exchange QUARTERLY

Q3/14

1031 EXCHANGES
DELAWARE STATUTORY TRUST
TENANT IN COMMON
ENERGY
NON-TRADED REITS
SELF-STORAGE
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RETAIL
SECONDARY MARKET
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721 UPREIT
LIMITED PARTNERSHIPS
OFFICE
SECURITIES
MULTI-FAMILY
SENIOR HOUSING
DIRECT PARTICIPATION PROGRAMS

HISTORY RHYMES

Taylor Garrett
Partner, Managing Director
Mountain Dell Consulting, LLC

MARK TWAIN ONCE SAID, "HISTORY DOESN'T REPEAT ITSELF, BUT IT DOES RHYME."

When I read this quote a number of years ago, I do not think that I fully understood it's significance. After experiencing the "Great Recession" and the difficulties that were experienced by owners of commercial real estate and those of us involved in the securities industry, and now participating in the recovery, I am beginning to appreciate the wisdom behind Twain's comment. Although there are certainly differences between our industry today and the industry from early last decade, there are some distinct similarities that I believe are indicators as to what might happen in the future.

In one way or another, our company has been gathering information on the securitized 1031 exchange market for over a decade. By doing this, we have been able to gather a plethora of market intelligence through statistics, data, and market feedback. As we have reviewed this information, we have seen some interesting trends this time around. For example, in 2007 over 40% of equity raised was placed into multi-tenant office properties. Another 25% was in multi-tenant retail, hospitality, and industrial properties. Today, very little is being raised in any of those asset types. The pie charts you see on page six illustrates that, today, 47% of the securitized 1031 equity is going towards retail properties (particularly those that have a long-term, triple-net lease). Additionally, 41% of the equity raised is currently directed towards multi-family properties. This marks a significant shift in market appetite.

Much of this change comes from the preference for Delaware Statutory Trust (DST), rather than the tenant-in-common (TIC) structure. The article by Mike Bendix of DFPG Investments, Inc. entitled, *Happy Birthday, DST*, and the article by Darryl Steinhause of DLA Piper, *Delaware Statutory Trusts and CMBS 2.0: What Lenders Don't Know Can Hurt You*, provide important information regarding the potential benefits of DSTs and risks that may adversely impact them. Scott Smith, of FactRight, LLC, has authored our third article, *Adventures in 1031 Due Diligence*, which focuses on certain aspects of sponsor level due diligence that may be important to broker-dealers, registered representatives, and investors.

It is an exciting time to be involved in the securitized 1031 exchange market. Over the next several months, key questions impacting our industry are likely to be answered. We look forward to seeing whether or not the market will become interested in the multi-tenant office and retail properties that were such a substantial part of the equity raised during the mid-2000s, or if 1031 demand continue to be met largely by two asset types. Will senior living, self-storage, and other asset types continue to find increased market acceptance? What will sponsors and their attorneys do to continue to structure innovative and compliant offerings? Only time will provide the answers to these questions.

What we already know is that the amount of equity, and the velocity with which it is being raised, continues to increase. After reviewing our statistics, we anticipate that 2014 will be comparable to 2003, when $756 million of equity was raised. While that is a significant increase to what has been raised over the past five years, it still only represents 20% of the $3.65 billion of equity that was raised in 2006.

In this inaugural edition of the *Exchange Quarterly*, we have tried to outline important aspects of how today's industry is similar to, yet different from, the TIC industry of several years ago. We trust that the articles provided by these experts will provide you with important insights into DSTs, meaningful due diligence, and the current iteration of our securitized 1031 exchange marketplace. Indeed, the rhyming has already begun.

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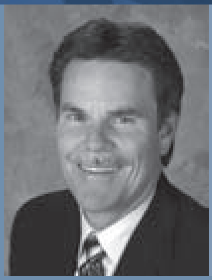

HAPPY BIRTHDAY, DST

Mike Bendix
CEO
DFPG Investments, Inc.

THIS PAST JULY MARKED TEN YEARS SINCE THE TREASURY DEPARTMENT AND INTERNAL REVENUE SERVICE (IRS) ISSUED REVENUE RULING 2004-86 WHICH CONCLUDED THAT MULTI-OWNER INTERESTS IN DELAWARE STATUTORY TRUSTS (DST) "MAY BE QUALIFYING PROPERTY IN A TAX-DEFERRED LIKE-KIND EXCHANGE" IF THE OTHER REQUIREMENTS FOR SUCH TREATMENT ARE SATISFIED.

Although beneficial interests in the DST are treated as securities under federal securities law, they are treated as ownership of real estate by the IRS under Section 1031 of the Internal Revenue Code. In the decade since this important ruling, DSTs have become the preferred structure for undivided fractional ownership in real estate for sponsors, lenders and investors. This 10-year anniversary is a great time to review the benefits, particularly as compared to tenant in common (TIC) ownership which was the only realistic option for fractional ownership prior to 2004.

Perhaps the most important advantage of the DST is that the DST is a separate legal entity, owning 100% of the fee interest in the real estate while the investors receive a beneficial interest in the DST. Lenders prefer to make a loan to this single borrower rather than to multiple TIC owners which generally results in more favorable financing terms. In addition, the individual investors are spared the time and expense of providing the tax returns, financial statements and credit reports which are normally required for loan approval.

OTHER ADVANTAGES OF THE DST

No LLC—Unlike offerings structured as TICs, there is no need to set up a single-member LLC for each investor. The fractional owners receive a beneficial interest in the DST which is bankruptcy-remote and are, therefore, spared the formation costs and annual fees of an LLC.

Trustee Makes Decisions—Important decisions, such as when the property is to be sold, are made by the trustee. DST beneficial interest holders have the right to receive distributions but have no voice in the operation or disposition of the property. This eliminates the concern over a rogue "holdout" investor that plagued many TIC offerings because of the requirement for unanimous consent on all major decisions.

"Bad Boy" Carve-Outs—Investors have no individual liability beyond its original capital contribution as it relates to the property and is not required to sign any environmental indemnifications or guarantees. This feature is equally appealing to lenders as they need only to look to the sponsors with respect to carve-outs from the non-recourse provisions in the note.

Number of Investors—The IRS imposes no limit on the number of investors in a DST. This provides significant advantages over the TIC structure which limited the number of investors to 35. Sponsors are able to accept smaller minimum investment sizes and offer larger properties within the DST. These smaller minimums allow exchangers to allocate their exchange equity over multiple offerings, allowing diversification in property type, geography and sponsor. In addition, a variety

of in-place leverage options enables the 1031 investor greater flexibility to fully satisfy his debt replacement requirement without increasing the debt unnecessarily.

1031 Exchange and Real Estate—The IRS' treatment of DST interests as real estate means that the owners of the beneficial interests may perform another tax deferred exchange of their pro-rata ownership interests when the property is sold. The investors also enjoy most other real estate-related tax advantages such as depreciation and a stepped-up basis to their heirs.

Ruling vs. Procedure—TIC sponsors structured their offerings based on a set of guidelines from Revenue Procedure 2002-22 in an effort to avoid partnership treatment. Under Revenue Ruling 2004-86, on the other hand, the IRS blessed a structure employing a specific entity, the Delaware Statutory Trust.

General Considerations—DST ownership is designed for investors seeking tax deferral, passive ownership of high-quality replacement property(s), prepackaged in-place financing, and professional management. The DST can also be used as a reliable backup to an investor's list of identified replacement properties or for investing the "remainder equity" from the relinquished property sale. The latter can occur if not all exchange funds (or debt) have been utilized for full tax deferral or if the exchanger is unable to complete other identified replacement transactions for financing or other reasons.

Despite these positive characteristics of DSTs, this is not to imply that they are without risk or complications. Revenue Ruling 2004-86 created a list of limitations on the powers of the trustee. These guidelines prohibit the trust from negotiating new loans or refinancing, limit future capital contributions and restrict negotiation of new or current leases. These lease restrictions are most often addressed by the use of a master lease to ensure new tenant leases can be negotiated and executed.

Violations of one of these provisions could require the DST to convert to a limited liability company, commonly referred to as a "Springing LLC." The danger is that such a conversion may be treated as a partnership for federal income tax purposes which would eliminate the investors' ability to perform a tax free exchange upon the ultimate sale of the real estate. A possible solution would be to convert back to a DST once the problem which triggered the Springing LLC has been corrected but this concept is largely untested.

DSTs are not right for every property, and will not be a suitable investment for every investor. They are, however, an excellent alternative for investors who are seeking to benefit from what DSTs have to offer, and are comfortable with the risks associated with them.

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DELAWARE STATUTORY TRUSTS AND CMBS 2.0

What Lenders Don't Know Can Hurt You

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AS THE COMMERCIAL MORTGAGE-BACKED SECURITIES (CMBS) MARKET IS RECOVERING, LENDERS AND THE B-PIECE BUYERS OF THE LOANS ARE CREATING A NEW WORLD IN LENDING.

While tenant in common transactions are slowly making their way back into the market, many lenders are grappling with the Delaware Statutory Trust (DST) borrower, particularly in transactions where the property is subject to a master lease with the sponsor. The terms of the financing can have a significant impact on both the operations and the tax treatment of the DST. Full and accurate disclosures regarding the terms of the loan obtained by the DST are important for broker-dealers and investors so that they can understand the tax and business ramifications of the loan before making an investment decision. In many cases sponsors and their counsel fail to include specific discussions of these items in the offering documents and the tax opinions.

1. Respecting the Master Tenant's Separateness. The DST may enter into a master lease with an affiliate of the sponsor. The master tenant will be responsible for operating the property, including entering into subleases with the user-tenants of the property. The master tenant will typically have the right to all operating revenue assigned to it and will hold cash reserves necessary to pay for repairs, replacements and other operational requirements for the property. In addition, in some cases such as assisted living facilities or hospitality properties, the master tenant will own significant personal property and operational licenses. While the DST owns the real estate, it does not own any of the items held by the master tenant. For federal income tax purposes the master lease must be considered a true lease and the master tenant cannot be in a partnership with the DST. If there is not a true lease or the master tenant and the DST are considered to be in a partnership, the acquisition of DST interests will not qualify as real estate for purposes of a Section 1031 exchange.

A. The most significant issue is that the Master Tenant cannot be a co-borrower under the loan. If the master tenant is a co-borrower under the loan it is unlikely that the DST will qualify for a Section 1031 exchange.

B. A related issue is whether the assets of the master tenant can be used as collateral for the loan obtained by the DST or can be used to pay the loan. Lenders want to obtain access to assets of the master tenant (i.e. the subleases, any third party contracts, licenses, personal property, etc.) so that in the event of a foreclosure, the lender will be in possession of all of the items necessary to operate the property. In addition, certain lenders also want the master tenant to pledge its assets for the DST loan. If there is a pledge by the master tenant of its assets to the DST lender, it is likely that the direct pledge would cause the beneficial interests in the DST not to qualify as real estate for purposes of Section 1031. An alternative structure that should work from a tax perspective is a "back-to-back" pledge. First, the master tenant pledges its assets to the DST as security only for its obligations under the master lease (i.e. the payment of rent). Then, the DST pledges the master tenant pledge to the lender. Thus, if there is a problem at the property and the lender is pursuing a foreclosure of the real estate, it will also foreclose on the back-to-back pledges and can therefore gain access to the master tenant's assets but only to the extent of a default under the master lease.

C. The third issue is the desire for lenders to terminate the master lease upon an event of default under the loan. Many loan defaults relate back to property operations and the payment of rent required by the master lease. If the master tenant has failed to comply with the terms of the master lease, it will be in default of the master lease and the master lease can be terminated. However, if an event of default under the loan has occurred with no corresponding default of the master lease, should the master lease be terminated? Certainly, a

third party tenant would never agree that their lease would terminate if their landlord defaulted under the landlord's loan. It is unclear how the IRS would view this right in context of a true lease analysis. Although it is a negative factor in the determination, the termination right should not, by itself, be enough to cause the beneficial interests in the DST not to qualify as real estate for purposes of Section 1031. However, if a termination right is required by the lender, it should be disclosed both from a tax standpoint and from an investment standpoint.

2. Springing to an LLC. Because DSTs are limited with respect to their ability to take most actions, the trust agreements provide that the DST has the right to convert to a limited liability company (the "Springing LLC") in certain circumstances. Lenders view the right to spring in a somewhat schizophrenic manner.

A. In some cases, lenders attempt to place restrictions around the DST's right to spring. Limitations on the DST's right to transfer the property to the Springing LLC can result in the inability of the DST to take action necessary to save the property, including accepting additional capital. If the lender blocks the transfer, the property could be lost; even if there is substantial equity. Thus, it is important that loan documents allow the transfer to the Springing LLC without restriction.

B. Other lenders want to require the DST to spring at the lender's discretion. This can also cause significant problems for the DST. Lenders (and B-piece buyers) seem to be operating from an erroneous assumption – they believe that they cannot pursue their typical remedies if their borrower is a DST. The problem is that this belief is not correct. The lender has the right to take all actions that it could have taken if the borrower were a limited liability company or partnership, including foreclosing on the property. This may prevent a DST from restructuring the loan while remaining a statutory trust. Further, a lender can force the DST borrower to convert to a Springing LLC immediately prior to a foreclosure, which will cause the investors to recognize any built-in gain upon the foreclosure of the property because they will not have the ability to complete a Section 1031 exchange after the conversion. It is frustrating for sponsors to have the lender attempt to force a DST to spring in the loan documents when there is no benefit for the lender. While lenders cannot articulate a legal reason to require the spring, the usual answer is "the B-piece buyer requires it". Thus, the forced spring is merely punitive in nature.

C. Some lenders are also attempting to force the Delaware trustee into making the decision regarding the conversion to the Springing LLC. A decision to spring is best made by a person that has the investor's interest in mind and understands the operations of the property. Thus, the sponsor, as manager of the DST, is likely to be in the best position to make the decision. Attempts by lenders to usurp this power result in the decision being made by persons with interests that are not aligned with the investors. Does anyone really believe that a Delaware trustee or a loan servicer will know if and when the DST should spring?

The terms of the DST's financing can be important in determining whether there are any potential concerns from a tax standpoint and from an operational standpoint. Broker-dealers should be aware of the importance of these issues and review the offering disclosure and the tax opinion to make sure that there is a thorough description of the terms of the loan and the business and tax impact.

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ADVENTURES IN 1031 DUE DILIGENCE

Scott Smith
President and CEO
FactRight, LLC

I RECENTLY HEARD A NUGGET OF WISDOM FROM A BUSINESS PARTNER IN A MEETING WHEN HE SAID, "EXPERIENCE IS THE COMB LIFE GIVES YOU AFTER YOU'VE LOST ALL YOUR HAIR."

While it's a graphic metaphor, those who participated in the 1031 tenant-in-common (TIC) business prior to the recession may identify with the message. It has applicability in the area of due diligence as well. Due diligence isn't snapshot of an offering or a sponsor company at any given time. If we are doing it right, we are always reviewing a particular offering in light of all that we've seen in the past. We are never standing still. We come into a due diligence review from a previous review, and will carry the present review into the future.

Under the new Delaware Statutory Trust (DST) structures, 1031 syndications are resurging, and understandably so. As in the past, they offer 1031 real estate investors a relatively easy solution to the pressures created by time limits in the exchange. When you're on the clock, costs are often measured in terms of time. Proper due diligence takes time, even when the product is issued by a well-known sponsor firm. Improving analysis while decreasing the time it takes perform adequate reviews represents a constant opportunity for the due diligence community.

In this inaugural issue of *Exchange Quarterly*, I'd like to focus on an important due diligence issue that is always a priority, but has special relevance as more sponsor firms enter the 1031 DST market—sponsor financial due diligence.

SPONSOR-FINANCIAL DUE DILIGENCE

As with most of our work in private, Regulation D (Reg. D) offerings, the foundations of our analysis start with FINRA Regulatory Notice 10-22 (NTM 10-22), which depends heavily, in turn, on the antifraud provisions of the federal securities laws. The anti-fraud provisions impose a duty on broker dealers that recommend a security to conduct a reasonable investigation on the security and the issuers' representations about it. How much investigation constitutes a "reasonable" investigation is a function of circumstances. Some courts, however, have recognized that a more thorough investigation is required for securities issues by smaller companies of recent origin, particularly those that are non-reporting under the Securities Exchange Act.

Broker dealers often turn to third party due diligence companies not only to verify facts and figures, but to perform analysis that's too costly to perform in-house. Sponsor analysis is a great example of work that's best done by third parties. Most broker dealers have the capabilities to visit a sponsor's office, collect documents, and ask questions of the sponsor's management and directors. The real story, however, is the one told by tying together legal, organizational and operational information with information presented in the corporate financial statements. A sophisticated analyst will then examine what management says in light of what the financial statements say about the company. All of this can be intensive work that's best done by third party providers.

The first order of business in any review of a product sponsor is to answer a question that's more complex than it seems: Who is the sponsor of this product? FINRA Rule 2310 defines a "sponsor" as a person or legal entity who directly or indirectly provides management services for a direct participation program whether as a general partner, pursuant to contract, or otherwise. As the rule suggests, and as is often the case, more than one entity can combine to form a collective that sponsors a product. This is especially true of organizations that sponsor Reg. D offerings. The entity listed in a private placement memorandum as the sponsor is often a newly formed entity.

These newly formed sponsor-entities, like most other entities formed by these smaller firms, are supported by other entities owned by the firm. In borrowing a phrase used by parents, it usually takes a village to support a Reg. D offering.
Based on FINRA guidance, we can begin to better understand the ultimate purpose of due diligence on sponsors of Reg. D offerings. If sponsors are more like networks of different entities or people rather one sole company, then we're most concerned about how these networks are interrelated and how they support one another. Legal documents establish the relationships between entities that make up an organization. The financial statements verify those relationships, and the best statements that verify the relationships are audited statements. This is why we've heard an increasing call for audited statements at the sponsor level. Audited statements don't just present financial information in a consistent format, such as GAAP, but they also include disclosures in the form of notes to the financial statements so that the narrative of the story matches what has been gleaned from discussions with management, review of documents, and actual observations. Without audited financial statements and their accompanying notes, the real story is harder to piece together.

The measure of financial strength of the sponsor can be supported by the audited statements, but the presence of audited statements (or lack thereof) does not guarantee financial position of a company. They do not provide qualitative judgment on how well the firm is capitalized for certain ventures. That judgment is left to the due diligence community. Audited statements may also not cover all of the entities of an organization that support the sponsorship of the offering. Finally, an entity's audited statements may lead directly to an individual or family that controls the sponsor. Once the trail leads back to individuals, analysts are less likely to see audited personal financial statements, if they get to see personal statements at all.

The trail may also lead to other sponsor offerings, and have bearing on the offering under consideration itself. Obviously, assessing the prospects for ongoing viability of the sponsor is critical, because most often the sponsor will serve as asset manager of the 1031 offering. However, sponsor financial due diligence takes on increasing importance in the DST context, where a sponsor firm may be called upon to capitalize several master tenant entities for other offerings through demand promissory notes. In other cases, it may be guaranteeing offering level obligations, like certain loan carve-outs. Investigation of such contingent exposure is necessary.

WINDOW

Sponsor level due diligence is a big undertaking, and it doesn't stop with financial statement review. A sponsor's prior performance, legal documentation, background checks and internal controls are also vital areas that require attention in any review. No thorough review would be complete without them. Among those areas, however, a sponsor financial statement review should rank high as a top priority in any analysis. Without a financial review, reviews of the other areas may only provide chapters of a story without the complete novel. The financial statements should provide a window into all of the sponsor's operations.

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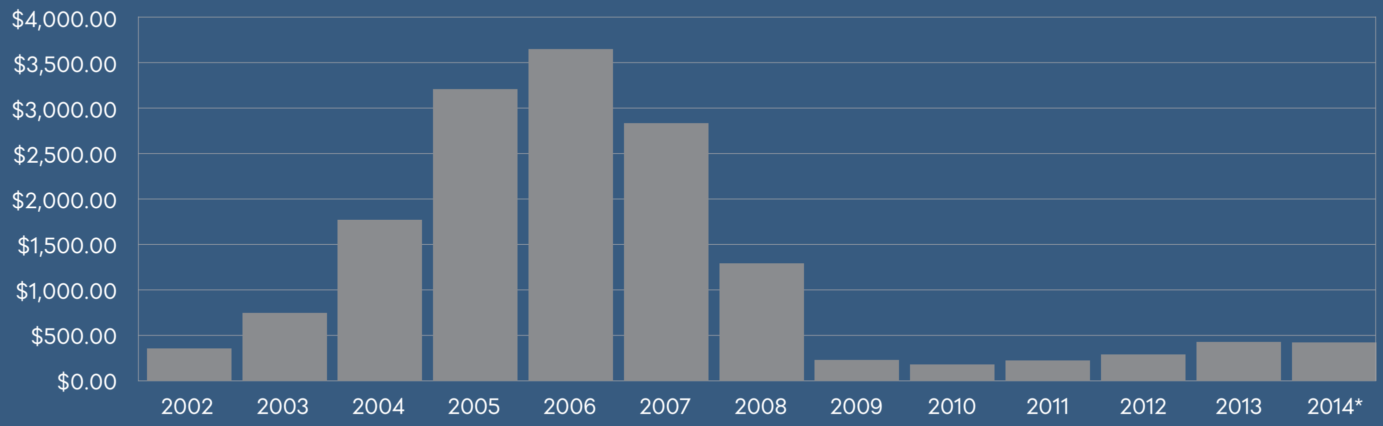
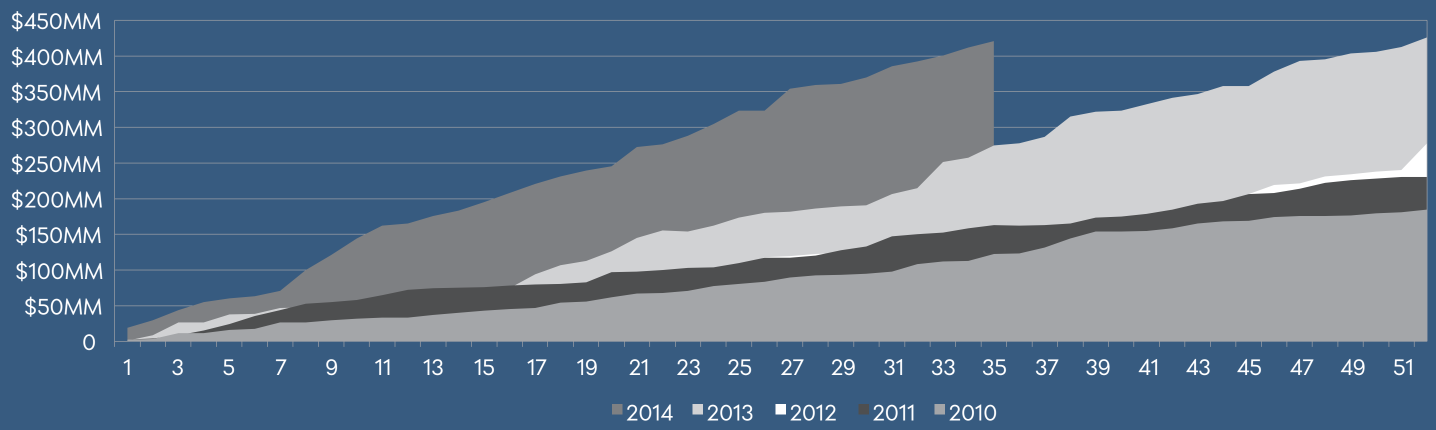
2014* NUMBERS

EQUITY RAISED (2002 – 2014*)



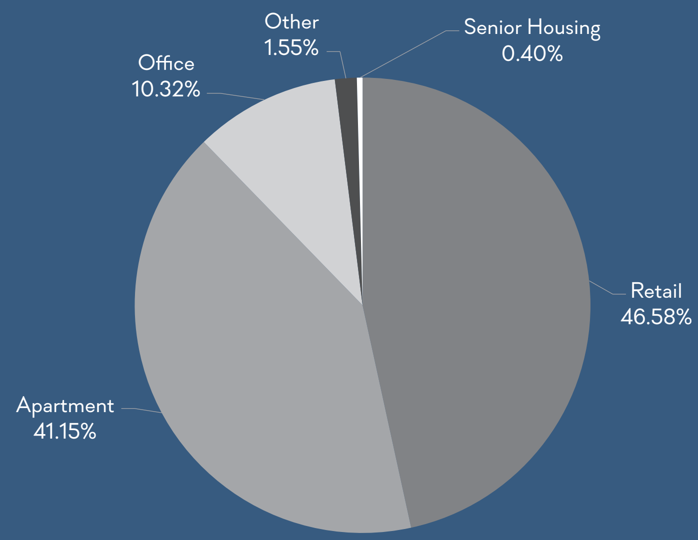
CUMULATIVE EQUITY RAISED COMPARISON (2010 – 2014*)



* 2014 data is through September 5, 2014

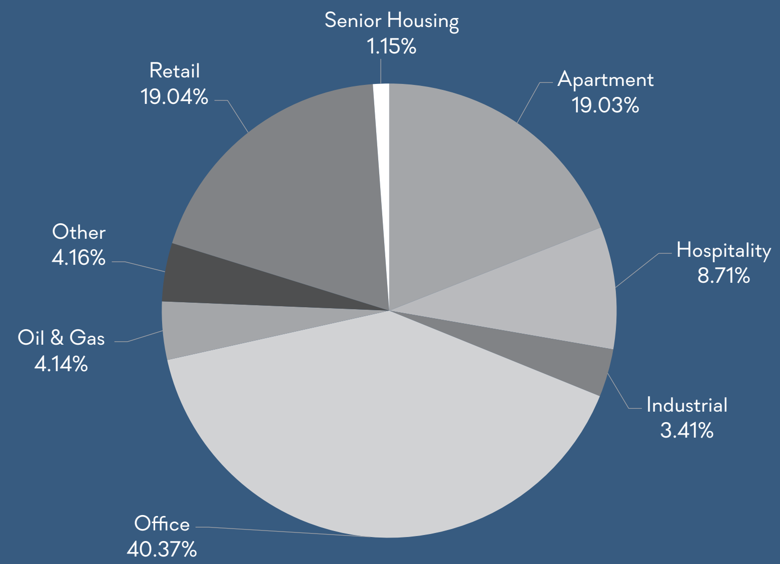
2014* EQUITY RAISED BY ASSET TYPE

Retail	$197,039,017	46.58%
Apartment	$174,062,596	41.15%
Office	$43,658,273	10.32%
Other	$6,542,926	1.55%
Senior Housing	$1,700,000	0.40%
	$423,002,812	



2007 EQUITY RAISED BY ASSET TYPE

Apartment	$529,235,625	19.03%
Hospitality	$242,249,000	8.71%
Industrial	$94,942,120	3.41%
Office	$1,122,890,690	40.37%
Oil & Gas	$115,085,415	4.14%
Other	$115,635,589	4.16%
Retail	$529,783,782	19.04%
Senior Housing	$31,944,655	1.15%
	$2,781,766,876	



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