The Optimal Exchange Strategy – Exchange Economics

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This is the second in a series of articles on the subject of optimizing 1031 exchanges in today's CRE marketplace. The first article described the challenges and risks associated with 1031 exchanges in today's inventory-constrained market for high-quality investment assets. Essentially, satisfying the 1031 deadlines for identifying and acquiring replacement property often makes forward exchanges unattractive because of the relatively high risk of failure. By contrast, acquiring replacement property first, in the context of a reverse exchange, means that the investor has accomplished the overall goal of the exchange and is then faced with the challenge of having to sell relinquished property to complete the exchange - a task that is far easier in today's market and, therefore, carries far less risk of failure. In many cases, an investor's exchange strategy can optimized by controlling the timing of critical events.

In this article, we discuss the aspects of optimization having to do with the real cost of an exchange, ROI on invested capital during the exchange and maximizing tax deductions from depreciation. The discussion will reveal that what is optimal for the QI is usually not optimal for the investor and that optimizing the exchange for the investor nearly always means minimizing the amount of time that a QI is holding the investor's cash proceeds from the sale of relinquished property.

We'll use a simple example to illustrate the type of analysis that can lead to financial optimization. Suppose that Mary (a savvy real estate investor) bought an income-producing property 8 years ago for $1million using a $600k interest-only loan and $400k in cash and that the property generates rental income at a 6.5 CAP rate relative to the original $1million investment. Mary has been told by her Broker that the FMV of her property is now $2million and that it will be relatively easy to sell, unless she gets crazy. Suppose further that Mary decides to liquidate some legacy T-Bills and municipal bonds (currently earning 1.5%) and to use the additional cash to buy a different income property for $3million that also has a 6.5 CAP, which would mean a significant increase in rental income. Mary wants to use a 1031 exchange to preserve her capital and she has a good enough relationship with her bank so that she can borrow part of the purchase money (up to $1million) for the new property at a rate that is very attractive compared to its CAP rate.

Mary is familiar with 1031 exchanges and knows that the following will be the situation if she starts the exchange process using a forward exchange:

- Her $1.4million in equity (less closing costs) will be held by the QI until she is ready to acquire replacement property

- She'll have 45 days to identify potential new property and 180 days to acquire one or more of the properties she identifies
- The forward exchange fee will be between $750 and $1,500, depending on which QI she engages
- The QI will pay little, if any, interest on her $1.4million
- Both her rental income and her depreciation deduction will go to zero when her current property sells

For Mary, the real cost of a forward exchange is very high. The lack of any meaningful ROI on the capital being held by the QI and a zero depreciation deduction means that a significant amount of money ($1.4million) will provide virtually no financial benefit to Mary for up to 180 days. And, given the difficulty of finding high-quality $3million properties with 6.5 CAP rates, it's likely that her money will be held by the QI for most of that 180 day period. The calculations are shown in the table below.

Mary's ROI Comparison	**Old Property Performance Before the Forward exchange**	**Forward Exchange with Cash Equity of $1.4million Held by a QI**
Net Rental Income, monthly	$5,417	$0.00
Debt Service @ 5%, monthly	$2,500	$0.00
Net Monthly Income	$2,917	$0.00
Depreciation, monthly	$1,709	$0.00
Monthly interest on exchange funds (0.01%)	-	$117
Exchange fee, one time	-	$1,000
Total income/ROI, 3 months	$8,751	**<$650>**
Total depreciation, 3 months	$5,128	$0.00

As shown, both Mary's income and depreciation deduction would disappear at the start of a forward exchange. Assuming a 3-month exchange period (perhaps a bit optimistic), she'll pay a total of $650 for the exchange. However, the QI will earn a fee (say $1,000) plus some amount of interest on Mary's $1.4million for 3 months. QIs earn "marketing fees" from depository banks in addition to any interest "split" that is negotiated with a particular client. This is how most QIs generate the bulk of their revenue.

Now suppose that Mary - unhappy with the prospects of leaving her money with a QI and getting virtually nothing for it - learns that things are very different with a reverse exchange. Specifically, she learns the following:

- In a reverse, she'd buy the new property before selling the old and the QI would hold title to the new property in an LLC for her benefit during the exchange
- She would have to supply the money needed to acquire the new property before having access to the $1.4million in equity that is in her old property
- She would continue to derive rent and depreciation deductions from her old property until it was sold *and* she'd get the rental income from the new property even though title to it was being held by the QI
- She'd have responsibility for the cost of operating both properties
- The fee paid to the QI for the reverse exchange is higher, probably $5,000 for her situation
- When the old property does sell, the cash proceeds ($1.4million) would be returned to her immediately (1 day after the close)

The fact that the “burdens and benefits” of both the old and the new properties belong to Mary in a reverse exchange makes the situation entirely different, as reflected in the following table:

Mary’s Financial Results During a Reverse Exchange	**Old Property**	**New Property**	**Totals**
Net Rental Income, monthly	$5,417	$16,250	$21,667
Debt Service (5% & 4.5%), monthly	$2,500	$3,375	$5,875
Net monthly Income, pre-tax	$2,917	$12,875	$15,729
Depreciation, monthly*	$1,709	$0	$1,709
Interest on exchange funds, monthly	$0	$0	$0
Exchange fee, one time	-	$5,000	$5,000
Total pre-tax income, 3 months	$8,751	$33,625	$42,376
Lost interest (T-Bills & Bonds @ 1.5%)	$0	$7,875	$7,875
Total depreciation, 3 months	$5,127	$0	$5,127

*In a reverse exchange, depreciation deductions for the “parked” property may not be taken while title is held by the LLC formed by the QI.

For Mary, the difference in the strategies is stunning. If she used a forward exchange, she'd have virtually zero ROI for a period of 3 months on $1.4 million in cash equity; in fact, the exchange costs her $650. Her $1.4million in cash lies fallow in the hands of a QI who is making money on her money. This is offset slightly by the interest on $2.1million worth of T-Bills and municipal bonds that she was able to hold for 3 additional months. By contrast, if she used a reverse exchange, she will get rents from *two* properties. Yes, she has debt service to pay on two loans but the arbitrage between the CAP rates and the cost of the debt is attractive - otherwise there would not be so many buyers for good income producing real estate! And, yes, the fee for the exchange is higher but that is more than offset by the overall ROI generated by her $2.1million during the exchange period. Lastly, when the exchange is complete, she'll have immediate access to the $1.4million in equity from her old property, with freedom to re-invest it as she sees fit, and she'll be able to take a depreciation deduction of $5,128 per month on the new property. The following table compares the two strategies directly. In the forward exchange, Mary is leaving a significant amount of money "on the table" and a healthy portion of that is being taken by the QI. In a reverse exchange, Mary pays a flat fee - that does not change whether her exchange lasts one month or six months - and receives the net income and depreciation deductions from her old property until it sells *plus* the net income from the new property.

Mary's Comparison of Forward and Reverse Exchange	**Forward Exchange with Cash equity of $1.4million held by a QI**	**Reverse Exchange with Replacement Property Parked**
Net Rental Income, monthly	$0.00	$21,667
Debt Service, monthly	$0.00	$5,875
Net Monthly Income, pre-tax	$0.00	$15,729
Depreciation, monthly	$0.00	$1,709
Monthly interest on exchange funds (0.01%)	$117	$0
Exchange fee, one time	$1,000	$5,000
Interest (T-Bills & Bonds @ 1.5%)	$7,875	$0
Total income/ROI, 3 months	**$7,225**	**$42,187**
Total depreciation, 3 months	$0.00	$5,128

In this simple example, the advantages of a reverse exchange are clear. Both pre-tax income and depreciation deductions are far more attractive for Mary than in a forward exchange. Obviously, not every investor's situation will be this straightforward. However, every situation in which the investor has a reasonable option of acquiring replacement property before selling relinquished property should be subjected to an analysis of the financial difference between a forward exchange and a reverse exchange. This type of approach is not widely promoted in the QI community because the fact is, as our example has indicated, keeping an investor's capital deployed in income producing property will nearly always provide superior financial results for the investor.

For many investors, the challenge may be assembling the funds needed to make the acquisition of the new property before the funds from the sale of the old property are available. This is a valid objection to using reverse exchanges and some investors will have no choice but to use a forward exchange for this reason. However, many investors, when they see the potential upside, may decide that some "creativity" is called for because of the advantages – both timing control and financial results - of using a reverse. We have seen all of the following creative solutions applied to make a reverse exchange work:

- Arrange with the bank lender for a loan that is larger initially and stipulate that the principle will be reduced when the old property sells
- Temporarily use other funds knowing that the funds will be "replaced" as soon as the old property sells
- Obtain reasonable bridge financing from a third-party lender or use an equity line (e.g. a HELOC) to obtain a short-term loan using other assets as collateral
- Refinance the new property after the exchange in order to replace money sourced elsewhere

All of the options come at a cost, some higher than other, that have to be factored into the ROI calculation as described above. However, the cost is likely to continue to be less than the CAP rate on the new property and the arbitrage on the interim cash needed in a reverse exchange will continue to be attractive. To reiterate, finding the optimal solution is the goal and making these calculations is a critical part of deciding which strategy is best.

In conclusion, ROI on invested capital goes to virtually zero during a forward exchange because the QI is required to hold the cash equity and there are few, if any, rational "investment" vehicles for that cash that earn more than 1% for the QI. Since QIs are often compensated with "marketing fees" rather than real yield on funds, they are retaining most of the earnings on the cash for themselves. In addition, there are no depreciation deductions available in a forward exchange because the asset has been sold.

For a reverse exchange, when the Investor has the ability to acquire the replacement property before selling the relinquished property, the investor retains both burdens and benefits of *both* properties until the relinquished property is sold. This usually results in two sources of rent and two loans to service but, with

today's CAP rates and interest rates, this will nearly always result in positive net monthly income and a ROI picture that is always superior to that of a forward exchange.

Given the challenges of today's commercial real estate marketplace, having tools to optimize investment decisions in terms of accomplishing specific goals, reducing risk of failure and obtaining optimal financial results are critical. The reverse exchange is one of these tools. While many QIs may portray a reverse exchange as a "last resort" or "necessary evil", enlightened investors increasing realize the strategic value that can result and are using reverses to increase control and financial performance. Enlightened 1031 exchange companies will provide tools that enable investors to model both simple and complex situations to determine how best to manage timing and how best to obtain the best ROI on valuable capital.