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The State of the East Bay Investment Income Real Estate Market

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Featured Listings



Federal Express, Columbus, GA – Single Tenant, Net Leased Investment, new 10 year lease, 6.80% Cap rate, 15 acre lot. **\$4,950,000**



1930 Channing Way, Berkeley – 24 Apartment Units, swimming pool, automated parking and entry gates, carport parking and storage for every unit, onsite laundry, separate meters for gas and electricity, **\$3,500,000**

For more properties see *Kilpatrick & Co. Listings* and also visit us online at www.KilpatrickandCompany.com

An Introduction to NNN Leased Investments

There is a lot of buzz about the surging popularity of the 1031 tax-deferred exchange and “net leased” investments. If executed properly, the 1031 exchange allows an investor to defer all capital gains on the sale of an investment property if the investor purchases another investment property within a relatively short period of time. But what can you do if you no longer want to be involved in real estate management? “Net leased” investments are the single most popular exchange option for people wishing to avoid management responsibilities while receiving secure, stable, and sizable cash flows. I will visit some of the basics of what investors need to look at to evaluate these opportunities.

When it comes to net leased investments, return, location, tenant strength, building quality, and the lease are the most important factors to evaluate. If any one of those aspects is truly lacking it can be enough to sour the whole investment, but there is almost always some give and take between them.

Return is generally measured as a cap rate (capitalization rate). This is simply the net income divided by the purchase price. Depending on which part of the country the property is in, who the tenant is, and how many years are left on the lease, cap rates will generally be between 5% and 8% for most secure investments.

While net lease investment marketing materials tend to emphasize the tenant strength and return, location is still very important, just as in any real estate purchase. Income levels and other demographics, surrounding competitive tenants, overall barriers to entry, and development levels are all good indications of where the real estate market is headed long term in the location you’re evaluating. They also help you assess whether you could replace the tenant if necessary.

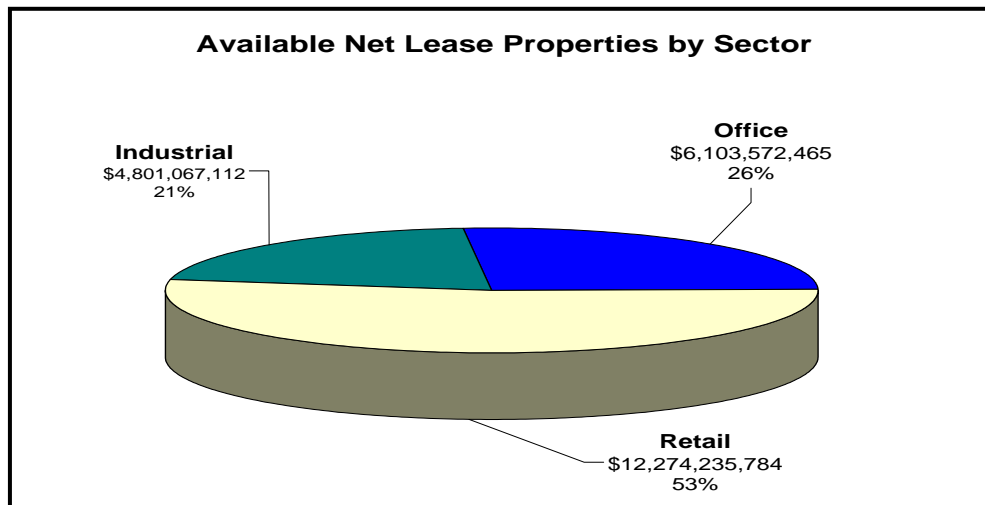
Ideally you will not have to replace the tenant. Most net leased investments have a strong tenant on a 10 to 20 year lease. This makes tenant strength extremely important, because if a tenant goes completely insolvent and declares bankruptcy they may walk away from their lease, leaving you with a vacant building instead of the 20 years of rent you expected! Standard & Poor’s is a company that rates the long-term financial viability of various public companies and assigns them a credit rating. For a non-public company, if they will release their audited financial statements, you can come up with your own opinion with your accountant or financial advisor’s help. You should also look at their industry sector and their business model, along with whether they operate in 100 locations or 2. Companies such as Dunn & Bradstreet will help you evaluate the financial strength of a private company for a nominal fee.

Evaluating the building is important. Even with new construction, any plans you can get your hands on will help, but physically looking at the building is essential. For example, if you hate the way a particular fast food restaurant looks, perhaps people won’t eat there, it might be more difficult to lease, and it might be more difficult for you to sell in the future. Many lenders will require a Phase 1 Environmental study. This gives you a pretty comprehensive report of any environmental contamination risks. With new construction, a survey and as-built plans are extremely helpful and sometimes required by the lender as well. While not common, you should still hire a professional inspector if you feel that the building may have construction defects or other problems.

One of the most important parts of a Net leased investment is the lease. This is often a 20-80 page document. It is the only roadmap you have to detail the 10-20 year tenant-landlord relationship you are about to enter! If the lease says very clearly that the tenant is responsible for everything—that’s great. If it says you are responsible for gutters, drains, HVAC, roof, structure, parking lot striping, and insurance, then you are. It is common and acceptable for a “net lease” to include landlord responsibilities for certain items, but you should understand that up front and not have it come as an unpleasant surprise should something go wrong. You should read your lease word for word, and consider hiring an attorney to read it and discuss it with you to make sure it says what you think it says.

This article is a general introduction to net leased investments only. Net leased investment loans are very different from other loans, and there are other complex issues to consider. If you are contemplating buying or selling a net leased property, do your research, consult appropriate professionals, and don’t skimp on the time, energy, and money needed to make an educated decision.

Summary of Vital Statistics



Source: The Boulder Group

Q3 2006		
Sector	Mean Cap	Change*
Industrial	8.10%	+10
Retail	7.20%	+10
Office	7.90%	+20
*Change in basis points		

Source: The Boulder Group

Q: “I’ve been hearing a lot about investing in TIC’s – what in the world are these? Are they safe, and are they right for me?”

A: Over the past two years, I’ve been hearing this question more and more often. It seems hardly a week goes by without my clients being invited to a Tenants-in-Common (or TICs) seminar or receiving literature in the mail. Tenants-in-Common is technically just a way of holding title to a piece of real property, just like being on title as joint-tenants or holding title as community property. However, when people speak about TIC’s, they’re generally referring to one of two things. One is partial ownership of a typically smaller multi-family building where the TIC owners act as if they owned individual condominium units. An example is a 3 unit building where 3 people buy it as tenants in common with the intention of moving into all 3 units. Generally, they’ll need an operating agreement detailing what their responsibilities to each other are and what amount of the pro-rated expenses they’ll each be responsible for. The other major investment vehicle involving TIC ownership is that of large investment opportunities generally targeting exchange buyers. This latter form of group investment has been surging in popularity and is a rapidly increasing method of benefiting from the ownership of a portion of a larger investment while avoiding most, if not all, of the management headache.

There are many major TIC sponsors but the structures are usually quite similar. The general idea is that there are economies of scale in purchasing larger investments. Most TIC investments are usually in the \$10-\$30 million range. Most are out of state where cap rates (returns) are higher. Conversely, a disproportionate share of TIC buyers are from California and other areas where returns on investment are very low. A TIC offering can be an apartment complex, office building, retail center, etc, and similar to regular individually owned investment property and the return varies inversely with the risk. In many cases, these transactions are put together and coordinated by 3rd party “Sponsors” for due diligence. The advantage to having a 3rd party is for their unbiased outlook on the transaction. Further, this is a great way to shift the burden of liability for due diligence to the outside 3rd party. You should still research the real estate just like you would if you were buying it on your own, but also evaluate the sponsor’s reputation and track record.

Q: “Is it possible, or even legal, to do a 1031 exchange into a TIC? What are some possible disadvantages I might face?”

A: While there are aspects of a 1031 exchange involving a TIC that can be risky and illegal, if the proper procedures are followed, the technique is specifically sanctioned by the IRS. In fact, the IRS published Revenue Procedure 2002-22 which outlines how to correctly structure a TIC offering to individual 1031 Exchange investors. Sponsors generally look to that guidance publication specifically to make sure that they conform.

By definition, a TIC is multiple investors, generally 2 to 35. This can be problematic since the structure of a TIC can require “ultra-majority” voting for major decisions, and certainly if the worst case scenario occurs where major problems arise, the number of co-investors can be a challenge. Each investor should have their own LLC which then owns their share of the TIC, thus shielding them from their co-investors and vice versa. This lack of control can be problematic for some – TICs are not the solution for everyone. As the popularity of this investment vehicle has grown, offerings have sprung up everywhere. They should be carefully reviewed and their sponsor’s history should be fully considered. If you do your careful due diligence and consult appropriate professionals, you may find that a TIC could be a valuable addition to the diversification of your portfolio.

Triple Net Lease Case Study Before

Sale of Downleg(s)



Pre-Sale Cash Flow: \$64,500



Pre-sale Cash Flow: \$42,000

Combined Pre-sale Cash Flow: \$106,500

After

Purchase of Upleg(s)

Purchased for \$4,250,000
Guaranteed by FedEx Corp.



New Cash Flow: \$157,162

Purchased for \$1,050,000
Guaranteed by Carroll's Corp.



New Cash Flow: \$35,678



Purchased for \$1,000,000
Guaranteed by Carroll's Corp.

New Cash Flow: \$43,678

End of Exchange Cash Flow is more than
doubled: \$236,518

Kilpatrick & Company Listings

On Market...



3570 Pacheco Boulevard, Martinez, 10 Units, excellent cash flow opportunity, minutes from freeways 4 & 680, upgraded and remodeled units, lots of

upside potential, Separate meters for gas, electricity **\$1,095,000**



2029 Central Avenue, Alameda, Large 10,350 square foot lot, 6 studios, 2 ones, high ceilings, and terrific views, ideal restoration project, strong upside

in rents and appreciation, **\$1,200,000**



6 Divisible Vacant Land Parcels, Lodi, M-2 zoning, can build commercial, retail, and industrial units, good visibility, all utilities on site, one block from downtown redevelopment area, **\$1,650,000**



4901-4905 Telegraph Ave, Oakland, 18 unit rooming house, 2 retail spaces, 2 office spaces, retail spaces rented by Bigum's Silver Lion Bar & Tanjia

Restaurant, close to Temescal Plaza & upscale condos, **\$1,100,000**

In Contract...



Berkeley office investment, 19,500 rentable square feet, significant upside with redevelopment, holding income in place, low maintenance asset, strong rental demand, **\$4,600,000**



1433 Spruce Street, Berkeley, 8 apartment units in North Berkeley, well maintained apartments, attractive patio garden landscaping, convenient to "Gourmet Ghetto" restaurants, shopping and transportation, **\$1,275,000**



6446 Colby Street, Oakland, 9 Apartment units - includes 1 non-conforming cottage, Victorian style units, Rockridge area, **\$1,250,000**

Sold...



16160 Marcella Street, San Leandro, condominium map in place, separate meters, parking and storage for each unit, located near 580, 5.23% cap, **\$2,850,000**



20957 Chester St., Castro Valley– 12 Unit, very well maintained building in Castro Valley, no Rent Control, possible condo conversion. **\$2,190,000**



Federal Express, Macon, GA, new 10 year lease with national credit, 11.33 acre lot, 6.85% cap, **\$3,822,482**



5609 College Ave., Oakland, A++ location in upscale Rockridge neighborhood, easy access to Rockridge BART, 16 GRM, **\$2,350,000**