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2022 Outlook on the 1031 exchange market

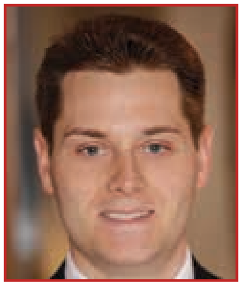
By Beth Mattson-Teig

A frenzy of real estate sales propelled demand for 1031 like-kind exchanges last year, and the 1031 market is poised for another strong year ahead in 2022.

Commercial and multifamily sales combined reached a record $808.7 billion last year, well ahead of the pre-pandemic total and previous high watermark of nearly $600 billion achieved in 2019, according to Real Capital Analytics. Although that surge was felt across the 1031 marketplace, industry data from Mountain Dell Consulting shows that equity flows into the securitized 1031 market more than doubled, jumping from $3.2 billion in 2020 to $7.4 billion in 2021 (see table on page 4). "As good of a year as 2020 was, there was still a lot of pent-up demand from dislocation caused by the pandemic that propelled sales activity in 2021," says **Keith Lampi,** director and COO of Inland Private Capital Corporation. Interest rates remained incredibly low, which also helped to lubricate the wheels of the buy-sell market last year, adds Lampi.

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

Many industry participants are seeing that momentum carry over into early 2022. "It's too early to say that



ALEXANDER ANDERSON,
Director,
Time Equities

WARREN THOMAS,
Managing Partner,
ExchangeRight

ADRIANA OLSEN,
Senior Vice President, Marketing
Passco Companies

2022 is going to surpass 2021 levels by any drastic measures, but I do think we are on pace as an industry to really have another solid year," notes Lampi.

Time Equities Inc. completed about $115 million in 1031 exchange-related transactions last year. During the first six weeks of 2022, the company closed on another $50 million in transactions across four properties. Time Equities provides investment opportunities for 1031 exchange investors in tenant-in-common (TIC) investment structures, as well as assisting investors who are acquiring wholly owned like-kind replacement properties to execute their exchange. "I can see us possibly doubling our 2021 numbers this year and being over $200 million," notes **Alex Anderson,** director, equity division at Time Equities. "Our challenge is the ability to keep up with demand."

Time Equities isn't the only firm working to keep up with demand. ExchangeRight is bringing out a new net-leased portfolio DST about every 45 days. However, current demand is about triple what the company can produce, according to **Warren Thomas,** managing partner of ExchangeRight. "I think that demand is going to continue as long as those yields look attractive," he says. ExchangeRight raised a total of $673 million across its net-leased and value-add DSTs, preferred equity offerings, and REIT offerings in 2021, representing 27 percent growth from 2020 and the company's best year on record. The company anticipates that capital inflows could increase another 30 percent in 2022. "I think the DST industry is poised to have another banner year this year if we don't see significant interest rate increases," adds Thomas.

Tailwinds for 1031 exchanges

A variety of factors are spurring activity across the 1031 exchange marketplace. Early in 2021, there were a lot of tax-motivated sellers who were concerned about proposed tax reforms that could severely limit 1031 exchanges, as well as potential increases to the capital gains tax rate and changes to estate taxes. State tax law changes also drove some selling. For example, California's new Prop 19 that went into effect in 2021 eliminated the state's historically low property tax basis and dramatically changed the economics of holding a property. "Once that was lost, that drove some of the sales in California from owners that wouldn't have sold otherwise," says Thomas.

Demographics have been another important driver behind 1031 exchanges with aging baby boomers that are selling properties as they transition to retirement or semiretirement. For example, the average age of investors coming to ExchangeRight's DST platform is between 70 and 72. "We're definitely in that retiree market, and they're looking for yield," says Thomas. Over the past five-year period, ExchangeRight's net-leased DST offerings have produced average annual investor distributions of 6.70 percent, exceeding projections during that time frame. Rising interest rates have put pressure on investor returns, which are now around 5.50–5.75 percent, which is still attractive relative to other types of investments, notes Thomas.

Demographics are playing a big role in rising equity inflows as aging baby boomers are looking to exit actively managed properties and transition to more passive investments and fixed-income assets as they move into retirement or semiretirement, agrees Lampi. "The concept of passive ownership has historically anchored our industry and will continue to do so," he says.

Property owners also remain highly incentivized by current market pricing to sell and realize gains. Commercial property prices have reached new highs in almost every property type. Real Capital Analytics' CPPI National All-Property Index for December jumped 22.9 percent year-over-year for all property types. Industrial saw the biggest one-year change with prices rising 29.2 percent, followed by multifamily at 23.6 percent.

"We expect another robust year in the DST channel for a variety of reasons," says **Adriana Olsen,** senior vice president, marketing for

Passco Companies. "Investors are still taking advantage of the seller's market and are selling assets now that they may have otherwise held on to. Or, they recognized, even more so during COVID, that they really no longer want the management headaches that come with managing their own assets. In addition, at least for Passco, we are always evaluating opportunities within our portfolio to exit at a profit, reinvest the proceeds in a newer asset and reset the loan clock. So, we expect to see a fair amount of cyclical equity in 2022 as well."

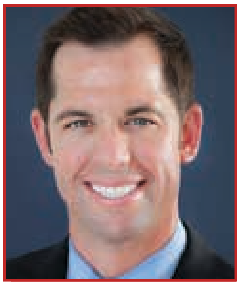
DST market continues to mature

Despite the surge in DST volume in 2021, the securitized 1031 market has been on an upward trend since 2015, regaining and exceeding volumes achieved prior to the global financial crisis. According to Mountain Dell Consulting, the industry hit a pre-GFC peak in 2006 of $3.65 billion in equity raised (see table on page 4). Volume once again climbed above $3 billion in 2019 with $3.49 billion in equity raised and only dipped slightly during 2020 to $3.19 billion.

"Over the last five years there has been a consistent march to new highs," says **Jay Frank,** chief operating officer at Cantor Fitzgerald Investment Management. There is a confluence of factors that have been driving DST growth over the past several years. In addition to the strong property valuations and aging baby boomers that are transitioning to passive investments that generate income, other key reasons are growing awareness around DSTs and further expansion of the wirehouse channel.

"In my opinion, the adoption of 1031s in the wirehouse channel is a primary driver of the momentum that we're seeing, and one of the reasons that I'm bullish on the continued growth of this space going forward," notes Frank. Some wirehouses have adopted the 721 UPREIT option, which has led to RIAs, and also the larger independent broker/dealers, having to offer these solutions in order to compete and provide options to their clients, he explains. (An UPREIT is a REIT structure that allows property owners to exchange their property for share ownership in the UPREIT.) The 721 UPREIT is not right for every investor, but increasing awareness is certainly contributing to the overall growth in the DST space, he adds.

In addition, the $7.4 billion in capital flows into DSTs last year is a "drop in the bucket" compared to the broader 1031 exchange market, adds Frank. "One of the bigger themes is there has been a 20-year educational process with financial advisers, CPAs, attorneys and, ultimately, with real estate owners, many of whom are learning about DSTs for the first time," he says. "We are in the early innings of DSTs being something that a majority of the real estate–owning population even knows about, and 721s are even further behind."



JAY FRANK,
Chief Operating Officer, Cantor Fitzgerald Investment Management

Where is capital flowing?

Multifamily continues to represent the dominant property type within the securitized 1031 industry. According to Mountain Dell Consulting, multifamily accounted for 48.9 percent of the equity raised in 2021, followed distantly by industrial at 17.9 percent and retail at 13.3 percent (see graph on page 12). One reason multifamily remains a consistent favorite is simple familiarity. Many property owners are selling out of a rental property, whether that is a single-family home, duplex, condo or a small apartment building. Multifamily also held up well during the global financial crisis and has continued to be a top performer over the past decade, recording strong occupancies and rent growth.

Bluerock Value Exchange focuses on class A apartment projects in high-growth areas of the Sun Belt, in states such as Florida, Texas and the Carolinas. "We are still very bullish in that sector. We think there are long-term systemic tailwinds that will drive investor capital into those sectors and deliver solid risk-adjusted returns," says **Josh Hoffman,** president of Bluerock Value Exchange. Bluerock also plans to venture into the industrial sector this year.

JOSH HOFFMAN,
President,
Bluerock Value Exchange

The main driver for DSTs for the majority of investors is stability of cash flow. "We invest in sectors that are going to maintain high occupancy levels, have the ability to generate year-over-year rent growth that will be able to sustain attractive income levels over a five- to seven-year hold period," says Hoffman. "Multifamily and industrial properties provide the best opportunities to do so in the current market."

Inland Private Capital is one sponsor that offers a broad menu of alternatives across property types such as multifamily, self-storage, student housing, retail and net-lease assets. "We never want to be beholden to one investment strategy because we know that as the market evolves, we want to put ourselves in a position to be nimble and evolve with a forward-looking mindset and interact with sectors that make good long-term sense at that point in time," says Lampi.

That being said, multifamily is still a top sector for Inland Private Capital, and Lampi believes there is opportunity for NOI growth with heightened demand from renters that will continue to push occupancies and rent growth. Another sector within multifamily that Inland Private Capital finds attractive is build-to-rent single-family rentals, where current demand is outstripping supply. These are purpose-built rental communities that offer individual single-family homes on sprawling acreage with shared community amenities, such as pools, clubhouses and fitness centers.

Self-storage also remains a big focus for Inland Private Capital. "Every time we bring a self-storage product to market, our investor base is incredibly active and interested in allocating a portion of their capital to that sector," says Lampi. "That interest stems from many of the same factors driving interest in multifamily. Storage owners have the ability to evolve with the market and push rental rates on a regular basis and increase value by virtue of their property management expertise, which really resonates with the broader investment community given the current inflationary environment."

Exploring oil & gas strategies

High valuations in the commercial real estate sector are incentivizing some investors to look at reinvesting gains outside of real estate into direct title investments in the oil & gas sector. Specifically, the two types of oil & gas investments that are eligible for 1031 exchanges are deed and title for mineral rights and working interest. Mineral rights typically generate royalties from extracting or mining of the mineral reserves. Deed and title for a working interest is akin to buying cash flow on production.

Although oil & gas interests qualify as real property that are eligible for Section 1031 like-kind exchanges, it is a unique asset class. Investors like oil & gas because it is a great diversifier, notes **Matthew Iak**, executive vice president at U.S. Energy Development Corporation. Typically, oil & gas interests offer a slightly higher risk-adjusted yield compared with many property types, albeit with less

1031 Securitized Market

YEAR	EQUITY RAISED ($M)	NO. OF ACTIVE PROGRAMS	NO. OF SPONSORS WITH ACTIVE OFFERINGS
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
2021	$7,400.01	265	42

Source: Mountain Dell Consulting

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upside appreciation on the exit. Oil & gas also has tax properties that allow it to generate a more tax-efficient yield as investors can get up to 15 percent of gross income tax free. Another factor that drives investor interest in oil & gas from 1031 exchangers is the arbitrage between the two markets. Currently, property values are relatively high, while energy is coming off a cyclical low and moving higher, notes Iak.

MATTHEW IAK,
Executive Vice President, U.S. Energy Development Corporation

The main challenge for investors is that it can be a tough market to move into. Whereas DSTs saw nearly $7.5 billion in capital inflows from 1031s, oil & gas captured a relatively tiny amount of inflows from 1031 exchanges, at less than $50 million, estimates Iak. A big reason why is it can be very hard to find investment opportunities. "We have so much demand and very little product," he says. Investors are likely to find more investing opportunities in 2022 as rising oil prices motivate some existing owners to sell. However, investors also need to move cautiously as those opportunities do come with a little more price risk, he adds.

Adjusting return expectations

Although industry participants are bullish on the outlook for the 1031 investment marketplace in 2022, there are some potential challenges ahead. Capital crowding into the real estate investment market has put downward pressure on cap rates, while interest rates have moved higher ahead of Fed rate increases expected in 2022. "That is certainly squeezing the spread and cash flow to investors," says Hoffman. In some cases, investors have had to lower expectations on yield. In multifamily, for example, "A" properties in top locations are generating yields or initial cap rates ranging between 3.5 percent and 4.0 percent.

"We do expect robust rent growth in the multifamily space, and that is supported by forecasts

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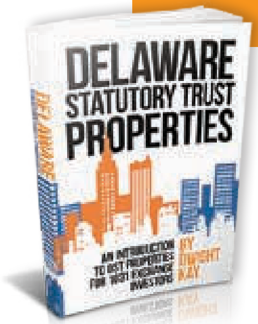

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Will tax reform risk linger?

Across the commercial real estate industry, there was a collective sigh of relief last fall when word spread that 1031 exchanges were no longer on the chopping block for potential tax reform. Nonetheless, the industry is keeping its foot on the gas when it comes to advocating for the preservation of 1031 like-kind exchanges.

So far, 1031 exchanges have proved to be fairly resilient to proposed tax changes. The latest threat came from President Biden's proposal to cap Section 1031 like-kind exchange treatments to gains of $500,000 per individual and $1 million per couple as a means to help generate revenue to support his administration's "Build Back Better" infrastructure plan. According to information released last fall by the House Committee on Ways and Means, it doesn't appear that Section 1031 exchanges are currently on the list of proposed tax provisions being considered.

The risks that were very heightened in 2021 appear to have subsided with the failure to move Build Back Better legislation forward, notes Adriana Olsen, senior vice president, marketing for Passco Companies. Although some members of Congress appear steadfast in not wanting to pursue a bigger package, there remains a window for a series of smaller bills to move along that might include tax reform, she says. "There's no rest for the weary in continuing to track what's going on up on the Hill as we move closer to election 2022," she says. "In reality, there's probably only another two or three months to see what may emerge. The new Supreme Court justice and the need for another continuing resolution on the budget will suck air from any movement to break BBB apart."

Despite its now 100-year history, 1031 exchanges have been on the chopping block in the past, and it could be the target of tax reform by future administrations. "Last year was a critical year because it really highlighted how important the 1031 exchange rule is. There were a lot of studies and analysis done that related to the trickle-down effect it has on the economy and other professional businesses as a whole if it were to be removed," says Alex Anderson, director, equity division at Time Equities Inc. "That information is something that will be kept available for a very long time to come, and it would be a big part of the conversation if limitations to 1031 exchanges were to come up again."

Whenever talk of tax reform occurs, it does drive some investors to sell property and do a 1031 exchange to get in front of potential changes. "We definitely saw a lot of panic around end of 2021 deadlines," says Anderson. People were focused on the idea that if they didn't complete their exchange or sell their property within the 2021 calendar year, then there could be a potential look-back or challenge to the exchange, he says. "That definitely drove a lot of decisions to sell properties and expedite an exchange." However, what used to be a daily conversation in 2021 has largely disappeared in 2022, he adds.

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from research analytics firms, which should provide increasing year-over-year yields to those investors over the next couple of years," says Hoffman. "So, from an income perspective, we think multifamily is still a good asset class to be in. From an appreciation and value perspective standpoint, with long-term drivers for demand, investors couldn't pick a better asset class to be in even where asset prices are at today."

However, cap rate compression could drive some investors to seek higher yielding investment opportunities. "People are yield starved, and they're coming to us because they're looking for a higher cash flow," says Anderson. Time Equities follows a value investing strategy with a focus on buying properties with current cash flow and upside potential that can be achieved through lease-up, raising below-market rents or some type of repositioning. "As a value buyer,

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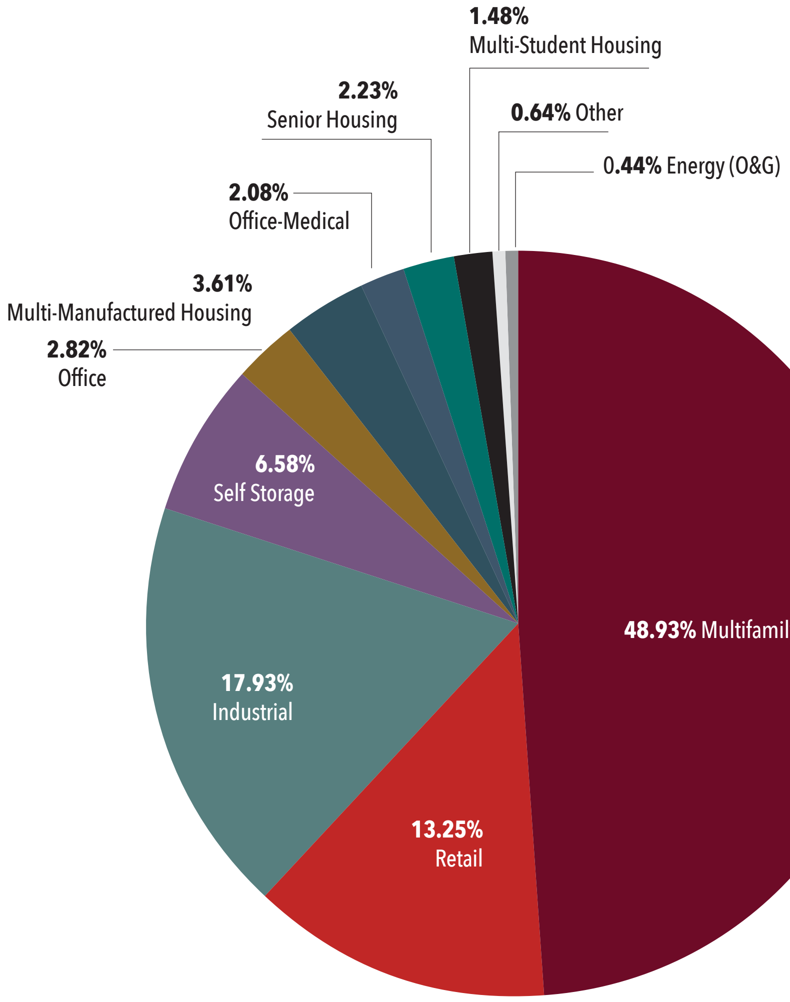
Sales by asset type

Q4 2021/Year-end



Source: Mountain Dell Consulting

we're driven more toward contrarian assets," notes Anderson. For example, the company recently completed the acquisition of a student housing property in Johnson City, Tenn., near East Tennessee State University. Time Equities purchased the 132-unit/528-bed property for $17.75 million or an unlevered cap rate of 5.73 percent.

Investors and financial advisers do need to be cautious at this stage of the commercial real estate market where many sectors are approaching what could be peak pricing. "From 2001 to 2008, we saw trends of products being formed that didn't have economic substance, but they would sell out. I'm a bit fearful that we are in this type of frenzied environment," notes Thomas. "There are some sponsors bringing out DSTs at very low cap rates that should have more of a risk premium. When you begin to see that, it never ends well. So, advisers and broker/dealers have to be extremely careful, which is tough because there is such demand," he says. "On the positive side, there is maturing of the industry and good sponsors that are getting even better."

Beth Mattson-Teig is a freelance writer based in Delano, Minn.

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