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Syndicates need properties that have "real" appreciation potential and that do not require intensive management.

Characteristics of Properties Suitable for Syndication

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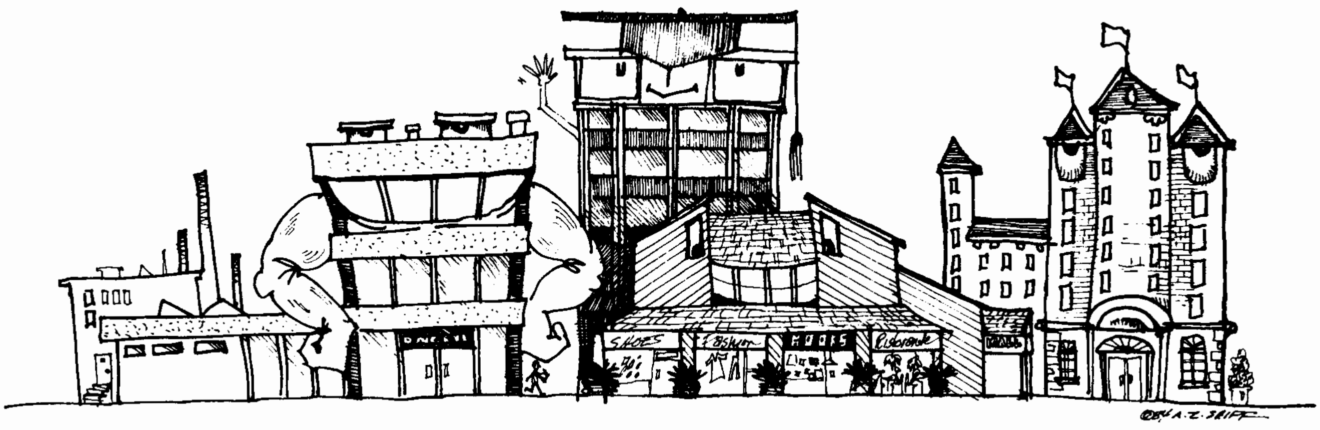

IN SELECTING REAL ESTATE for syndication, the purchaser should seek out properties that possess two characteristics: significant long-term appreciation potential plus a relatively low requirement for intensive management.

These criteria are particularly important to an investor in a tax-oriented real estate syndicate because (1) the property must give the investor some real appreciation if the investor is to receive enough cash when the property is sold to pay his minimum taxes,[1] and (2) there is generally no assurance that the original general partners or syndicate organizers (usually individuals) are and will remain capable of managing the investment over a long period of time.

In a typical deep-shelter syndicate investment, an investor may receive tax deductions over a fifteen-year period amounting to up to six times his original cash investment. When the property is sold, just the minimum capital gains taxes due from the reduction in the investor's basis would exceed his actual original cash investment.[2] The investor's equity interest in such an investment must appreciate by at least 125 percent of his original cash investment if he is to have enough

[1] See Paul Zane Pilzer, "You *Can* Lose in the Wrong Syndication Investment," 14 REAL ESTATE REVIEW 27 (Spring 1984).

[2] Generally, upon sale or liquidation, a limited partner's taxable capital gain equals his net cash profit (sales proceeds less original investment) less the sum of all his annual taxable income (loss).

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cash to pay his minimum taxes. Of course, the investor has had such good tax advantages during the life of the investment that he is ahead on a cash basis even if there are little or no cash sales proceeds from which he can pay the taxes due upon sale. However, by the end of the investment period, the investor has usually long since forgotten (or spent) his prior tax benefits.

Before a syndicate investor (usually as a limited partner) purchases an investment unit in a real estate syndication, he generally performs a detailed analysis of the underlying real estate and he carefully studies the financial projections. However, he often forgets to question the business experience of the syndicate organizers or general partners. In some real estate investments, this business ability can be more important to the success of the investment than the actual real estate itself. The more intensive the management that the investment requires, the more likely it is that the success of the investment is tied to the ability of the property manager, a factor not disclosed in the financial projections.

DEFINING LONG-TERM APPRECIATION

A real estate investment appreciates for one or both of two reasons: there is *real* appreciation of the underlying asset and/or there is monetary inflation.

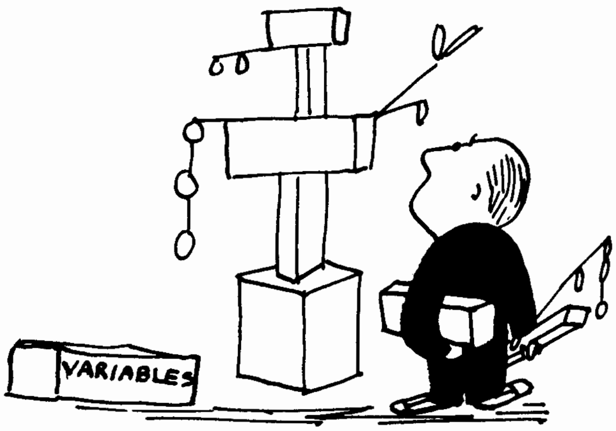
A specific piece of real estate experiences real appreciation because its productivity value increases or because it benefits from changes in the supply/demand equation. A shopping center may increase in value because the number of people who shop at the center increases. (Percentage rent, and consequently productivity value, increases.) A single-family house in a specific area may increase in value because either the number of people who desire houses in that area (demand) increases or the quantity of available houses for sale (supply) decreases. These are both examples of *real* real estate appreciation.

The investor seeking real appreciation should always be aware that in a stable economy, this type of appreciation is usually part of a zero-sum game. In an economically stable, zero population growth environment, for every property that increases in real value another similar property decreases in value. If more people shop at one shopping center, then fewer people must be shopping at another shopping center. If more consumers desire homes in one location, then fewer consumers must desire homes in another location. Obviously, real growth in either population or gross national product can also produce *real* appreciation.

Inflation appreciation occurs because real assets hold their true value in inflationary times. This in itself would not create real appreciation for the real estate investor because he would just break even with inflation. However, real estate investments have traditionally been financed with long-term fixed-rate debt, which has caused the investor's equity investment to be leveraged against inflation. Thus, during inflation, the investor who is leveraged by a fixed-interest loan experiences real appreciation at the expense of the lender who experiences real depreciation.

THE MANAGEMENT FACTOR

The success of every type of real estate investment depends not only on asset characteristics, such as location, construction, and market demand, but also on the skills of the owner/manager. However, the degree of dependence on the personal management skills of the owner/manager varies widely for differing types of real estate investment. For example, an operating hotel property involves much more management on the part of the owner than a single-tenant net-leased industrial property.



A real estate syndicate should always be concerned with how readily it can replace one manager with another—that is, with the liquidity of the management component. There may be several strong operating companies available to take over the management of a prime hotel property in New York City if the current operator should fail to meet performance standards or go out of business. But there may be few, if any, bidders responding to offers for a new management contract for a resort hotel in a rural location. Similarly, the number of potential suitors for the management contracts on office buildings or apartments depends on location, project size, construction type, market demand, and other factors.

The length of time that individual management skills are required is also a measure of management intensity. An investment in a to-be-developed property may be critically dependent on the developer's skills during the construction and leasing stage, but less dependent on those skills during the long-term ownership of the property. Generally, investors should assume that it is unlikely that specific individuals will remain involved in a project for long periods (five to fifteen years) of time.

SUITABILITY OF VARIOUS TYPES OF REAL ESTATE FOR SYNDICATION

There are inherent characteristics in many residential properties that make many of them unfortunate choices for syndication. Office buildings and shopping centers are attractive syndication types. Obviously, there are good candidates for syndication in unlikely categories and bad candidates in attractive categories. We explore below the major characteristics of each category.

Apartments

Apartments represent the majority of real estate syndication investments. Yet some apartment buildings (particularly, garden apartments) are perhaps the worst types of real estate for syndication by tax-oriented "deep shelter" syndications.

As indicated above, the underlying real estate asset in a tax-oriented investment must appreciate by a minimum amount if the investor is to have enough funds to pay the taxes that are due upon sale. But in many areas of the United States, apartments typically depreciate in value. Garden-type "stick" construction is designed to last from seven to ten years. Although rents usually increase annually, increases in maintenance costs (the costs of replacing roofs, asphalt parking lots, kitchen appliances, and internal fixtures) typically exceed rental increases. The improved asset can be economically obsolete long before the syndicate projections (sometimes fifteen to twenty years) are realized. Low- or middle-income apartment units are particularly vulnerable to economic obsolescence because tenants' ability to absorb rental increases is limited by their ability to pay.

Another problem that investors in apartment building syndications should consider is the relatively significant requirement for skilled management. In Dallas, for example, where the average apartment tenancy is 6.9 months, the keys to keeping an apartment project occupied are the management and marketing skills of the operator. Additionally, the maintenance of the asset itself requires a high degree of skill, a requisite that increases over time. Ultimately, the investor becomes more dependent on the continued diligence of the property manager than on the quality of the real estate asset itself.

Historically, some apartment syndications have performed well. But success in the 1970s was probably related to skyrocketing land prices and to inflation. In today's market, apartment buildings (other than high-rise and mid-rise construction in urban areas) are poor long-term investments except as land speculations.

Office Buildings

Office buildings can be good real estate syndication investments for many of the same reasons that apartments are poor syndication investments. First, most office buildings are built to last from fifteen to forty years, although interiors are usually reconstructed every five to eight years. The costs of increasing operating expenses usually can be passed on to tenants during the term of their leases. The typical first-class office tenant has the ability to pay rental increases because he usually spends ten to twenty times his rent on employees' salaries and telephone and other equipment.

The multitenant office building is, of course, dependent on management skill for full occupancy. However, office leases average from three to ten years in length, and tenancies endure for longer periods than in uncontrolled residential properties. Additionally, most office buildings are large enough to attract the attention of third-party professional management companies which are available if the original syndicator/operator becomes less competent. On the other hand, the management requirements of smaller and/or older office buildings begin to approach those of garden apartments.

Retail Properties

Shopping centers (both regional and strip) are generally very good investments for real estate syndicates because (1) they include a relatively high component of land value and they, therefore, may offer excellent prospects for long-term appreciation, and (2) the tenants (usually credit) typically sign long leases that require them to maintain (or pay their pro rata costs of maintaining) the property over the life of their leases. This latter feature results in a relatively low need for long-term intensive management.

However, shopping centers typically are not syndicated because they are generally more expensive to purchase than other types of real estate, and they produce only modest tax advantages. Institutional and foreign investors, who seek long-term appreciation and low components of management intensity, have bid up the prices for prime retail properties. This means that shopping centers are sold at low rates of capitalization. The lower initial yield of shopping centers makes it difficult to obtain high leverage, which is the essence of tax-oriented real estate syndication. The typically high land value component results in a smaller depreciation component than that supplied by other property types. Low depreciation means reduced tax benefits. Furthermore, the typical triple-net form of retail lease makes the tax benefits that do exist less attractive than they might be to tax-oriented syndicate investors.[3]

Industrial Properties

Industrial properties are also good properties for syndication for the same reasons that certain retail properties are attractive. The fastest-growing areas of many major cities are former industrial property locations. Industrial tenants typically maintain most of their leasehold premises themselves, and high-quality third-party management is readily available.

Industrial properties also have the same disadvantages as syndication properties as do shopping centers. They include a substantial component of land value, which reduces their depreciation benefits, and they usually are rented by means of net leases which reduces their attractiveness to investors who seek to shelter other earned income. However, they often can be purchased at relatively more attractive prices (i.e., at higher capitalization rates) than other types of property. Thus they have access to higher leverage than retail properties.

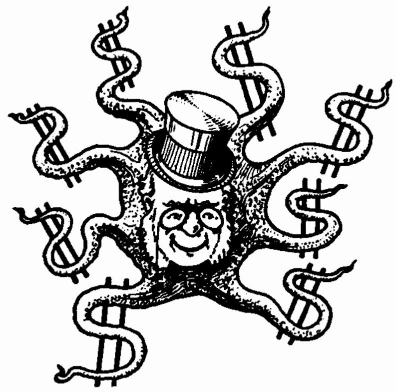
However, industrial properties have not been purchased by many real estate syndicates, primarily because they are aesthetically unattractive and, consequently, they do not appeal to individual investors. This substitution of emotional attitudes for investment sense will probably change as the retail syndication market becomes more sophisticated.

Special Use Properties

Single-purpose properties, such as free-standing restaurants and special manufacturing facilities, can be good syndication investments only in limited circumstances. They should be carefully chosen for their long-term land residual value; they should be subject to long-term triple net leases; and they should be occupied by credit tenants.

There is usually no residual value in the improvements of such properties. And the risk of finding a replacement tenant if a lease expires during the contemplated holding period is so great that no passive syndicate investor should wish to undertake that risk.

However, single-purpose retail properties are usually well-located at major intersections. If the land component of such a property is sufficiently large, the odds that the property may in time be put to a higher use are calculable. On the one hand, the existence of a credit tenant usually allows for a highly leveraged acquisition which can ameliorate some of the negative tax factors associated with the large land component and triple net lease. On the other hand, most leases for these types of property have long-term, low-rate renewal clauses, which prevent the residual value of the property from emerging during the lifetime of a typical syndication.



CONCLUSION

Obviously, the investor who chooses his investment by crude rules of thumb concerning the "type" of property is not using sufficiently refined guidelines. The characteristics of the property are more important than the type of property. The two major characteristics that are overlooked by many contemporary real estate syndicators are the following:

- The underlying real estate asset must appreciate enough in "real" value to allow the tax-oriented syndicate investor enough sales proceeds to pay his deferred taxes; and
- In certain types of real estate, the investor is relying more on the continued diligence and expertise of the real estate manager than on the quality of the real estate itself.

[3] If the owner of a real property is not subject to the risk of increases in certain types of operating expenses, the investment is considered to be a passive investment and some of the tax deductions (which result from interest deductions) are subject to the $10,000 investment interest limitation. The general practical effect of this rule is that an investor in a syndication that owns net-leased property usually can utilize his excess tax deductions from the syndicate only to shelter "unearned" (dividends, interest, etc.) income.