Mountain Dell Consulting is pleased to provide you with the Exchange Quarterly for the second quarter of 2016. We have selected a few articles to educate our readers, and a statistical summary of the securitized 1031 industry.

Our target audience is the investment professional who may be very active in the 1031 exchange space or investigating the pros and cons of entering it. As the real estate market continues to strengthen, our audience will grow as well as the need to educate them.

Demand for tax-deferred (1031) exchanges ebbs and flows with market conditions. In many parts of our country, market conditions have been red hot; values in many regions are higher than they were during the last market peak. Equity raised to date has been very consistent, but not as much as was expected. Savvy sellers are shopping and comparing exchange property options, property sponsors, transaction professionals, and costs.

We hope the articles in these issues elevate participation at this exciting time. A summary of the most recent market intelligence follows. A more detailed version was recently presented at the ADISA Due Diligence Symposium, available upon request. In reviewing the most recent market data, we note the following.

$1.4 BILLION IN EQUITY

- Current equity raise rate is about $115 million per month;
- 2016 equity has been very consistent, month to month, compared to 2015 with its ups and downs and a very strong year end equity raise;
- 2016 year end totals are expected to be greater than $1.4 billion, based on a hopefully strong year end performance and a friendlier lending environment;
- Large blocks of 1031 exchange investments are going into single, one-off non-securitized investments, with a small remainder going into securitized 1031 DST offerings; and
- 1031 rollover business was expected to boost the market, but has only attributed to about 10% of the business, as the majority of equity raised is new capital.

CHALLENGING LENDING ENVIRONMENT

- The recent challenges of the CMBS market has made loans tougher to get and more expensive, slowing the progress made in the 1031 market; and
- Recent adjustments towards lower interest rates has helped some sponsors obtain financing, but more upfront cash is required and leverage has gone down.
APARTMENTS / MULTI-FAMILY DOMINATES

- Equity raised has been dominated by apartments (54% of all sales), followed by retail (24%), and office (12%); and

- The demand appears to be higher than the quality of supply in certain asset/sub-asset classes, namely: apartments, senior housing, student housing, medical office, and self storage.

SMALL NUCLEUS OF SPONSORS

- Although 25 sponsors have had an active offering in 2016 and many others have talked about entering, the total number of product sponsors who are currently raising some equity has dropped to 19;

- In 2003, it took 21 sponsors to raise $756 million, whereas we could raise almost twice that with the same number of sponsors in 2016;

- Most sponsors are avoiding 506(c) registered offerings based on negative comments from the broker-dealer community in 2015, but today, many broker-dealers have reconsidered and are warming to the idea of 506(c) offerings, but supply is very low;

- Only a small number of sponsors offer TIC structured offerings and most sell out quickly, but the vast majority continue to be structured as DST offerings;

- Available equity has been hovering around $300 million, dominated by retail and apartment offerings; and

- Although 7% first year yields can be found, usually using interest only to get there, average first year returns for industry at 5.32% continue to decrease.
I took a rep out to dinner one night in order to discuss our storage fund. He ordered a nice meal with the appropriate wine, promptly turned to me and said, "Don't like storage. Would never use it. Won't sell it." I appreciated his candor, wished he had spoken up prior to ordering, and contemplated a response. I countered, "I bet someone in your family has a storage unit." Taken aback, he reluctantly admitted his brother had a storage unit and had been renting it for years.

The purpose of this anecdote is to demonstrate two points. The first is that not everyone loves storage. The second, one of the key elements of self storage, is that a lot of people do like storage, whether they be customers or investors. Storage is unique because virtually every person, every company, and every organization is a potential customer.

People frequently ask which demographic market works best for self storage. We believe the entire country is our market. Demographics are not as important as population density.

In addition to density, self storage is dependent on a vibrant economy and a mobile population. We like to see people relocating from city to city, moving in and out of apartments, buying and selling houses, getting married and divorced, starting companies, building inventory, and storing supplies. These are the people and businesses that drive self storage demand.

Most people rent a storage unit with the intent of only staying a few months. Many, however, end up staying for years. Another key element to storage: What starts as a convenience, becomes a necessity. Once a person rents a storage unit, it tends to become an extension of the home or business. This leads to many long term customers and a stable customer base. For our properties, the average tenant stays more than two years.

Storage facilities are marketed in many different ways. High visibility locations, curb appeal, attractive rates and discounts, good customer service, internet advertising, amenities such as climate control and restricted gate access, are all common marketing elements.

However, the one that rarely gets mentioned, but may be the most important reason storage is so successful, is the 30 day lease. People can literally move in one day and move out the next. The lack of a long term commitment is, in my opinion, the primary reason storage is so successful.

The flip side of the 30 day lease is that the owner can raise the rent on every tenant with a 30 day notice. This is a huge financial advantage that storage has over most other product types. The rent increases tend to be nominal on an individual basis, but can have a significant impact on the profit in the aggregate. A $10 monthly increase on 500 tenants can generate an additional $60,000 a year in income, with very little increase in expense. $60,000 capitalized at 10% is worth $600,000 in value.

Many sophisticated operators raise a customer's rent six months after they move in and annually thereafter. They know that after a few months, a customer is unlikely to move out because of a small rent increase. This is a unique reason why storage works.

All investing involves risk. The greatest risk in any real estate investment may be the lack of control. While owners may be able to control the property, no one can control the competition, demographic changes, consumer tastes and behavior, or the economy. As a result, experience, a strict investment discipline, and site selection are obviously very important. Everyone wants the perfect site which, in the real world, does not exist. Every property has its flaws. Some flaws can be overcome. Some can't. Perhaps the hardest part about investing is being realistic and having the discipline to walk away.

Another risk is debt. Most real estate properties can cover their operating expenses from rental income even in a depressed market. But too much leverage can bring down even the best properties. Interest keeps accruing 24/7, in good markets and bad. Leverage can dramatically increase the yield and potential
profit, but at the expense of increasing risk. We prefer not to exceed a loan to value ratio of 65%. The most underrated or ignored operational risk for storage may be off site management. Running a storage business is a day to day operation involving hundreds, or in our case, thousands of tenants. Owners who lack the business skills, marketing sophistication, or real estate knowledge can struggle to maximize profits.

As an investor, what does this mean? How do I, the investor, make money? First of all, evaluate your personal goals and preferences. Does a storage investment appeal to you or are you more comfortable with some of the other product types? Does the time frame work? Is the yield acceptable? Is the upside commensurate with the risk and lack of liquidity? If the answer is "yes," invest with someone who has significant self storage experience.

Recently, I met with a developer to discuss purchasing his storage facility. I questioned some design and operational issues. His response was, "I am still learning." Probably better to let him learn with someone else's money.

Capitalization rates continue to drop as more money chases fewer deals. Given the aggregate wealth of the baby boomer generation, it is unlikely cap rates will change much in the coming years. This makes finding profitable properties even harder. Our focus is on dense population areas, markets with high barriers to entry, and properties that are owner managed. Owner managed properties are almost universally under managed.

Does storage work as a DST? If it works as a storage investment, it certainly should work as a DST. In addition to the advantages and disadvantages discussed above, storage has the advantage of having a lower total value than many other real estate investments. Very few storage properties sell for more than $20,000,000 and many sell for less that $10,000,000. That means a DST investor can get a bigger ownership share of a storage property, compared to larger DSTs with other product types.

Another DST benefit of storage is that capital expenditures are relatively predictable. Capital items tend to be roof repair or replacement, building and door painting, and paving maintenance. These costs can be estimated and reserves established to cover the term of the DST.

A negative to DST investing is the difficulty predicting uncontrollable costs, primarily real estate taxes, insurance, and utilities. There is no way to be totally comfortable predicting these costs 5-10 years out. As a result, either the investor or master tenant, or both, are exposed to increased costs over which they have no control. It does not necessarily make a good deal bad. Just something else of which to be aware.

In summary, self storage has many unique advantages—a large and diverse market, a mobile population, a stable customer base, and the 30 day lease that works for both customers and investors. But it is not without risk—factors outside of an investor’s control, too much debt, or poor management.

In my mind, investment opportunities are there every day. The hard part is finding them, doing the necessary homework, and making an informed decision. I hope this brief background on storage will make your job a little bit easier. Good luck.

Mr. Dahn has over 30 years of experience in the self storage industry and is the President of Dahn Corporation. Dahn is the sponsor of a family of self storage funds including America360 and a number of storage DSTs.
In the legal realm, conservation easements are an evolving financial planning tool allowing taxpayers to claim federal income tax deduction and, in some cases, engage in some gift and estate planning, while also preserving real property interests with conservation values. Since easements applied to conservation are a somewhat obscure form of land use, most do not know what they are or how they are used. A conservation easement is a legal agreement between a landowner and a land trust or government agency, that is put into writing, and is used to protect land with conservation value.1

Governed by Internal Revenue Code §170(h), this I.R.C. provision lays out the basis of what qualifies as a tax deductible conservation easement.

Conservation easements grew out of a recognition that the United States Government was limited in its ability to purchase, manage, and properly preserve areas of historical and ecological significance. The use of conservation easements began to gain steam by the 1980s, and by the 1990s, exploded on the scene.2 The desire to protect lands that serve a general public benefit has led to several million acres of conservation-sensitive land being protected by conservation easements.3

A conservation easement as defined by the federal tax code as a contribution of a qualified real property interest, to a qualified organization, exclusively for conservation purposes.4 This definition, however, leaves something to be desired to the casual reader who is unfamiliar with what a conservation easement actually is. This makes it necessary to break down the definition and parse in order to understand what a conservation easement is and how they function.

Section 170(h)(2) of the Internal Revenue Code (“I.R.C.”) describes a qualified real property interest as any of the following interests: (i) the entire interest of the donor other than a qualified mineral interest; (ii) a remainder interest; and (iii) a restriction (granted in perpetuity) on the use which may be made of the real property.5 To put this in layman’s terms, the conveyance involves a real property interest owned in fee simple by the donor that is encumbered with significant use limitations. A donor (i.e., the land owner) grants an easement effectively limiting its ability to commercialize the land in earnest to a donee (i.e., a land trust or government agency), who in turn is empowered to enforce the development related restrictions. Notwithstanding the easement, however, the donor retains fee ownership of the property and may reserve certain rights to use the property as long as those rights do not interfere with the property’s conservation values. Therefore, the donor still owns the fee simple to the property, has the ability to transfer those rights subject to the easement, and has the ability to use the land within the use restrictions as stipulated by the conservation easement agreement. The types of land use rights

1 See Kate Deal, Incentivizing Conservation: Restructuring the Tax Preferred Easement Acceptance Process to Maximize Overall Conservation Value, 101 Geo. L. J. 1587, note 3 (2013)
4 I.R.C. § 170(h)(1)
5 I.R.C. § 170(h)(2)
often retained by the landowner may including by way of examples hunting, hiking, fishing, forest and wetlands management, farming and agriculture, and in many cases, using the property for residential purposes. However, the conservation easement runs with the land and is not extinguished upon sale or transfer of title. While the issue is still very much in doubt, the IRS also frowns upon measures undertaken by the land owner and donee to modify the easement’s restrictions and reserved rights.

Organizations that qualify to be donees for conservation easements are determined under I.R.C. §170(h)(3). A State, possession of the United States, a political subdivision of either a State or the United States, the United States itself, or the District of Columbia qualify as organizations able to obtain conservation easements so long as it is made exclusively for public purposes. Another way that an organization can qualify for conservation easements is by being registered as a I.R.C. § 501(c)(3) entity. Generally, the organization that receives the conservation easement must have a commitment to the conservation purposes of the donation and must be able to effectively enforce the terms of the easement agreement. This means that the donee organization must be committed to conservational preservation activities as a part of its business mission, and must have the physical and intellectual manpower and monetary resources to monitor the property and enforce the restrictive covenants set forth within the easement into perpetuity. For these reasons, the undertaking of finding a qualified donee, while do-able in many cases, requires some due diligence work on the part of the landowner.

The final key to the conservation easement is that it must have a conservation purpose that is actually recognized by I.R.C. §170(h)(4). This section states that a conservation purpose must fit one of four descriptions: (i) the preservation of land areas for outdoor recreation by, or the education of, the general public; (ii) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (iii) the preservation of open space where such preservation is for the scenic enjoyment of the public, or where the preservation will support a clearly delineated Federal, State, or local governmental conservation policy, and, in either case, will yield a significant public benefit; or (iv) the preservation of an historically important land area or a certified historic structure. The conservation aspect of a conservation easement boils down to this: the land that is to be protected must serve some purpose that would benefit the general public as a whole and would be accessible to or viewable by the public. The land does not necessarily have to be accessible to the public for use, however it must meet one of the other qualifications of a conservation easement. Examples of areas that are likely to qualify as having significant conservation values include and are not limited to 100-plus acres of quality forested lands along a scenic highway, a forest or aquatic area where endangered wildlife lives, or an area of mountainous forest that the public can hike and camp on.
To properly structure a conservation easement, the easement agreement must be executed by a donor and donee. As is common with other forms of property rights conveyances, conservation easements are conveyed by deed and are recorded in the real estate records of the county where the property is located. The deed will describe the conservation purpose(s), the restrictions on use, and the permissible uses of the property. The deed is recorded in the public record and must have legally binding restrictions enforceable by the donee organization under state law. The amount of control that is retained by those receiving the easement is dependent on the terms of the conservation agreement. The property interest that the donee organization receives is encumbered by the restrictions spelled out in the conservation easement agreement and the restrictions are binding to the donor landowner and all future owners of the property. Again, an important point that should be covered in the drafting of the conservation easement agreement is to not allow the donor to retain rights that would be inconsistent with the easement’s conservational purposes. If the property is encumbered by a mortgage, the lender must subordinate its economic rights to the easement donee prior to the easement being signed and filed. In summation, and short of providing a listing of all regulatory requirements that apply to the drafting and conveyance, one should realize that the entitlement to a federal income tax deduction is dependent upon the strict compliance of a plethora of rules and requirements generally found within Treasury Reg. §1.170A-13 (covering record keeping, donation substantiation, and appraisal requirements) and Treasury Reg. §1.170A-14 (covering requirements relating to qualified interests, conservation values, perpetual conveyances, and valuation).

Despite their limited exposure as a mainstream tool, conservation easements are important for both land owners and organizations seeking to protect the environment. Land owners, even though they are giving up commercialization rights to their property, can receive significant income tax deductions that allow them to use their land in many respects. Organizations seeking to protect the environment also achieve their goals while arguably saving themselves from having to raise capital necessary to acquire and protect large amounts of conservation sensitive land. The I.R.C. provides an opportunity for both sides to benefit from conservation easements while still protecting the public’s interests in preserving and using land with conservation value. As conservation easements become more prominent it will be important to monitor the direction that the law moves in order to capitalize on this beneficial tax deduction.

For more information about conservation easements, please visit the following resources within our educational series:

- **Part II** Income, Gift and Estate Tax Rules Applicable to Conservation Easements
- **Part III** Use of Conservation Easements in Syndications
- **Part IV** Traps for the Unwary in Easement Syndications

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15 Treas. Reg. § 1.170A-14(g)(1)
16 Treas. Reg. § 1.170A-14(f)
17 Treas. Reg. § 1.170A-14(g)(1)
18 Treas. Reg. § 1.170A-14(e)(2)
Critics of non-listed REITs often cite illiquidity as one of the major drawbacks of non-listed REITs. These same critics fail to mention three key related points.

1. Commercial real estate assets are illiquid by nature. You can’t immediately sell a building or even part of a building for cash like you can the stock of a listed REIT, which behaves more like high yield income stock than a commercial real estate investment. Non-listed REITs, not listed REITs, are structured to mirror the nature of commercial real estate assets.

2. The illiquid nature of commercial real estate and non-listed REITs protects them from the punishing roller coaster of returns experienced by listed REITs. Over the past five years, commercial real estate and non-listed REIT returns have been high and stable, while listed REIT returns have been extremely volatile with low returns experienced in 2013 and 2015.

3. Non-listed REITs are limited liquidity investments, not illiquid investments. Non-listed REITs offer share redemptions to provide investor liquidity, and third-parties offer other liquidity options. Investors should understand the limited liquidity features of non-listed REITs as well as other liquidity options, and investors and sponsors should understand the value of an active secondary trading market.

**LIMITED LIQUIDITY OF NON-LISTED REITS**

Non-listed REITs have share redemption programs that provide limited liquidity for investors. These share redemption programs have several important features that investors should understand:

1. **Annual Redemption Limits**: Share redemption programs have annual redemption limits with 5% as the most common annual limit. Certain non-listed REITs offer up to 10% or even 20% annual redemptions, but these are exceptions to the non-listed REIT standard of 5% per year. Non-listed REITs also typically have provisions that also limit redemptions to the proceeds received through reinvested distributions.

2. **No Redemptions in First Year**: Non-listed REITs typically do not offer redemptions to investors in their first year of their investment in the non-listed REIT. Buyers must be prepared to hold their shares for at least one year.

3. **Subject to Revision**: Share redemption programs can be modified by the board of the non-listed REIT. Non-listed REITs typically offer quarterly redemptions, but certain non-listed REITs affiliated with AR Global have recently revised their share redemption programs to only offer redemptions on an annual basis.

4. **Subject to Closure**: Share redemption programs can be closed by the board of the non-listed REIT. After the Great Recession, most non-listed REITs shut down their share redemption programs due to a spike in redemption requests above annual limits and the need of non-listed REITs to maintain liquidity in the face of declining operations.

5. **Sealed Pricing**: Non-listed REITs typically have sealed redemption pricing with increasing redemption prices over time. Investors typically must wait four to five years to redeem their shares at 100% of the original offering price paid by the investor.

With the limited liquidity and unguaranteed nature of share redemption programs, non-listed REIT investors need other liquidity options that can provide immediate liquidity at fair prices.
OTHER NON-LISTED REIT LIQUIDITY OPTIONS

1. Tender Offers: Several firms make tender offers to investors in certain non-listed REITs. Tender offers are legal offers to purchase a specified number of shares at a specified price. Tender offer prices, however, are significantly below the reported net asset value per share of a non-listed REIT. Tender offer prices can be discounts of 60%-90% of the net asset value. Tender offers take advantage of investors trapped in non-listed REITs with closed share redemption programs and prey on fear and uncertainty to obtain non-listed REIT shares at deeply discounted prices.

2. Secondary Trading Markets: Several firms provide opportunities for the secondary trading of non-listed REIT shares. The secondary market structures range from seller established pricing to auction trading similar to eBay. Central Trade & Transfer, for example, has an auction trading platform. The typical market trading prices are a 15%-20% discount to the reported net asset value for non-listed REITs with high current distributions or a 30%-50% discount to the reported net asset value for non-listed REITs with low or suspended distributions. In either case, the pricing of shares sold on the secondary market are significantly higher than tender office prices.

SECONDARY TRADING MARKETS

Due to their higher trading prices and third-party negotiations in many cases, secondary trading markets represent the best long-term liquidity option for investors when they cannot utilize share redemption programs. Secondary trading markets, however, face two key hurdles for their long-term growth.

First, non-listed REIT sponsors have been reluctant or unwilling to publicize secondary trading markets, despite the long-term value that they would provide for non-listed REITs. With tens of millions of equity still trapped in closed non-listed REITs without redemption programs and rising redemption requests over the past year, sponsors and investors would benefit from publicizing and supporting secondary market transactions as a means of providing liquidity for their investors. Sponsor support is important for the long-term growth of the secondary market.

Second, lack of transparency on non-listed REIT performance and valuation keeps many investors out of the secondary market. Unfortunately, history has shown that many non-listed REIT values were inflated and did not accurately reflect market values. Inland Western, which is now Retail Properties of America, is just one high profile example of inflated net asset values reported by the sponsor. Third-party resources providing performance and valuation data are essential for the long-term growth of the secondary market.

THE VALUE OF AN ACTIVE SECONDARY TRADING MARKET

Liquidity goes hand-in-hand with volatility. Highly liquid investments will have volatile pricing, while limited liquidity investments will have more stable pricing. Non-listed REITs are an effective way for investors to get access to commercial real estate investments in a structure most similar to commercial real estate. Non-listed REITs, however, need to maintain their limited liquidity through the continued use of share redemption programs and the expansion of the secondary trading market for non-listed REIT shares of closed non-listed REITs. An active secondary trading market would provide expanded liquidity for non-listed REIT equity and increased transparency on non-listed REIT performance, which are two important benefits to investors.
2016 Q2 NUMBERS

EQUITY RAISED COMPARISON THROUGH Q2

CUMULATIVE EQUITY RAISED COMPARISON (2010 – 2016*)

*2016 data is through Q2, 2016
2016* EQUITY RAISED BY ASSET TYPE

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<th>Asset Type</th>
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2007 EQUITY RAISED BY ASSET TYPE

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*2016 data is through Q2, 2016