DISPOSITION

One option is the outright **disposition** (sale) of the fee simple ownership interest in Jessica Crest. If you decide to sell Jessica Crest, you have to go through the process of finding a buyer. Depending on the building and market, a "typical" sales process requires three to twelve months. To prepare the property for sale you must gather your documents and contracts, prepare financial statements, have an accounting firm audit those statements, perhaps create a sales book, hire lawyers to negotiate and structure the sale agreement, possibly hire a broker to help sell the property, spend time negotiating with buyers, etc.

In addition to the time and energy involved, the sales process has significant costs, as lawyers, accountants, and brokers do not work for free. Many of the costs of these services are relatively fixed. As a result, fees as a percentage of the total sales price tend to be larger for smaller properties and smaller for larger properties. In general, 2%-5% is a good estimate for the transaction costs associated with selling a property, but keep in mind the actual percentage fluctuates with property value. If you have a large trophy asset, like Rockefeller Center, the fees as a percentage of value will be substantially less because the amount of work and value added by the brokers are not large relative to the value of the property. If, however, you have a $5 million property, then the fees can easily exceed 5%. Assume that you estimate that selling Jessica Crest will cost you $3 million in fees.

Assume that after 6 months of searching for a buyer, you successfully sell Jessica Crest for $140 million. You will use the $140 million in **gross sales proceeds** to repay the $60 million mortgage. If the buyer uses debt financing to purchase the building, there are technical complications in the final closing, as the buyer will be unable to pay you until they receive their mortgage. However, the buyer's lender will not provide a mortgage until they have a first lien on the property, which cannot be given until you sell the property and repay your loan. To solve this problem, you will simultaneously close the sale, repay your existing loan, and transfer the first lien to the purchaser's lender.

Assuming that you are not a non-taxable entity such as a pension fund, another major payment you have to make upon sale is your long-term **capital gains tax**. Under U.S. tax code, there are two components of the capital gains tax. The first component is the actual gain you achieve on the building. In this case you paid $100 million for the property and you sold it for $140 million. This $40 million gain is (currently) taxed at 15%, or $6 million in taxes. But remember that the capital gains tax rate changes over time as tax law evolves.

The second capital gains tax component (under current law) is that you have to pay taxes on the property's **accumulated depreciation**. You have been depreciating the building over the past three years to shield income from ordinary income taxes. The government (currently) requires that you pay a 25% tax rate on accumulated depreciation. Depreciating the $75 million you attributed to structure over a 39-year schedule ($1.923 million per year), means that you have taken $5.769 million in total accumulated depreciation over the past 3 years. In reality, the accumulated depreciation will be larger than $5.769 million, as not all non-land value will be attributable to the long-lived structure. Other non-land value is allocated to shorter-lived improvements such as furniture, fixtures, and equipment (FF&E). The shorter the depreciation schedule, the higher the allowable percentage of item cost written off in each year. For simplicity, we assume that the total accumulated depreciation at the point of sale is $5.769 million. The government will tax this amount at a 25% tax rate, or $1.442 million in taxes. Combining these capital gains tax components, you will pay a total of $7.442 million in capital gains taxes upon the $140 million sale (Figure 18.3).

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FIGURE 18.3

Jessica Crest Disposition Capital Gains Taxes Calculation	
Capital Gains Tax Rate	15.00%
Accumulated Depreciation Tax Rate	25.00%
Depreciation Allocation to Structure	$75.00 MM
Depreciation Schedule	39 years
Tax on Gain	
Property Appreciation ($140 MM – $100 MM)	$40.00 MM
Capital Gains Tax at 15.00%	$6.00 MM
Tax on Depreciation	
Annual Depreciation	$1.923 MM
Accumulated Depreciation over 3 years	$5.769 MM
Depreciation Tax at 25.00%	$1.442 MM
Total Capital Gains Taxes	$7.442 MM

Thus, as shown in Figure 18.4, after repaying the loan, paying all fees and paying the IRS you are left with $69.56 million of the $140 million in gross sales proceeds. This post-sale cash amount can be thought of as your net equity or **wealth position**.

FIGURE 18.4

Jessica Crest Disposition Net Equity Calculation	
Sales Revenue	$140.00 MM
Debt	($60.00 MM)
Fees	($3.00 MM)
Capital Gains Tax	($6.00 MM)
Depreciation Tax	($1.44 MM)
Net Equity/ Wealth Position	$69.56 MM

Online Companion Hands On: Go to the Online Companion and select the link for Chapter 18. Scroll down the page to the Excel Figures section and download the Excel file. Complete the formatted, blank Figure to solve for the Net Equity of the property owner given the Assumptions provided at the top of the tab.

In addition, you may face a prepayment penalty for repaying your loan prematurely. This analysis assumes that you have no prepayment penalty because given your repositioning strategy, you probably would have selected

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a floating rate loan that allowed you to sell the building with little-to-no prepayment penalty after roughly 3-4 years. This exemplifies how the type of debt selected depends on your investment and exit strategy.

Upon completion of the sale, you have sufficient funds to execute the other repositioning deal, as you have $69.56 million and only needed $40 million in equity for the new project. However, freeing up your money came at a cost. Specifically, even though you doubled your equity from $40 million to $80 million on the investment, you only have $69.56 million in your pocket due to the substantial leakage from fees and taxes. Are there exit alternatives available which reduce these leakages from sale?

REFINANCING

An alternative exit strategy for the Jessica Crest property is **refinancing** (i.e., taking out a new loan on the property). If the original lender was willing to lend $60 million on the $100 million Jessica Crest property (a 60% LTV) prior to repositioning, a lender should be willing to lend you substantially more once Jessica Crest is stabilized and worth $140 million. Instead of selling the property, assume you obtain a new 65% LTV ($91 million) first mortgage. In this case, after repaying the original lender, you are left with $31 million in "excess" refinancing proceeds ($91 MM in new debt minus $60 MM of original debt repaid).

While the refinancing process is much cheaper than the sales process, as you do not have to pay the transfer taxes and brokerage fees, you probably will have a loan fee of 50 basis points on the new mortgage, as well as legal and accounting fees. But even if you pay $1 million in refinancing costs, it is a notable reduction from the costs associated with the sale option. Plus, if you refinance, you postpone paying capital gains taxes, as they are only triggered upon sale. This is the major advantage of the refinance option relative to a sale.

Given the time value of money, you generally prefer to defer the inevitable tax liability. In fact, the longer you think you will hold the building, the more attractive is the refinance option. For example, if you plan to sell the building tomorrow, the refinancing option makes no sense because you simply pay $1 million in refinancing fees, as well as the sale-related fees and taxes. But if you plan to hold the property for 60 years, the present value of the deferred capital gains tax liability from refinancing now is effectively zero.

As shown in Figure 18.5, upon refinancing Jessica Crest, you realize net refinancing proceeds of $30 million ($31 MM in excess proceeds minus $1 MM in fees), which is at your disposal for new investments. However, although you avoid the incremental $2 million in fees and the $7.442 million in capital gains taxes incurred if you had sold, the $30 million in net proceeds from refinancing the property are $39.56 million lower than the $69.56 million in net proceeds derived from an outright sale. Where did the remaining money go? The answer is that you still own a $49 million equity position in Jessica Crest after refinancing, as the building is worth $140 million against a $91 million loan (Figures 18.5 and 18.6).

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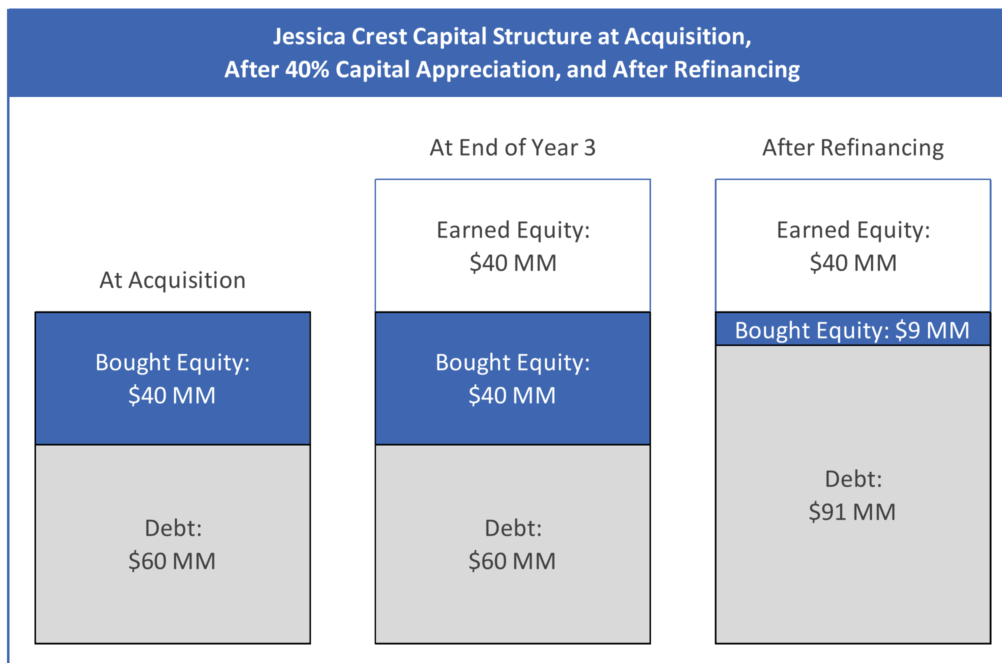
FIGURE 18.5

Jessica Crest Refinancing Net Equity Calculation	
New Property Value	$140.00 MM
New Debt at 65% LTV	$91.00 MM
Repayment of Old Debt	($60.00 MM)
Equity to Holder	$31.00 MM
Fees	($1.00 MM)
Capital Gains Tax	$0
Depreciation Tax	$0
Net Refinancing Proceeds *	$30.00 MM
Equity in Jessica Crest	$49.00 MM
Net Equity	$79.00 MM

* Available for new projects

FIGURE 18.6



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Therefore, your total wealth position after refinancing is $79 million ($30 MM in cash from the refinancing plus $49 MM in equity in the property), which is higher than the $69.56 million from selling the building.

Yet, after refinancing you still have a problem, as you need $40 million in cash for the new repositioning deal. Therefore, refinancing does not always meet your objective. Of course, if the increase in value were greater, or the refinancing LTV were higher, the refinancing option may achieve this goal. Or if you only need $30 million for your next investment, refinancing is very effective. But in our example, too much value remains tied up in Jessica Crest for refinancing to achieve your objective.

What can you do to solve this equity gap? You could take on a smaller repositioning project or sell a slice of either Jessica Crest or the new project to an equity partner. A problem with finding an equity partner is there are relatively few buyers of **minority interests** in privately owned properties, as relatively few investors want an illiquid ownership stake, particularly where their vote will never impact decisions.

Of course, investing $40 million in another property is not every investor's objective, and thus the refinancing option is very attractive for investors who are happy to retain an interest in the stabilized property. For those happy to take $30 million out of Jessica Crest and keep the $49 million equity position, the refinancing option is perfect because of the lesser value leakage. Remember that there is no single objective for all investors. Numbers are important, but who you are and what you are trying to accomplish will ultimately dictate your exit strategy.

LIKE-KIND EXCHANGE (1031 EXCHANGE)

There is a third exit possibility that is U.S.-specific. Under current U.S. tax code, IRS Section 1031, you can pursue a so-called **like-kind exchange**, which essentially allows you to sell your property free of state and federal income taxes if you purchase a "similar" property within a prescribed period of time, hence forestalling capital gains taxes until you ultimately break the ownership chain. Also, the "1031 exchange" allows you to restart your depreciation schedule. This is particularly helpful if you have a building that is nearing the end of its depreciable life. Under the like-kind exchange principle, you can exchange your property partnership interest for an IRS-qualified partnership interest in a different partnership. If correctly executed, this legally-technical exchange process defers your capital gains tax until you sell your new interest.

Using the Jessica Crest example, you would sell the $140 million Jessica Crest building exactly as before. You will pay the sale-related fees and retire the debt, but you do not pay the capital gains taxes immediately if you successfully find a building for purchase which qualifies under the tax code for a 1031 exchange. Volumes of tax law dictate the circumstances under which you can effectuate a like-kind exchange and defer taxes, and the nuances constantly change.

There are some general guidelines you can use to understand the application of like-kind exchange as an exit strategy, but you must make certain that the new property is being held for investment or productive use. The property cannot be acquired with the intent of being resold after a short time period. One of the criteria is the items exchanged must generally be the same business. For example, you cannot sell Jessica Crest and buy an oil and gas company, stocks, or bonds and treat it as a like-kind exchange. Broadly speaking, whether a property is considered like-kind is up to the "nature and character of the property, not its grade or quality" (IRS Code Sections 1031(a)-1(b)). You may do exchanges on both unimproved and improved property. The IRS does not consider real estate outside the United States as like-kind property.

There are two noteworthy margins that people try to capitalize on via like-kind real estate exchanges. The first is to sell a stabilized building, while purchasing a building where there is opportunity to add value. In our example, you would look to sell your stabilized Jessica Crest property for the poorly-managed, partially-leased building you wanted to reposition. As long as you can get the IRS' blessing of the repositioning purchase as a qualified like-kind exchange, you have satisfied your strategic objective of purchasing the new value-added project while deferring your capital gains taxes on the sale of Jessica Crest.

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The second opportunity is to sell your property and buy a stabilized building that offers a better refinancing opportunity and a reduced management burden. The poster child transaction in this case is to exchange a multi-tenant corporate office complex for a new building that is leased on a long-term basis exclusively to the U.S. government. The upside of this building is that lenders are willing to lend against it as collateral at a higher LTV ratio than on Jessica Crest, due to the higher tenant credit and long-term lease of the government. Figure 18.7 illustrates such an exit strategy.

FIGURE 18.7

Jessica Crest Like-Kind Exchange Net Equity Calculation	
Part 1: Sell Jessica Crest Asset	
Sale Price	$140.00 MM
Debt (60% LTV)	($60.00 MM)
Fees	($3.00 MM)
Capital Gains Tax	$0
Depreciation Tax	$0
Equity Freed	$77.00 MM
Part 2: Buy U.S. Government-Leased Asset	
Purchase Price	$140.00 MM
Debt (75% LTV)	($105.00 MM)
Equity in Asset	$35.00 MM
Equity Freed	$77.00 MM
Equity in Asset	($35.00 MM)
Fees on Purchase	($1.00 MM)
Equity for new projects	$41.00 MM
Net Equity	$76.00 MM

As before, you sell Jessica Crest for $140 million, repay the $60 million loan, and pay $3 million in fees. But you will not pay capital gains tax in this example, as long as the “replacement” purchase of the government-leased building qualifies as a like-kind exchange. As a result, as shown in Part 1 of Figure 18.7, you net greater proceeds from the sale of Jessica Crest within a like-kind exchange exit than from the sale in the straight disposition strategy ($77 MM versus $69.56 MM shown in Figure 18.4).

As shown in Part 2 of Figure 18.7, you buy the government-leased building for $140 million with a combination of $35 million of equity from the Jessica Crest sale and $105 million in senior mortgage debt (a 75% LTV). You will incur $1 million in fees to borrow the $105 million, allowing you to take $41 million out of the new property while retaining your $35 million equity position for a total wealth position of $76 million. Although the $76 million derived from the like-kind exchange is less than the $79 million net value from a refinancing (due to the higher fees associated with selling Jessica Crest), you are able to achieve your objective, as the $41 million pulled out of the property provides you the $40 million necessary to purchase and reposition another property (and put $1

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million in your pocket). You also are able to focus your energy on the repositioning exercise because the government-leased property you own is a relatively low-headache management task. In contrast, with a straight refinancing you still have to actively manage the Jessica Crest property.

A major drawback is that other bidders looking to protect their tax position will also be attracted to the exchange property. As a result, the price of a poster child transaction replacement property is generally bid up to the point where some of your tax savings are often passed on to the seller in the form of a higher price. It should also be noted that it is nearly impossible to find a property worth the same as yours. For this reason any excess gain is taxed, with this excess known as the "Boot."

To execute a 1031 exchange, you appoint an independent specialist known as a "QI", or **qualified intermediary**, to help sell the property. The qualified intermediary's purpose is to set up an agreement, so that an escrow or closing agent transfers the property to a buyer and that the sales proceeds go directly to the qualified intermediary. If this were not so, the 1031 exchanger would be taxed on the proceeds. The exchanger has to acquire a new property within a limited number of days. The new property must be designated as a "replacement" by the exchanger, and this designation must be sent to the person from whom the exchanger will acquire the property. This is known as the "identification" process. The exchanger must identify a property that is not owned by a subsidiary or employee of the exchanger. The IRS Code has a detailed description of the people from whom the property cannot be purchased, known as "disqualified persons." While there are many types of like-kind exchanges, conceptually they are merely technical variants.

EXCHANGE FOR PUBLIC COMPANY SHARES

Another possible exit strategy is to exchange your ownership interest in Jessica Crest for a monetarily equivalent ownership interest in a publicly-traded company. For instance, you could exchange the $140 million Jessica Crest property for common shares in publicly-traded Boston Properties. If this transaction is structured properly, you will again be able to defer taxes and will not recognize capital gains on the transaction until you sell your Boston Properties position. Your tax basis from Jessica Crest will carry over to your interest in Boston Properties and your capital gains will be determined based on the proceeds from its sale versus the old basis. However, to achieve such deferral of capital gains can require rather complex structuring. You will generally receive dividend rights and voting rights equal to your pro rata share of the acquiring public company. This transaction provides you with a small slice of ownership in a larger, more diversified pool of assets. However, you will not have control of the property and will generally lose the property management fees you previously earned from the property. Figure 18.8 summarizes the four exit strategies discussed so far.

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FIGURE 18.8

Jessica Crest
Comparison of Common Exit Strategies

Jessica Crest property value at end of Year 3: $140.00 MM

Exit Type	Taxes at Exit: Capital Gains	Taxes at Exit: Depreciation	After Exit: Wealth Position	After Exit: # of Controlled Properties
Fee simple disposition	Yes	Yes	$69.56 MM	0
Refinancing	No	No	$79.00 MM	2
Like-kind exchange	No	No	$76.00 MM	1
Exchange for public company shares	No	No	$77.00 MM	0

GO PUBLIC

The alternative to the four types of exits discussed so far is to take your company and properties public. As discussed in more detail in Chapter 21, to do so, you will need a much larger pool of assets than just Jessica Crest. Your company must consist of a large pool of diversified properties in a particular property type, or the investor community will probably be unwilling to purchase your stock at the initial public offering (IPO). Furthermore, the pool of assets will need to be structured in a manner dictated by the public market: low debt, predictable cash flows, independent governance, and high reporting transparency. If your portfolio lacks these qualities, it is unlikely you will be able to receive fair value from the public market investor community.

In addition, an IPO takes 12-18 months. If your IPO succeeds, you will incur total fees equal to about 10% of the total money raised. In fact, you will incur $500,000-$1 million in expenses whether you successfully complete an IPO process or not. If you pursue an IPO, you are subject to the vagaries of timing and the market during the process. If the market weakens, you may be unwilling to issue equity at substantially reduced prices. On the other hand, if the IPO is successful, you will be able to access public capital markets and can use the proceeds to purchase additional properties or pay down debt.

CLOSING THOUGHT

Selecting an exit strategy is critical. The optimal strategy depends on your objectives. While the numbers and calculations are important, exit is ultimately a personal decision. Two people looking at the same numbers on the sale option and the refinance option may make completely different decisions based on their objectives. Like most things in real estate investing, selecting an exit strategy is definitely not a one size fits all exercise!

Online Companion Audio Interview: To hear a conversation about this chapter's content, go to the Online Companion and select the link for Chapter 18. Scroll down to the Audio Interview section and listen.

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