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1031 EXCHANGES

MAY 2021 SPECIAL REPORT

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A closer look at 1031 Exchanges

Insights, trends and possible changes on the horizon

By Steve Bergsman

Looking at the amount of money raised annually by the 1031 exchange market over the past 20 years, it's a classic roller-coaster of high peaks and low valleys (see chart, page 4). In 2002, only $357 million was raised. A mere four years later, in 2006, a new record was set at $3.7 billion, which was immediately followed by a slow decline into the financial crisis of 2008 and a trough extending from 2009 to 2015. Afterward, the market rocketed forward once again, totaling more than $3 billion raised in 2019 and 2020.

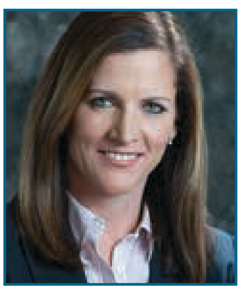
The question, then, is when the next big decline begins — in all rollercoaster rides, the peak is followed by the screamingly fast plummet. The answer, however, depends on the overarching real estate market, which, so far, still looks solid. Indeed, the 1031 exchange market is expected to reach a new apex this year at more than $4 billion raised. According to Taylor Garrett of Mountain Dell Consulting, first quarter 2021 was unofficially a billion-dollar quarter. He adds, "When you put $5 billion into the economy and interest rates are at a historical low, no one knows what will happen."

TAYLOR GARRETT,
President, Orchard Securities,
Managing Partner,
Mountain Dell Consulting

The 1031 exchange market has been ablaze. Capital Square 1031 experienced its best year in 2020, acquiring more than $1 billion worth of properties for Delaware statutory trust (DST) deals. That pushed it close to $3 billion under

LOUIS ROGERS,
CEO and Founder,
Capital Square

JOSH HOFFMAN,
President,
Bluerock Value Exchange



JILL MOZER,
Managing Director,
National Sales Director,
Black Creek Group

LARRY SULLIVAN,
President and COO,
The Passco Companies

management in DSTs. Mountain Dell ranked Capital Square as the third-largest player in the 1031 market, but Louis Rogers, CEO and founder of Capital Square, says the company is having its best first quarter and may move to No. 2.

The market comprises about 40 sponsors of 1031 programs today, but the top seven companies control close to 70 percent of the market. No major institutional finance companies, such as Blackrock or Morgan Stanley, are in the business, mostly because it's a vastly different game, with the 1031s marketed through independent broker-dealers and registered investment advisers (RIAs). Nevertheless, the number of sponsors is expected to grow this year.

"For decades, we have heard about how investment banks and private equity firms would be getting into the business, but the independent broker-dealer space is very specialized and much more oriented to retail investors, the typical accredited investor — $1 million net worth or $200,000/$300,000 income with spouse — not the ultra-wealthy," says Rogers. "The sponsors value their relationships with the independent broker-dealers and registered investment advisers, and emphasize programs for retail investors. Other firms are getting into the 1031 space, and those entities are typically real estate companies that already sponsor REITs or funds."

Record sale prices for real estate are driving the market, explains Rogers. "Real estate owners can sell their investments for record prices. Cash is seeking real estate, which is driving the price up. The price being paid, generally, across the country is higher, and the volume of sales is greater, than in prior years."

Nonprofessional property investors, after years of ownership, eventually arrive at a fork in the road. They want to monetize their hard assets, but they don't want to pay taxes on the profits. The mainstream solution is the 1031 exchange. Coming out of the Great Recession, the DST became the preferred tax-deferral structure because it was more flexible, pooled multiple assets into one vehicle, allowed a larger number of investors, and management of the asset went to the sponsor.

The main reasons why the DST is the preferred structure for investors, says Josh Hoffman, president of Bluerock Value Exchange, are: (1) It's a passive investment with an institutional company managing the program; (2) all debt is nonrecourse; (3) there are no on-going liabilities; and (4) it requires a low minimum investment. If investors sold a duplex or a corner commercial lot for less than $1 million, for example, they could diversify into multiple DST programs with sector and geographic diversification.

"Growth is returning as our economy reopens," observes Jill Mozer, managing director at Black Creek Group. "The housing market has fared well, with owners of single-family and multifamily properties taking advantage of favorable pricing and deciding to sell. Additionally, many people who are approaching retirement, or who are already retired, are seeing this as a good time to sell their rental and investment properties to get into more passive and institutional-quality properties. This trend will continue through 2021. Expect strong growth in 1031 exchange transactions, and specifically into securitized DST 1031 offerings."

The oldest segment of the 1031 business was the baby boomer, who might have owned a duplex, four-plex or triple-net retail space and wanted to move into a more passive investment. With the baby boomers aging, however, the business is attracting their children, who don't want to manage their dad's real estate and would prefer a more passive investment. Finally, an emerging third player in the market is institutional-type investors, including everything from family offices to real estate investment trusts.

In 2020, of all the 1031 offerings, 161 were DSTs, compared with 21 tenancy-in-common, and one direct title and LLC. To break it down even more, 123 of the offerings were registered as 506(b) and 47 as 506(c). That trend line is not going to change in the near term, but what happens in the far future is hazy.

Both 506(b) and (c) programs target the accredited investor, but a 506(b) is a private placement, meaning an individual must work through an independent broker-dealer or a registered investment adviser. The 506(c) allows for general solicitation, where the sponsor can actively advertise to the general public. That could remove the input of financial advisers and leave investors to do their own due diligence.

"So, the 506(c) has a growth paradigm that comes off new capital conduits, like online sourcing," explains Larry Sullivan, president of the

Passco Companies. "The (b) is a more traditional line of access with broker-dealers and registered reps. Both have their avenues and stables of people who support one or the other, or both."

Companies such as Inland Private Capital Corp., one of the pioneers in the securitized 1031 exchange market, continue to favor 506(b). Indeed, Inland continues to transact in the 506(b) market mostly because it benefits from having the largest network of broker-dealers and registered investment advisers to distribute its products, says Keith Lampi, president and COO of Inland.

"From Inland's perspective, of course, it would be advantageous to broadly market our offerings, but when I think about the regulatory burden of 506(c), and the push back we could receive as a result, the cost of 506(c) ultimately outweighs the benefit from a marketability perspective," explains Lampi. "506(c) offerings allow an issuer to broadly solicit accredited investors, without the need for a pre-existing relationship, and to generally advertise a private offering, but requires the issuer to take reasonable steps to verify investors' accreditation, which can be much more onerous to the issuer.

"If an issuer directly solicits investors, the issuer could be subject to greater liability since the usual guardrails of a broker-dealer or RIA relationship are missing," he continues, "and investor protections, which are built into the rules governing broker-dealers and RIAs, also are gone. In summary, the effects on the issuer are the opening up of new sources of capital but at a greater risk, in addition to the political alienation of business partners."

Lampi predicts newer market entrants that do not have established track records or access to market-wide distribution may consider 506(c) as an alternative.

KEITH LAMPI,
President and COO,
Inland Private Capital Corp.

1031 MARKET & MARKET SHARE

December 31, 2020

Inland Private Capital Corp.	19%	Four Springs TEN31 XCHG	1%
ExchangeRight Real Estate	12%	Nelson Partners	1%
Capital Square Realty Advisors	11%	Cunat Inc.	1%
Black Creek Group	8%	Griffin Capital	1%
Passco Companies	7%	CAI Investments	1%
Cantor Fitzgerald Investors	5%	Time Equities	1%
NexPoint Real Estate Advisors	5%	NB Private Capital	1%
Madison Capital Group	3%	Resource Royalty	1%
RK Properties	3%	Starboard Realty Advisors	1%
BlueRock Real Estate	3%	CORE Pacific Advisor	1%
Carter Exchange	2%	1031 CF Properties	<1%
Kingsbarn Realty Trust	2%	Real Estate Value Advisors	<1%
Livingston Street Capital	2%	Hartman Income Management	<1%
AEI Trust Advisors	2%	Inspired Healthcare Capital	<1%
Net Lease Capital Advisors	1%	Moody National Companies	<1%
Valeo Group Americas	1%	Croatan Investments	<1%
Flatirons Asset Management	1%	Senior Living Fund	<1%
Platform Ventures	1%	InCommercial Property Group	<1%
Syndicated Equities Group	1%	American Capital Group	<1%
Trilogy Real Estate Group	1%	Arrimus Capital Partners	<1%

It all might change, depending on what happens in Washington, D.C., over the next four years. As Sullivan observes, the 506(c) has been "driving down a nice road with continued growth," but the ultimate outcome of which one will be stronger or bigger "is still up in the air."

In general, full-cycle DSTs were valued above $1 billion in 2020, and it is expected another $1 billion will come to full cycle in 2021. Most of those investors will roll over their investments into a new DST because they did so well with the prior investment.

"There has been a significant amount of full-cycle DST programs where investors realized 8 percent or 9 percent average return on the low end, and double-digit percentage on the high end," says Hoffman. Bluerock, for example, took a program full cycle in February of this year. The 300-plus-unit, class A multifamily property, located in an Atlanta suburb, was bought for $84 million in December 2016 and sold for $100.5 million a little more than four years later. The appreciation was about 18 percent but, combined with distribution, investors received a 44 percent total return, or an 11 percent annualized return. Bluerock data showed 80 percent of those investors will roll into a subsequent exchange, mostly with the same sponsor: Bluerock.

In general, how a deal performs correlates to the percentage of people who reinvest. It is safe to assume the higher the internal rate of return on a deal, the higher percentage of investors that will reinvest in a subsequent DST program. Inland, for example, recently sold a suburban

1031 MARKET
Since 2002

YEAR	EQUITY (MILLIONS)	NUMBER OF ACTIVE PROGRAMS	NUMBER OF SPONSORS WHO RAISED EQUITY
2002	$356.60	45	14
2003	$756.00	84	21
2004	$1,770.00	141	39
2005	$3,210.00	306	57
2006	$3,650.00	341	71
2007	$2,830.00	261	64
2008	$1,293.00	149	50
2009	$228.80	43	28
2010	$169.80	21	13
2011	$227.60	31	10
2012	$277.80	21	8
2013	$427.10	45	12
2014	$731.45	47	16
2015	$1,074.57	105	25
2016	$1,438.64	113	29
2017	$1,947.49	126	30
2018	$2,479.89	139	38
2019	$3,486.19	171	38
2020	$3,192.32	170	40

Indianapolis apartment building for a "substantial profit" compared with the price investors paid going in. As a result, investors made a considerable amount of money upon sale.

"A majority of those investors are considering Inland DST products as an investment alternative as they work toward completing a subsequent 1031 exchange," says Lampi.

> *"It all might change, depending on what happens in Washingont D.C., over the next four years."*

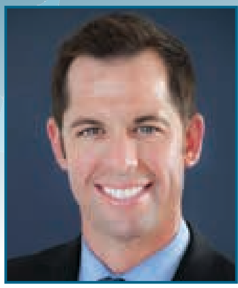
It also helps to have some name-brand product or be in a market with cache. Cantor Fitzgerald expects approximately 80 percent of its investors to roll into a new Cantor DST offering after the conclusion of a prior 1031 exchange program. In January, the company acquired an Amazon.com facility for a DST with a total offering price of $86.2 million. The $37.3 million equity was oversubscribed in four days, with more than $60 million in backups.

Over at Passco, the number of investors exiting existing programs and continuing in a new Passco program has escalated in the past two or three years, with rollovers jumping from 50 percent to 70 percent in some deals.

"Everyone has benefited from a strong bull run, and the assets Passco is bringing to market were bought just four to seven years ago," says Sullivan.

Another reason for the strong trend line for securitized 1031 alternatives: Investment options have increased. A couple of DST sponsors that have entered the market offer the investor a different exit by exchanging the beneficial interest in the DST for units in a REIT operating partnership (a tax-deferred I.R.C. Section 721 exchange). Ideally, the operating

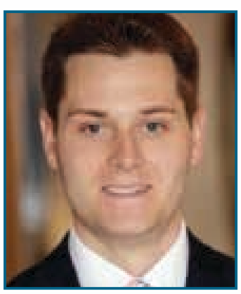
partnership owns a large diversified portfolio of real estate with greater optionality around subsequent liquidity.



JAY FRANK,
COO,
Cantor Fitzgerald

This exchange combination was pioneered in 2012, when Griffin Capital Company bought a healthcare property in Nashville that it rolled into a securitized DST program. Once the transaction was seasoned over two to four years, the operating partnership retained a one-time option to swap the beneficial interest in the DST for operating partnership units of Griffin Capital Essential Asset REIT through a 721 exchange, swapping a real property interest for a security interest — in this case, the operating partnership unit in a REIT that now has approximately $5.8 billion of office and industrial assets. Griffin Capital anticipates launching similarly structured offerings in 2021.

The 721 exchange is gaining popularity as a tax-deferral strategy, in part due to concerns the Biden administration will modify, restrict or end the 1031 exchange. "The 721 is rarely talked about in the context of legislative changes," notes Jay Frank, COO with Cantor Fitzgerald. If the rules are changed, an investor who owns a property or a DST interest might not be able to complete another real estate exchange once the asset is sold; however, an investor may be able to complete a 721 exchange into a diversified portfolio via an UPREIT that can be held in perpetuity.



ALEXANDER ANDERSON,
Director, Equity Division,
Time Equities Inc.

The original structure of 1031 exchanges, the tenancy-in-common (TIC), has not disappeared. One big company that still offers customized TICs is Time Equities Inc (TEI). TEI has been around for more than 50 years, and many of its generational investors are high-net-worth individuals seeking diversification and durable cashflow distribution. In 2020, with COVID prevalent, TEI was able to identify and acquire for TIC investors three apartment buildings and one office complex that collectively required more than $60 million. Each of the capital raises took place toward the end of fourth quarter 2020 and into first quarter 2021, with one deal closing at the end of 2020 and the rest during first quarter 2021.

According to Alexander Anderson, director of the equity department at TEI, the company targets properties that can generate growing distribution to investors, commencing at 5 percent to 6 percent per annum, depending on the property type. Time Equities is planning on more TIC programs this year, in addition to unveiling its first DST program.

In 2020, the average first-year cash-on-cash return for the DST industry was 5.17 percent, reports Mountain Dell. That may not be the case this year, despite the fact many investors are absolutely yield crazy.

"The DST business prioritizes capital preservation first and yield second," explains Frank. "We try to educate people that you don't want to be chasing yield right now. If you do, you might not like what the value of that type of asset will be in five to seven years."

More than likely, if someone wants to get above 5 percent yield, the asset in the DST will be something other than multifamily, such as retail, hotels or student housing, and the geography will be in a tertiary market or consist of older inventory. Most of the assets on the market that are selling quickly — from 50 to 100 days — are showing initial yields in the 4 percent to 5 percent range.

"Anything showing greater yield was probably bought late last year or early in 2021," says Frank. Cantor Fitzgerald will launch two big multifamily DSTs, valued at $100 million, a class A+ development in Fort Collins, Colo., and class A- in Washington, D.C. As leveraged yields for high-quality products in good markets are in the low- to mid-4 percent range, that's where these Cantor DSTs will start out, as well.

"As a result of increasing interest rates and rising real estate valuations, on a cap-rate basis, we are likely to see average rates of return continue to compress in the coming months," adds Lampi. "A lower income profile does not necessarily translate to a lesser-quality investment — return is relative to the other investment options an investor might consider on a risk-adjusted basis. If history is any indicator of total return performance, there is virtue in buying higher-quality, conservatively underwritten properties in well-located areas at a lower return profile."

Here's the quandary the DST market is facing at the moment: Interest rates are gliding north, which normally means capitalization rates will do the same. That has yet to happen. If cap rates don't move up as interest rates do, it becomes more difficult to underwrite real estate to drive the kind of leveraged cash-on-cash return usually delivered to the market. It used to be, back in the TIC heyday of 2006–2007, investors sought a leveraged 7 percent cash-on-cash return with a tolerance for 75 percent leverage. Since the market came back from the great financial crisis, it is less accepting of leverage risk, such that loan-to-value ratios have come down to inside 55 percent and, as a result, average leveraged cash-on-cash yields have come in closer to 5.0 percent to 5.5 percent, depending upon the asset class.

"Clearly as leverage ratios decline and interest rates increase, while cap rates remain sticky, cash-on-cash returns will decline," says Kevin Shields, chairman and CEO of Griffin Capital Company. "Unless cap rates expand to respond to increasing interest rates, we will start to test the lower limits of investors' yield tolerance. DST investors generally have had a tendency to focus on yield. I hope sponsors are not, therefore, tempted to reach for yield by acquiring lower-quality assets or property located in tertiary markets, where exit liquidity may be challenged."

The lowest first-year yield of any major asset class in a DST is multifamily, which hit 5.02 percent, but that is partly due to the fact it is by far the most popular property type for DSTs. Some sponsors only create multifamily DSTs or multifamily with one other safer play, such as triple-net-lease retail.

"What it comes down to is multifamily offers the best risk-adjusted returns," says Hoffman. "With multifamily, a higher percentage of revenue hits the bottom line. Also with multifamily, there are no leasing expenses, tenant improvements, etc. Some investors see it as a defensive play. Housing is essential, and over the past decade, the country has seen a very robust demand for housing, whether single-family or multifamily."

KEVIN SHIELDS,
Chairman and CEO,
Griffin Capital Company

EQUITY RAISE BY ASSET TYPE

December 31, 2020

ASSET TYPE	AMOUNT RAISED	% OF TOTAL
Multifamily	$1,631,804,533	51.12%
Retail	$499,345,121	15.64%
Self Storage	$231,629,374	7.26%
Industrial	$207,343,669	6.50%
Office	$159,138,262	4.99%
Senior Housing	$139,360,285	4.37%
Medical Office	$115,390,266	3.61%
Hospitality	$87,453,386	2.74%
Student Housing	$69,703,027	2.18%
Other	$32,600,000	1.02%
Energy (O&G)	$18,556,068	0.58%
TOTAL	$3,192,323,991	100.00%

"Over many time horizons, multifamily has been the highest-performing asset class among the big five — multifamily, office, industrial, retail and hotels — and it has done so with the lowest volatility," says Sullivan.

In 2020, 51.12 percent of the equity raised went to multifamily, reports Mountain Dell. Structurally, that's because many 1031 investors and DST sponsors know and are comfortable with multifamily real estate. Furthermore, financing was more readily available for multifamily DSTs coming out of the 2008 recession. The rents for the asset class typically exhibit a lower level of declines and higher level of post-recession growth, compared with other commercial real estate classes.

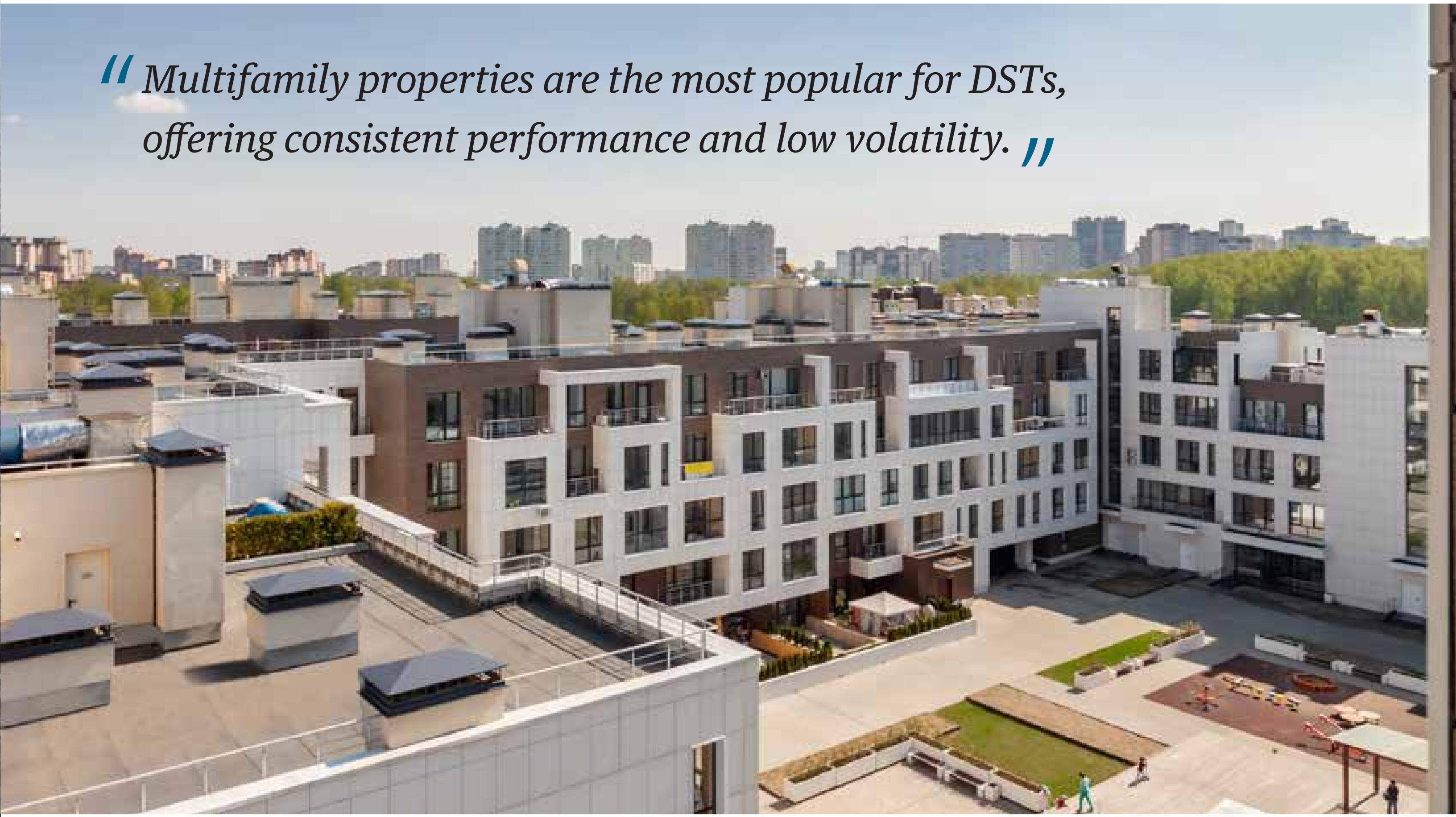
"We are seeing rent growth, particularly in suburban markets, to be the biggest value driver for the multifamily sector," says Mozer.

What happened during the year of COVID? Over at Capital Square, it reported rent collection was at 99 percent for all of 2020 and first quarter 2021.

Cantor, which primarily focuses on multifamily and net-lease properties in its DST business, reports it collected 100 percent of rents within its net-lease portfolio in 2020. On the multifamily side, Cantor's COVID strategy focused on helping residents remain in their homes while the pandemic created economic and employment uncertainty. This strategy resulted in downward pressure on property cashflows, caused primarily by lower rents, which were partially offset by higher occupancy. On the positive side, real estate asset values increased over the past 12 months for certain asset classes, including multifamily and industrial, as investors sought the relative strength of these sectors during the pandemic.

Despite the dominance of multifamily, the 1031 market achieved a great deal of diversification in 2020, with considerable investment going into retail, self-storage and industrial, and to a lesser extent senior housing and medical office. The ability to diversify is one of the key features of DSTs, which have a very low minimum investment amount, making it possible for investors to diversify into a portfolio of DST replacement properties to reduce concentration risk.

"Multifamily properties are the most popular for DSTs, offering consistent performance and low volatility."



Capital Square's portfolio, for example, includes multifamily, industrial and medical office. Adventuresome investors have also put money in hospitality, student housing, and even oil-and-gas industry real estate.

It has been suggested one of the reasons 1031 exchanges will hit record levels this year is concern President Biden will increase taxes or go after the 1031 exchange as the Trump administration did, leading investors to be more intent on consummating a 1031 exchange while it is still possible.

As to whether 1031s could be addressed as part of 2021 or 2022 tax reform or budget reconciliation, Sullivan notes, "there is really nowhere in print that says the Biden/Harris administration is officially planning to eliminate the 1031. There are references, however, in the Biden policy proposals to address childcare, education and elder care for costs to be paid for by rolling back tax breaks for real estate investors with incomes over $400,000. Tax breaks mentioned have included 1031s, among others."

In response, the industry is keeping its guard up, and being pro-active in regard to contacting, lobbying and educating lawmakers on the economic role 1031s play and their importance to constituencies, including seniors. ■

Steve Bergsman is a freelance writer based in Mesa, Ariz.

Personnel

INLAND

Inland
Private Capital Corporation

Leader in Securitized 1031 Exchange Transactions*

- Approximately $9 Billion in Assets Under Management
- Offered More Than $738 Million in Equity in 2020 Across 11 Offerings
- Raised Approximately $700 Million in Capital in 2020
- 748 Properties in 43 States

For more information, please visit inlandprivatecapital.com or call 888-671-1031.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