough to come to deal terms as a result.

• Challenge No. 3: The pipeline of 1031 transactions has effectively dried up, with deal flow down between 65 and 80 percent. The presumed buyers of many client properties have been unable to secure acceptable financing themselves, and many reasonably anticipated deals have fallen through.

The full implications of the unavailability of debt sourcing are in stark contrast to the recent past, and the sustained period of unprecedented low interest rates is now viewed in its proper historical context. This is an awkward period of adjustment for all concerned. The recession debate is officially over and so are the halcyon days for the net lease sector, TICs and other apparent 1031 exchange solutions.

For years, experts have tried to make a responsible case for investment-grade, credit-tenant, net-leased assets as a valid niche of the net lease marketplace. They are not sexy; they do not afford high cap rates as many have demanded higher yields; and they often have flat rent streams. Well, in this brave, new, post-credit crunch net lease world is found a new, more sobering atmosphere — this risk-averse asset class has a whole new cache. They can still be financed and their income streams are more stable and predictable than their high-flying recent competition in the net-leased investment marketplace. They represent a verifiable flight to quality in this market.

For 1031 exchange buyers, another challenge even when a sale closes escrow is matching the debt ratio from the relinquished property, often in excess of 70 percent, with available debt of the proposed replacement property (in the range of 50 to 65 percent) since debt, when available, is currently being underwritten with very different loan-to-value standards. There is only one asset class or niche in the NNN market that solves this problem for investors.

There are, in fact, net leased assets in this market that afford a 1031 exchange buyer a non-recourse mortgage with a loan-to-value ratio of between 85 to 89 percent based on the credit worthiness of the investment-grade credit tenant and the corporate guarantee of all tenant obligations, as previously underwritten by major financial institutions. As a result, they are easily assumable in a streamlined loan assumption process. This is rare, indeed, but a timely solution to the dilemma of matching debt in a current 1031 exchange. The exchange can be completed and capital gains liability can be deferred in a cost-effective and timely manner.

This net lease niche is worth exploring as a replacement solution for IRC 1031-1033 buyers. These assets can also serve as a profound solution in a commercial foreclosure situation, utilizing a high-leverage transaction when an investor is: (1) losing his property; (2) losing his equity; and (3) receiving a tax bill for "cancellation of debt" and "recapture of depreciation" — a triple whammy! A new service, aptly named ForecloseWithEase.com, provides a pre-foreclosure strategy incorporating a 1031 reverse exchange in commercial foreclosure situations using these investment grade credit tenant assets to defer the cancellation of debt and recapture of depreciation. Check out this asset class.

Sean O'Shea is managing director of BRC Advisors' Net Lease Investment Group.