

The Great CRE Pricing Standoff – Deal-Making in Wake of the IRS 1031 Extension

Dear Clients & Colleagues –

Imagine for a moment that you were an investor who sold a property on February 18th of this year. As your sale closed on that Tuesday, you had some familiarity with COVID-19, and perhaps had read in that day's national publication that China had recorded approximately 74,000 total cases, and Europe had 40 cases thus far reported. However you, like many others, still viewed this as something far from the United States' shores and did not fully comprehend or consider how different the world would look in just a few short weeks. Your simple plan: redeploy the proceeds from your sale into another asset of equal or greater value, following the tax-code deferred 1031 exchange guidelines. You were on the clock, with 45 days to identify which assets you would acquire or try to acquire.

Fast forward to April 3rd, a mere 45 days later. You now face an incredible quandary. The same national publication alerted you to the fact that more than 275,000 cases had been confirmed in the US, alongside approximately 7,000 deaths. While the human toll was certainly overwhelming, you faced the incredibly difficult decision of what to do with your tax-deferred exchange; risk reinvesting it with unprecedented economic turmoil swirling about, with many tenants not paying their April rent or bite the bullet and elect to not complete the 1031 exchange and pay significant tax consequences to the government.

Unbeknownst to you, countless investors faced the same conundrum, and the collective decision-making of everyone who shouldered the same burden would have a substantial impact on valuations and liquidity across the commercial real estate market. While it is impossible to know for certain, most estimates place the percentage of exchangers who would have chosen to pay taxes at roughly 40-50%. If we presume there is approximately \$85 Billion of 1031 capital in the market in any given 45-day identification cycle, the market was looking at losing up to \$40 Billion of capital redeployed if 50% of those exchanges chose to pull back from the marketplace and pay their taxes.

This is why the IRS' decision to extend all 1031 ID periods scheduled to expire from April 1st until July 15th was such an important announcement. While there will still be a substantial number of investors who do decide to pay taxes due to uncertainty, if even \$20 Billion of capital stays in the market, it will have a meaningful impact on stabilizing pricing.

The unprecedented IRS extension will also create a previously unseen dynamic that will greatly impact prevailing market pricing over the next 12-18 months. With such a massive wave of 1031 investors with ID Periods now expiring on July 15th, both buyers and sellers will likely wait until the first couple of weeks of July to do real deal-making.

Buyers are likely to calculate that they will be better served waiting to the very end as they will have more information about the public health and economic crises, and thus be better positioned to make smart investments. They are also likely to believe that seller pricing will become more "realistic" as the pain of the current environment hits home. Conversely, sellers are very likely to hold out on strong pricing with the belief that the sheer volume of exchanges expiring on July 15th, will cause buyers to "blink" and meet their pricing.

It's impossible to know which side of the bid-ask spread will ultimately win out; however, the strategic high-wire deal-making of the time period between July 4th and July 15th is likely to be one of the most interesting periods in the last decade.

Ultimately, the most important deal-making and associated pricing may well be in Q4 2020. Once the majority of the pre-COVID-19 exchange capital clears, the market will then become reliant on non-1031 investors as investment sale velocity occurring as we speak is in a sharp decline with much tenancy not paying rent in April or May. These investors not influenced by tax deferral will represent true fair market pricing that will likely be meaningfully lower than 1031 buyers. Sellers will take time to meet that market, and ultimately the market may take until Q1/Q2 of 2021 to truly find new normal pricing.

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