

Making it in Real Estate: Talk 5

John McNellis
October 2018

The 1031 Exchange: Panacea or Placebo?

John McNellis

October 2018

ULI YouTube Videos

1. “Starting Your Own Development Company”
 2. “Buying it Right”
 3. “Sell vs. Hold”
4. “No Partners, No Problems”

Making It in Real Estate

Starting Out as a Developer

John McNellis

"Put aside other real estate textbooks! John McNellis is a Picasso of storytelling, bringing the real estate process to life through humorous and compelling anecdotes and insights. With material as eclectic as the times in which we live, McNellis captures the fascinating odyssey of real estate investment, ownership, and development. Newbies and wily, cantankerous veterans alike will find this gripping primer on the real estate deal process to be a catalyst in turning creative ideas and big dreams into tomorrow's built environment."
—Jim Curtis, Managing Partner, Bristol Group

"John McNellis has a talent few other developers possess: he can swiftly cut to the chase to make a deal that works for both sides. He is among the best at knowing when a deal makes sense to pursue, or when to walk away and await the next one. If you want to learn what it takes to be successful in real estate, read this book."
—James S. Fassio, President and Chief Development Officer, Ross Stores Inc.

"John McNellis's book on real estate development and investment is extraordinarily insightful and full of wisdom. His wit makes it an easy read. I would highly recommend this book to both experienced and beginning real estate developers and investors."
—George M. Marcus, Chairman of the Board, Marcus & Milichap Inc. and Esser Property Trust Inc.

"John McNellis fills his book with rich insight, great advice, humor, and inspiration—sharing his deep experience and wisdom, helping us think more clearly about real estate and assorted business issues. A must-read."
—Mark L. Myers, Head of Commercial Real Estate, Wells Fargo & Company

About the Author



John McNellis is a principal with McNellis Partners, a commercial development firm he cofounded in the mid-1980s in northern California.

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Making It in Real Estate

Starting Out as a Developer

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The 11th Commandment

“Thou shall not sell for
cash”

The 11th Commandment...

...Isn't carved in stone.

1031 Basics

Identify trade property within 45 days
of initial closing

Close within 180 days

Price & debt to be equal/greater to
property being sold

An Assumption

Today's discussion assumes your "basis" in the property to be traded or sold is zero; i.e. the entire sales price would be taxable as capital gain.

Today's Question

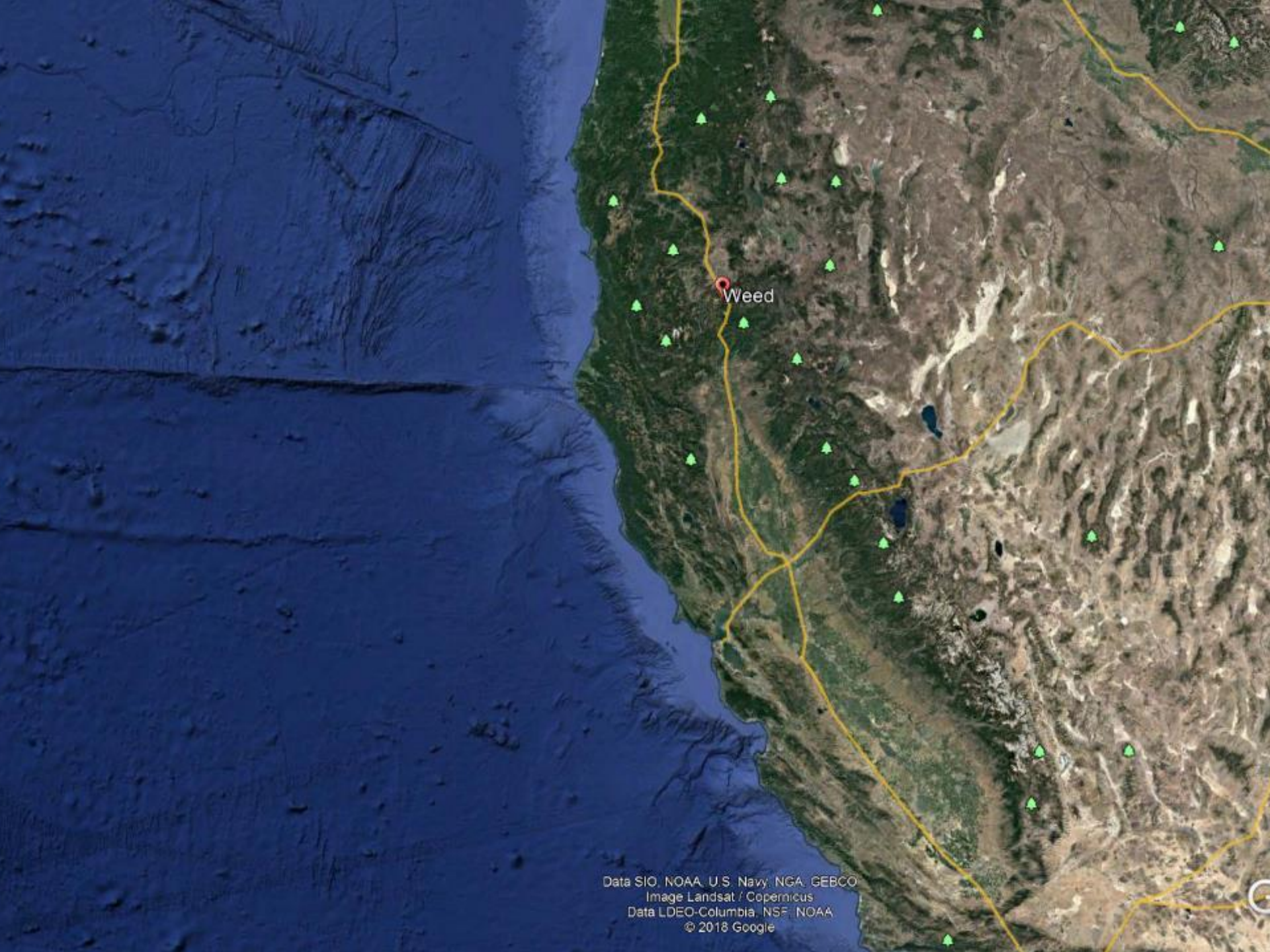
Is a 1031 Exchange (and avoiding taxes) better than selling for cash, paying your taxes and reinvesting the net proceeds?

Answer

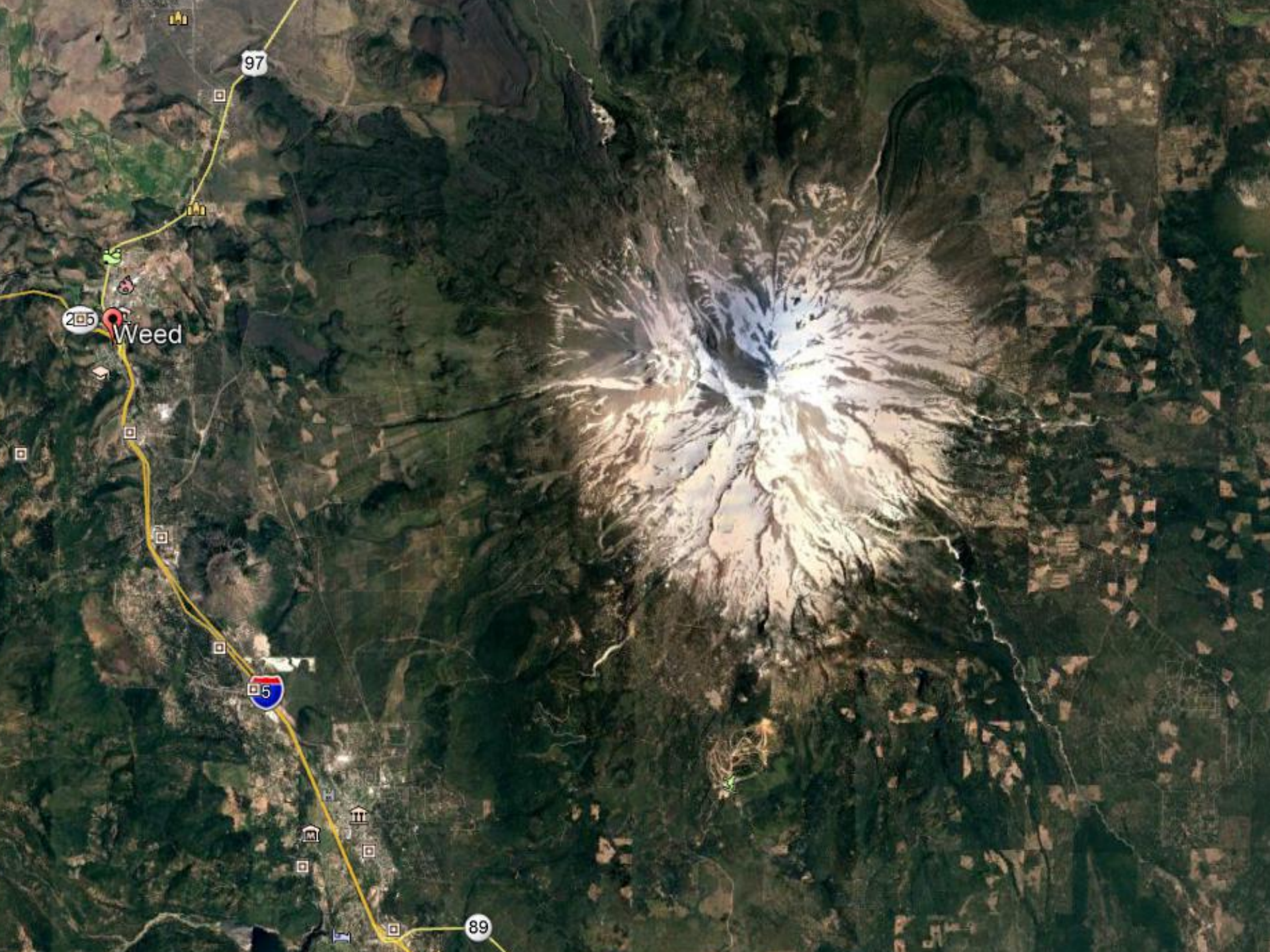
It depends

A Bad Trade
Weed, Ca
Summer 2007

Dirt: \$1,360,000



Data SIO, NOAA, U.S. Navy, NGA, GEBCO
Image Landsat / Copernicus
Data LDEO-Columbia, NSF, NOAA
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Weed
Eleven Years after

2018: Weed developed

Land cost in 2007: \$1,360,000

11 years' carry

@ 10%: \$2,707,000

All-in construction

costs: \$3,400,000*

Total cost: \$7,467,000

*No fees to us



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GROCERY OUTLET
Bargain Market

Produce: Every Week
Organics: Always

Supermarket Sale

Sale price: \$5,750,000

(5.55 cap/\$320,000 rent)

Less:

costs of sale (2.5%): \$143,750

land/development \$7,467,000

Profit:

a) With land carry: (\$1,860,750)

b) No carry: \$846,250

Trade vs. Taxes

Trade worked...barely

After much work, we net \$2.2 million
(original cash + \$846,000 profit); a 4%
annual return on investment

Stock Market Comparison #1

Pay taxes and invest proceeds in S&P
500 mutual fund: Net = **\$2,073,000***.

*\$1,360,000-33% taxes x 127.48% (total
S&P 500 return for 11 years).

Big Picture

S&P 500 has averaged 9%
compounded return since 1928.

A good trade

Trade into \$7.2 million shopping center at 8.3 cap rate with \$5 million in debt @ 4.8%:

Cash flow: \$358,000

16% cash on cash

Stock Market Comparison #2

\$2.2 million-33% taxes, invested in S&P 500
@ 9% = \$133,000 a year

**9% cash on after-tax cash, but only 6% on
the \$2.2 million**

Big Picture

Buyers make dumb trades to avoid taxes.

Trading into long-term, low yield properties (a Walgreens at 5%) often a mistake.

Pulling trigger on development deals within 45 days very difficult.

Advice

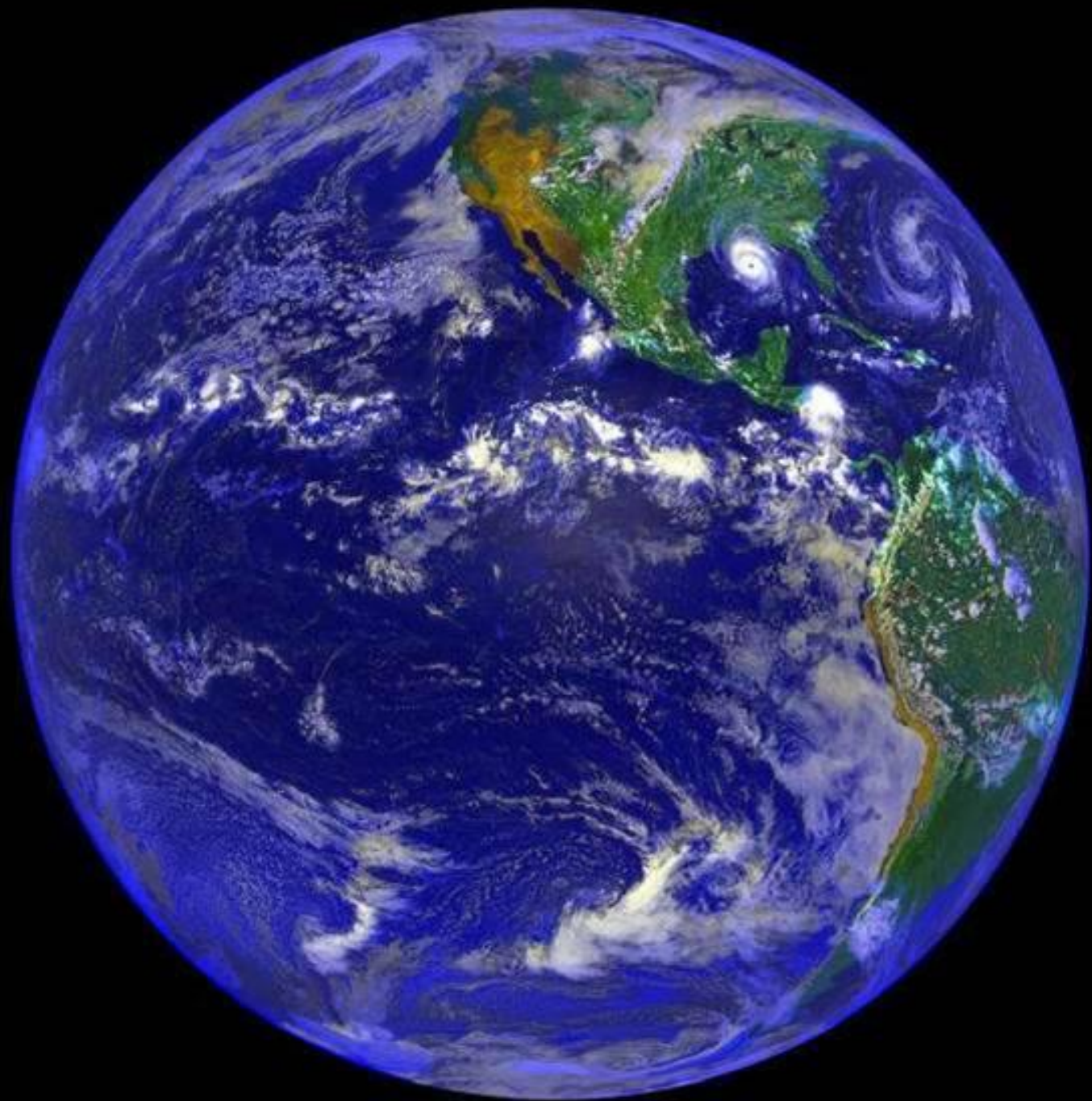
If you can't find a solid trade, consider selling for cash, paying your taxes and investing in an indexed mutual fund

Bigger Picture

Diversification is your friend

Bigger Picture

So is liquidity



Q & A