# Maximizing returns: What you need to know about 1031 exchanges and NNN properties

**BY BRANDI SMITH**

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One of the only constant things about commercial real estate is how much it changes. Trends cause shifts in demand, technology brings in new methodology and, as Texas CRE pros know all too well, a new presidential administration can alter how things are done. The Biden administration has already proposed restricting 1031 exchanges to $500,000 of gain, a move against which Asset Preservation, Inc. is pushing hard.

"The whole real estate industry has been working for two years to show Congress how much it would hurt jobs if they cut 1031s down," says Greg Lehrmann, Attorney and Senior Vice President with Asset Preservation. "It would freeze capital."

Asset Preservation, owned by Stewart Title, is one of the largest 1031 qualified intermediaries in the nation and a popular resource for would-be investors interested in a 1031 exchange. So named because it was created in IRC Section 1031, a 1031 exchange allows investors to swap one property for another, deferring capital gains taxes. In doing so, Lehrmann argues it keeps the commercial real estate market buzzing.

"When investors know they won't have to pay capital gains, they're more likely to make more transactions," he says. "That means the title company employees make more. The real estate agents make more. The landscaper makes more. Home Depot makes more. Everybody makes more when people can trade up in real estate without paying taxes and the government actually receives higher ordinary income-tax rates on the additional income earned by all those people and companies."

That's exactly what he says is happening right now as investors sell off high-maintenance real estate and exchange it for what he calls "mailbox money," more passive real estate.

"They have three choices: buying into a triple-net property, investing in a Delaware Statutory Trust (DST) or banking on income-producing minerals," says Lehrmann.

While the trend toward lower-maintenance property types was established long before the pandemic hit, the shutdowns certainly had an impact on NNN investments. But it wasn't all bad.

"The pandemic frankly was beneficial to some landlords that sought to expedite replacing tenants," says Patrick Luther, Managing Principal of SRS Real Estate Partners' National Net Lease Group & Investment Properties Group. "A tenant that could not operate or pay rent, but who, regardless of a pandemic, was only marginally successful, could be more easily evicted or removed and replaced with a higher rent-paying, higher-credit or higher-quality user."

While many investors scaled back or simply held on to what they had during the pandemic, now that the economy appears to be rebounding, so is demand for NNN properties.

"Buyers have returned (both private and institutional), as have lenders," Luther says. "Due to the pandemic, construction stalled for net leased assets, so there is a backlog of demand and a lack of supply, as a function of delayed new build inventory coming online."

Geoff Ficke, Executive Vice President of Colliers International's Capital Markets Group, calls NNN the "darling product type in the market right now," adding that there is "pent-up demand" on both the equity and debt side of the capital stack. During times of volatility or an uncertain market, a common trend is investors chasing predictable and fixed-income investments, a box NNN checks.

"It seems every deal we are working on is a bidding war," he says. "Assets that are well-priced and well-positioned in the market are often getting multiple bids usually resulting 5 to 10 (or more) offers."

Similarly, Luther says he's working more "buy side" representation than ever before.

"As inventory levels are low and the type of 'essential' net lease that buyers are seeking remains hard to find, more than our normal share of transactions are occuring off market and without formal listing agreement engagement," he says.

Light industrial, quick-service restaurants and medical users continue to shine, according to Ficke, who also points out Tractor Supply Company, United Rentals, FedEx, Davita and Fresenius are expanding throughout Texas.

"During the pandemic my team has allocated more resources to focus on these essential businesses, but the primary demand driver remains the credit strength guaranteeing the lease," says Ficke.

Luther adds that he's targeting "essential" users, such as drive-thru restaurants, dollar stores, drug stores and grocers, when it comes to retail product. Office, he says, remains challenged.

"Relative to geography, the activity level and values for any segment of the NNN market in areas that experienced heavy population growth during COVID-19 are robust. Pricing has improved and cap rates have compressed significantly in states like Florida, Texas, Tennessee, Nevada, and Arizona," says Luther. "Those states didn't just 'reopen' more quickly; they experienced a surge in new residents leaving states with more strict COVID regulations, such as California, New York and Illinois."

Market is key in any CRE conversation and Texas is about as hot as you can get, thanks to the thousands of people moving here.

"Given the dramatic surge in new residents and population growth, both organic and pandemic-prompted, we are seeing growth in all segments: medical, retail, industrial and distribution, as well as office," he says. "There is no shortage of businesses across these segments looking for the tax efficiency and other fundamentals provided by relocating to Texas."

That includes Luther, who himself is making the move to the Lone Star State this year!

You can learn more from him, Ficke, Lehrmann and many more experts during the 2nd Annual Texas Net Lease & 1031 Summit on June 24. Register at REJournals.com.