TICs Triumph

written by
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TIC sales are getting stronger, and are even being aided by the city's attempts to slow them down.

As predicted in my last article on tenancy-in-common trends at the end of 2012, the total TIC sales volume and number of units sold indeed has increased for the third straight year. On the final day of 2012, 357 TIC units had traded hands in districts 1-10 of San Francisco, for a total volume of almost $229 million. This was up about 11% in total units sold year over year and represented a more than 30% increase over 2011, where 272 TIC units traded hands. This trend of increasing TICs sales seems poised to continue at a strong pace.

Ellis Acts Up

There are many reasons for this trend. First, from 2008 to 2010 the real estate market was slower and buyers were less eager to jump in to the TIC market. As such, apartment owners and TIC speculators no longer felt comfortable with the risk of emptying their buildings of long-term tenants via the Ellis Act. The risk of not selling and also being unable to rent the units back out again seeming like a distinct possibility. The result was a lack of inventory in the TIC market and increased buyer demand.

As the market started to gain steam at the end of 2012, apartment owners and speculators saw the void in the market and once again started to take steps to fill it. Ellis filings are up approximately 26%, as reported at the last annual San Francisco Rent Board Eviction Report to the city's board of supervisors. This comes as more and more apartment owners realize that they can create more affordable ownership housing and escape from the perils of subsidizing their current rent controlled tenants, while avoiding having to comply with more and more bureaucratic red tape imposed by the city. The result of the increases in Ellis Act filings means that we will see a continued increase in the offering of TICs over the next several years and, with a booming tech market in the mid-Market corridor and on the Peninsula, the demand from buyers should be there to support it.

Recently, we have seen a lot of negative political press regarding the Ellis Act, stating that the evictions are an "epidemic" from which the city is currently suffering. I would personally make the point, however, that rent control is a much larger "epidemic" as a whole. Even with the 26% increase, the total of units actually withdrawn from the market via the Ellis Act was only 116, or less than .01% of the rental inventory in the city. Much has been made in recent days and months of the eviction of the Lee family from their unit on Jackson Street. Even though this is an unusual story

and an unfortunate situation, the Lees did enjoy 34-plus years of well-below market rent, and the benefit of rent control. For their landlord, the only way out of privately subsidizing these tenants was to Ellis Act the building. Media attention from this one incident, however, may have greater impacts on landlords' rights than just this single case.

Prominent real estate attorney Andrew Zacks of Zacks and Freedman had the following explanation of why Ellis Act filings are on the increase these days and why this trend may continue for some time: "There are currently efforts in the state capitol to limit the Ellis Act, and many clients who have been waiting on the fence are now realizing that the time is here to file their Ellis before risking the loss of opportunity."

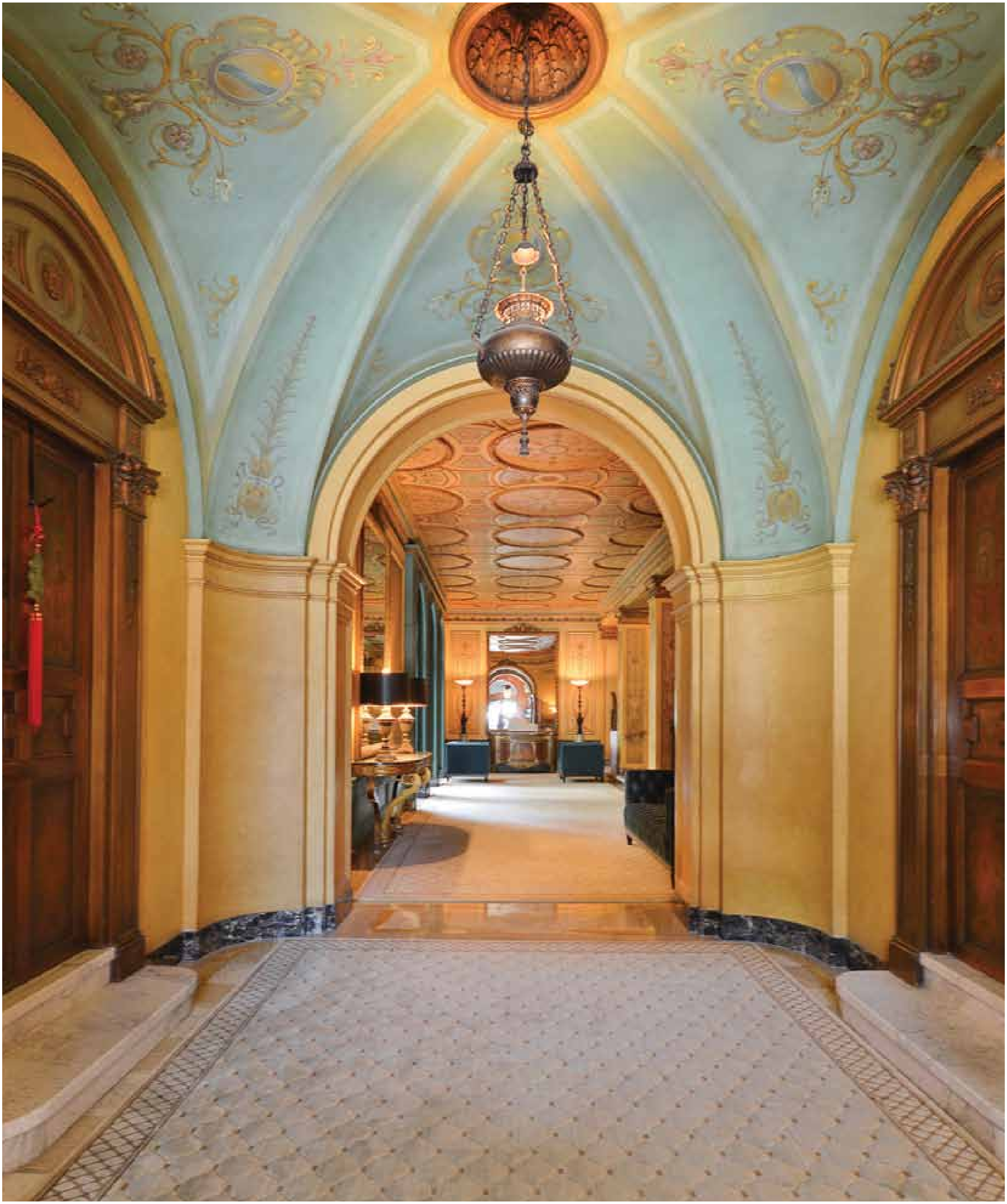
Zacks fears that with a state legislature that is much more progressive than in years past, there will soon be a significant challenge aimed at eliminating or severely restricting a building owner's opportunity to go out of the rental business. He is genuinely concerned that this could come into place sometime next year. "For my clients who are considering withdrawal from the rental market, now is the time," he says.

He expects that any legislation introduced at the state level may contain provisions invalidating Ellis Acts filed after the date of introduction of any proposed legislation (similar to techniques used by the San Francisco Board of Supervisors in introducing legislation over the last decade). Thus, if you are a landlord looking to remove your building from the rental market and ultimately sell your units as TICs, now would probably be a good time to call your attorney for a consultation.

Condo Conversions Quashed

Another reason for an increase in TICs is the recent condo-conversion legislation introduced and recently adopted by the San Francisco Board of Supervisors. Introduced by Supervisors Mark Farrell and Scott Wiener in 2012, their condo-lottery bypass legislation would have allowed TIC owners who had entered San Francisco's condo-conversion lottery to bypass the extreme backlog of about 1,800 TIC units in the lottery in exchange for a fee. Much to the chagrin of these two supervisors, though, their legislation was hijacked in a series of amendments introduced by Board President David Chiu, making the legislation "a mess," according to Farrell. In the end, after the legislation was amended, Farrell and Wiener were two of three supervisors who voted against it.

But these progressive supervisors did not realize that market forces are always stronger than political legislation. By eliminating the lottery and allowing bypass for the existing TICs in the lottery, with the caveat of lifetime leases for tenants in place at the time of conversion as well as disallowing TIC conversions for 10 years, the newly amended legislation stripped away the incentive for landlords to offer a "buy-out" to their tenants in order to convert to TICs. In the past, to preserve the ability to condo convert for future buyers of their units, developers and landlords would offer the tenants in occupancy hefty sums of money



to move out of their units and thereby avoid the Ellis Act, which has eliminated San Francisco TICs from condo conversion since 2005. Now, with no conversion possible in the foreseeable future, that incentive is gone. And with it, so are the days of tenants walking away with five- and six-figure settlement payments. Without the incentive to sell to prospective buyers of condo conversion, the Ellis Act has become the most optimal way to go in getting tenants in buildings to vacate.

Larger Projects Come Online

The elimination of the lottery also leveled the playing field on the size of projects that would be offered as TICs. When the lottery existed in its previous form, most TIC projects were in the category of 2-6 units, as those could someday possibly condo covert. With conversion on new projects off the table for at least 10 years, the door was opened for larger projects to continue to come online.

One great example of this is the Park Lane, with 33 units in a 1925 Art Deco luxury building at 1100 Sacramento St. on the top of Nob Hill, where owner Russell Flynn has begun to sell off the units as TIC interests. The Park Lane is inevitably compared with two projects that previously held the record for largest number of units: Nob Hill Gardens (14 units) three blocks higher up the hill, and Francisco Palms in the Marina District with 17 units. The Park Lane differs in that it's the largest project to date and is a luxury building with the highest prices per square foot that we've seen recently. A penthouse unit was listed at $6,995,000, which provides 3,398 square feet at slightly over $2,000 per foot.

Don DeFranco with the Park Lane sales team says that response has been very good on the units, which are 50% sold on their first release. He notes that they are seeing the expected buyer crowd: affluent buyers planning on using the units as a pied-a-terre, downsizing from larger homes in Woodside, Atherton and Hillsborough, and even possibly some previous tenants in the building who will ultimately get the opportunity to become owners of their wonderful units. DeFranco, who early in his career specialized in high-end co-ops in New York, compares the practice of TIC ownership on the higher end here to that of co-ops being sold off in the mid 1980s in New York.

Wearing my real estate broker's hat for a moment, I am happy to see exposure of the TIC market on the ultra high end, as this should continue to bring more buyers into the prospect of owning TICs as a solution to the lack of acceptable or affordable inventory in a city with high demand and low supply. A buyer would be hard pressed to find a similar condominium unit as well located and finished as the Park Lane. For creating this opportunity, I am very grateful to Flynn and his investor group.

At about the time this largest TIC project ever was announced, Bank of San Francisco and Bank of Marin (an early TIC pioneer who had taken a break from TIC lending earlier this year) joined the market

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of TIC lenders, and word on the street is that a leading residential mortgage lender will probably offer fractional TIC loans soon. Where we had two lenders lending at this time last year—Sterling and NCB—we now have at least four lenders willing to lend on fractional TICs and, if the large bank steps up, there will be five.

So what do I predict for the future of the TIC market? Well, the easy answer is that more of them will be developed, listed and sold. With more units in the development pipeline, more landlords realizing their ability to exit the rental market may be limited, and more competitive terms on fractional financing, 2014 should shape up to be a great year for the TIC market. Though a far cry from the 724 units sold in 2007, this year's projected numbers indicate we will have a third year of consecutive sales increases, and it is very likely that that trend will continue into 2014. Much to the dismay of tenant advocates and a majority of the San Francisco Supervisors, TICs are here to stay; and no matter how hard they try to push TICs down, it keeps popping up in a different place, stronger every time.

Realtor Jesse Fowler works with many other well-established real estate professionals and skilled builders to develop and market TIC projects in San Francisco. He has 20 years of experience in San Francisco real estate, listing and marketing TIC properties, single-family homes, condominiums, multiuse and income buildings. A Noe Valley native and homeowner, Fowler is a broker associate at Brown and Company Real Estate and can be reached at jesse@jessefowler.com.