



## CHASING THE HIGHEST YIELD

### Looking behind the mechanics of yield and how a higher projected yield might not always be better

The Delaware Statutory Trust (DST) market has seen exponential growth in the last few years, with 2022 seeing a projected capital raise approaching \$10 billion. What draws so many to these 1031 exchange investments? Some of the benefits include tax deferral, access to institutional-grade properties, portfolio diversification, no management responsibilities, and more. It's a quick-paced market with more new sponsors (sometimes with no track record) entering the market. It is crucial for investors to review investment offerings to understand how cash flow is being generated. Here are some tips for understanding controversial DST cash flow strategies.

#### BE AWARE OF CONTROVERSIAL DST CASH FLOW STRATEGIES:

##### ● BUYING LOW-QUALITY ASSETS

Buying low-quality assets in unreliable markets may yield a higher cash flow—but it's usually only temporary. For industrial properties, the quality of the tenant is the most important consideration. It's the investor who assumes the risk that the asset may become a concern or cannot be sold for a favorable price. Sometimes a higher cash flow might represent higher risk.

##### ● NOT PROPERLY FUNDING PROPERTY RESERVES

It's always important to have reserves in case of a last-minute repair, costly upgrade, and to properly position the asset when selling. A larger reserve can mean a lower cash flow amount, but it also means a more secure investment. Remember that funds in a reserve account also belong to investors.

##### ● DEFERRED ASSET MANAGEMENT FEE OR OTHER FEES USUALLY PAID FROM PROPERTY'S PROFITABILITY

Deferring a payment of these fees until after the sale of the property changes this to a fee from Closing Costs and has potential tax implications. Look for the waived fees that are used only when necessary to support yield during value-add implementation or initial lease trade out in high growth markets.

##### ● OVERLY AGGRESSIVE ASSUMPTIONS

Remember that there's no general standard for due diligence practices. Watch out for aggressive assumptions in future NOI (net operating income) growth that are not reasonable relative to market rates or tied to proven value-add renovations. If actual results do not equal the aggressive assumptions, investors may lose out on income and/or principal.

##### ● USING CASH RESERVES TO SUPPLEMENT CASH FLOW

This method can be commonly used to temporarily inflate cash flow. Instead of cash flow coming from the profitability of the property, this could be considered as The DST sponsor returning an investor's principal to make cash flow appear solid. Also, using reserves could put the DST's value, hold period, and overall return all at risk, so be careful.

<sup>1</sup>Based on 1031 DST/TIC Market Equity Update by Mountain Dell Consulting as of September 15, 2022.

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# Do Your Due Diligence

## Checklist to Evaluate a DST Sponsor

With every DST sponsor differing in experience, strategy, and overall capability, the themes and questions below can help financial professionals and investors evaluate DST sponsors.

### TRACK RECORD

- ✓ What's the number of sponsored programs and total equity offered since inception?
- ✓ What types of assets are under management and what is their performance?

### INDUSTRY EXPERTISE

- ✓ How long has the sponsor worked in the relative real estate business?
- ✓ Is the management team knowledgeable on property types and the markets where their properties are located?
- ✓ Does the sponsor handle property management or outsource to a third party?

### SPONSOR FEES

- ✓ What kind of fees does the sponsor require?
- ✓ Are disposition fees and expenses capped?

### SIZE & FINANCIAL STRENGTH

- ✓ How large is the sponsor company?
- ✓ How often does the sponsor perform cash audits on the DST properties?

### UNDERWRITING STANDARDS

- ✓ What does the underwriting process entail for the sponsor?
- ✓ Does the sponsor underwrite and identify strong, creditworthy tenants?

### EXIT STRATEGIES

- ✓ What are the long-term goals and exit strategies of the DST?
- ✓ Does the exit strategy line up with the goal of the investors?

### THIRD-PARTY REPORTING

- ✓ Does the sponsor use independent analysis and reporting on their company?
- ✓ Does the third-party reporting come from a credible source?

### INVESTOR COMMUNICATIONS

- ✓ What are the sponsor's communications standards?
- ✓ Do they have an internal investor relations team?

### Risk Factors

Some of the risks related to investing in commercial real estate include, but are not limited to: market risks such as local property supply and demand conditions; tenants' inability to pay rent; tenant turnover; inflation and other increases in operating costs; adverse changes in laws and regulations; relative illiquidity of real estate investments; changing market demographics; acts of God such as earthquakes, floods or other uninsured losses; interest rate fluctuations; and availability of financing.

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