Inland
Real Estate Investment Corporation

Higher Income Doesn't Equal Higher Quality

Understanding Controversial DST Cash Flow Strategies

In the Delaware statutory trust (DST) market, a lower, stable cash flow might be better than a higher, financially engineered cash flow. Depending on how cash flow is generated, a lower cash flow might result in a healthier outcome in the long run.

The DST market has experienced significant growth in recent years, highlighted by a projected capital raise of more than $10 billion in 2022.1 Attractive benefits such as tax deferral, no management responsibilities, access to institutional grade properties, and portfolio diversification have increased the popularity of this 1031 exchange investment solution. As new DST sponsors enter the market (many with limited track records), it is important for investors to thoroughly review investment offerings to understand how cash flow is being generated.

Be Aware of Controversial DST Cash Flow Strategies:

1. **Using reserves to supplement cash flow –** This is a common method to artificially inflate cash flow, where a DST sponsor returns an investor's principal in order make cash flow look better. Using reserves to supplement cash flow could jeopardize a DST's value, hold period and overall return.

2. **Aggressive assumptions –** Every DST sponsor has their own internal standard for due diligence. One thing to look for is aggressive assumptions of future NOI (net operating income) growth, tenant quality, historical inflation, lease terms, and overall projected performance. If actual results do not equal the aggressive assumptions used by the DST sponsor, investors may experience a loss of income and/or principal.

3. **Purchasing low quality assets –** In DSTs, higher cash flow might represent higher risk. Buying low quality assets in unattractive markets may result in a higher cash flow in the short term. However, the investor assumes a risk that may not be worth the reward if the underlying asset becomes a concern. It is important to remember that in real estate, the time-tested rule of thumb is location, location, location!

4. **Underfunding property reserves –** The biggest lesson learned from the 2008 financial crisis is that DST investments need a significant rainy-day fund. In addition to budgeted property maintenance, a property may experience the need for last-minute repairs or for structural upgrades. Larger reserve accounts equate to a reduced cash flow but could also lead to a more secure investment. Remember, even funds in a reserve account ultimately belong to investors.

5. **Prepaying or reserving for normal expenses –** Examples of prepayments include those such as property taxes, insurance, mortgage interest, and lender reserves. These prepayments are easy to spot in a DST's projections. Look at each one-year expense category to check for amounts that are zero or dramatically less than earlier years.

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

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Due Diligence Checklist

Evaluating 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.

Industry Expertise	Size and Financial Strength
• How long has the sponsor been in business? • How much real estate experience does the management team have? • How familiar is the sponsor with acquiring and managing real estate investments? • Is the management team knowledgeable in the property types offered through the DST and the markets where their properties are located? • Is the sponsor knowledgeable of the entire DST investment process and willing to offer guidance and support?	• How large is the sponsor company? • How frequently does the sponsor perform cash audits on their DST properties? • What type of pricing and loan terms on properties can the sponsor obtain? • Can the sponsor offer their own capital to purchase properties, providing surety of close?
Track Record	**Underwriting Standards**
• General number of sponsored programs and total equity offered since inception? • Types of assets under management and performance? • Number of properties previously and currently offered? • How many DST offerings has the sponsor launched over the years?	• What is the sponsor's underwriting process and standards? • Does the sponsor take a conservative or aggressive approach to underwriting? • Does the sponsor underwrite and identify strong, creditworthy tenants?
Sponsor Fees	**Exit Strategies**
• What kinds of fees does the sponsor require (i.e. acquisition fees, disposition fees, asset management fees)? • How do those fees compare to other DST sponsors? • Is the sponsor transparent about all fees? • Are disposition fees and expenses capped?	• What is the long-term goal and intended exit strategy of the DST? • Does the exit strategy align with the goals your clients are trying to achieve?
Third-Party Reporting	**Investor Communications**
• Does the sponsor make sure independent analysis and reporting on is performed on their company? • Is the sponsor willing to send you to the third-party group performing the reporting? • Does the third-party reporting come from a credible source?	• What is the sponsor's communication standards? • How well informed do they keep investors? • What's the frequency of communications? • Does the sponsor provide timely information related to tax returns (i.e. 1099s, Form 8-Ks, Form 10-Ks, etc.)

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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