Like-Kind Exchange

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Qualified Intermediaries of Section 1031 Like-Kind Exchanges

Deposit gathering franchises:
Tax law increases stability. Higher interest rates increase profits

For almost 100 years, the tax laws of the United States have allowed investors to defer taxes on the gains generated by a property sale if the proceeds are properly re-invested in a "like-kind" property. This form of tax deferral is governed by Section 1031 of the Internal Revenue Code (IRC). IRC Section 1031 details a set of rules that allow investment or business-use real estate like-kind exchanges (LKE). The rules created the need for independent parties, Qualified Intermediaries (QIs), to facilitate the like-kind exchanges and hold the sales proceeds while a suitable property is identified and acquired.

Qualified intermediaries facilitate, provide reports to the taxpayer, and generally manage exchange transactions for taxpayers. In a typical transaction, the QI technically acquires the relinquished property from the taxpayer and transfers it to the buyer. The QI later acquires the replacement property from the seller and transfers it to the taxpayer. Hence it is acting as an intermediary in connection with the transaction. QIs receive fees for the services and, as a secondary function, generally hold the funds generated by the sale of the relinquished property while the exchange is arranged and completed. The funds are generally placed in interest-bearing accounts and/or short-term investment funds; and the QI and taxpayer may share the interest or investment income. Any portion of the earnings which are received by the taxpayer are considered interest income and are taxable. LKE transactions are an important tool for commercial real estate investors and business-use taxpayers and gather low-cost, stable deposits that generate fees and earnings on the deposits for 1031 exchange providers.

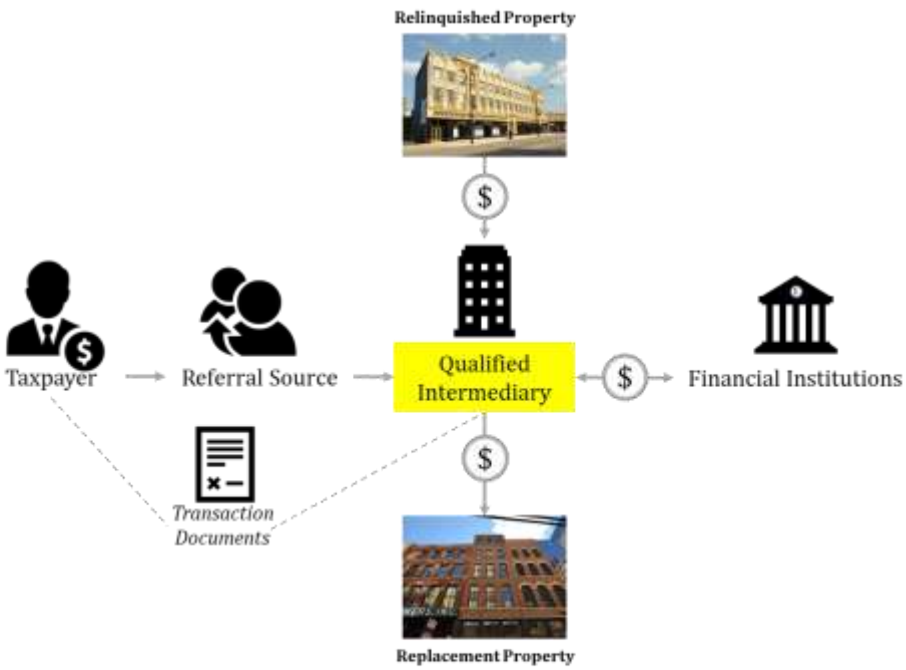
A number of recent developments affect the 1031 exchange industry:

- The Tax Cuts and Jobs Act, signed into law in December 2017, eliminated like-kind exchanges on personal property (e.g., off-lease assets, aircraft, railcars, vehicles, equipment, collectibles, franchises) but retained the provision for commercial and business-use real estate. LKEs involving personal property accounted for about 10% of industry volume.
- The Federal Reserve's recent policy of implementing slow but steady increases in interest rates has led to increased revenues and profits of QIs. Earnings of these 1031 exchange companies are growing rapidly.
- The Federal Reserve has been gradually reversing the policy of quantitative easing, which caused its balance sheet to balloon to $4.5 trillion. That balance sheet contracted by almost $400 billion in 2018. This reduction in liquidity, combined with a still-robust economy and rising interest rates, has caused banks to battle for deposits. QIs have deposits, and acquisitive banks have taken notice.

The 1031 exchange niche provides an interesting investment opportunity for banks, strategic investors, and financial investors. The industry is fragmented, with over 150 participants nationwide, according to the Federation of Exchange Accommodators (FEA), the industry's trade organization. In addition, the sector has relatively little regulation – there is no formal Federal oversight, and most states do not even require QI's to be licensed. We expect that acquisition and investment activity in this sector will spike, as banks and other investors recognize the opportunity to invest in an attractive, asset-light financial services niche benefitting from strong tailwinds, as interest rates and monetary policy stabilize at normal post-crisis levels. In particular, as banks aggressively seek to grow core deposits, 1031 exchange providers will continue to be attractive acquisition targets.

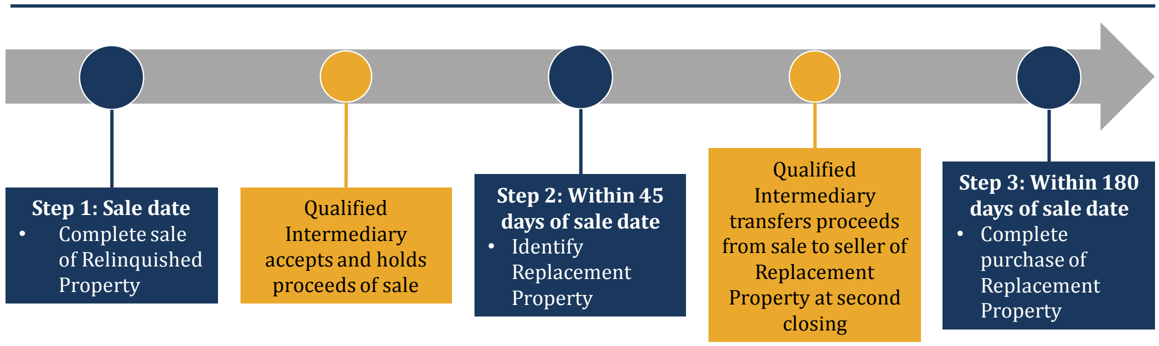
Like-Kind Exchanges – An overview

Like-kind exchanges must conform to strict rules in order to achieve the tax deferral allowed under IRC Section 1031. A key requirement is that the taxpayer selling the investment property must avoid constructive receipt of the proceeds from the sale. The QI receives the proceeds and holds them on behalf of the taxpayer and facilitates the purchase of the replacement property, which must be completed within 180 days. QIs rely on real estate brokers, attorneys, accountants, financial advisors, and repeat customers for deal flow. Reputation, experience, and operating efficiency are the keys to attracting transactions.



There are three major steps in a forward like-kind exchange transaction:

FORWARD 1031 EXCHANGE: TIMELINE



In addition to the typical forward exchange, some qualified intermediaries also facilitate reverse exchanges. In a reverse exchange, the replacement property is acquired by a QI's special-purpose entity, which holds the replacement property while the taxpayer identifies another property to be sold. The proceeds from the sale can then be re-invested in the initial property held by the QI on a tax-deferred basis. In a reverse exchange, the QI receives fees for structuring and executing the transaction but does not hold any proceeds from the transaction and therefore does not receive any interest earnings. There are also similar rules when an exchange transaction involves new construction or improvements to existing property.

A skilled qualified intermediary provides significant expertise to its customers. While qualified intermediaries do not provide tax or legal advice, they do provide several other services:

- Coordinating with the taxpayer and its advisors to structure a successful exchange
- Acting as an intermediary on behalf of the taxpayer between the buyer and seller
- Preparing the documentation for the exchange to ensure the transaction is structured in accordance with the Treasury Regulations
- Furnishing title and escrow with instructions
- Securing the funds until the exchange is completed
- Disbursing exchange proceeds to effectuate the purchase of replacement property
- Submitting a full accounting of the exchange for the taxpayer's records
- Requiring that a 1099-INT is sent to the taxpayer for any interest earned by exchange funds and paid to the taxpayer

Because of the close interaction between 1031 exchange providers and the real estate closing process, many QIs are owned by or affiliated with title companies and related entities.

Structure of the Qualified Intermediary Industry

IRC Section 1031 establishes who can serve as a QI – only parties that are not considered agents of the taxpayer initiating the like-kind exchange. Beyond this requirement, qualified intermediaries of like-kind exchanges are not subject to Federal regulation. The Dodd-Frank Act charged the Consumer Financial Protection Bureau with the task of reviewing and reporting to Congress regarding regulation of QIs. The CFPB issued its report in July 2012 and did not recommend any regulations. There are a few states (nine total, including California, Colorado, Nevada, and Virginia) that impose regulations on qualified intermediaries, generally regarding bonding requirements and, on occasion, licensing. The lack of regulation and strict capital requirements has led to a blossoming of small qualified intermediaries. The lack of regulation has also led to occasional malfeasance on the part of QIs. Taxpayers and their advisors must exercise due diligence when selecting a QI.

The industry is bifurcated into a relatively small number of significant participants and over 100 smaller QIs, according to the FEA. Here is a list of some of the more significant participants.

Selected 1031 Exchange Provider	Ownership
Accruit	Private
Asset Preservation	Stewart Information Services (NYSE: STC)
Chicago Deferred Exchange Company	Wintrust Financial (NASDAQ: WTFC)
First American Exchange	First American Financial (NYSE: FAF)
IPX 1031	Fidelity National Financial (NYSE: FNF)
Old Republic Exchange	Old Republic (NYSE: ORI)

Some of the largest qualified intermediaries are owned by title insurance companies or banks. Fidelity National is in the process of acquiring Stewart Information Services, which will combine two of the largest 1031 exchange companies in the country. Banks own these businesses as a stable source of low-cost deposits and as a complement to wealth management and CRE lending activities.

Banks View 1031 Exchanges as Deposit-Gathering Franchises

Since the Federal Reserve began raising interest rates from near zero three years ago, bank customers are starting to demand higher interest rates on their deposits, particularly at small and regional U.S. banks. The Fed has raised short term interest rates nine times since late 2015. Banks are scrambling to stop the exodus of deposits, as customers are withdrawing cash to earn higher yields elsewhere. Significant 1031 exchange providers that hold deposit balances are increasingly attractive to banks in this environment.

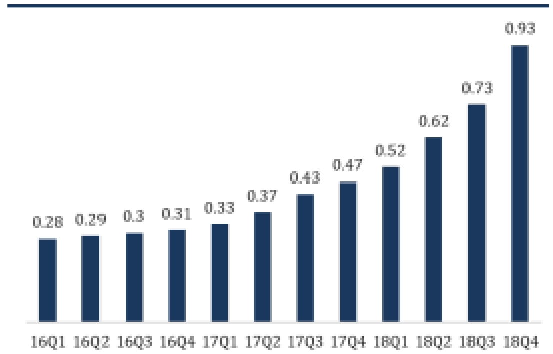
Deposits are leaving commercial banks …

DEPOSITS, ALL COMMERCIAL BANKS
(% CHANGE FROM ONE YEAR AGO)

Source: Federal Reserve

… And deposit costs are rising

AVERAGE COST OF FUNDS *(%)* – DOMESTIC DEPOSITS

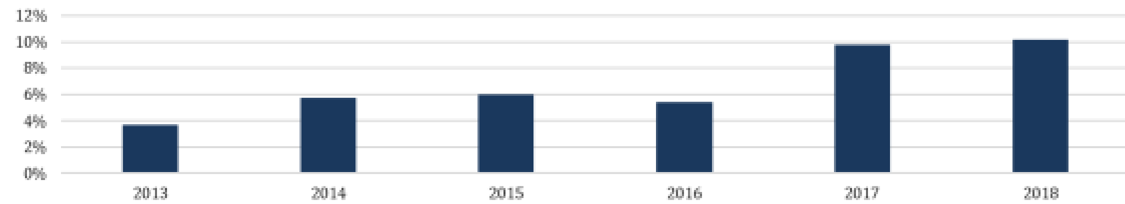


Source: BankRegData.com

Bank Valuations and Deposit Premiums are Increasing

The number of bank M&A deals increased only 1% in 2018; but average valuations increased 7% to 1.71x tangible book value, on the heels of a 22% valuation increase in 2017. Banks have a renewed focus on core deposits, an area that long went overlooked after the financial crisis, and premiums for deposits are rising. Deposit premiums in 2018 bank M&A transactions exceeded 10% on average, as compared to just over 3% in 2013. Increasing deposit premiums highlights the intense competition among banks for cheap funding and the value of deposit gathering franchises.

CORE DEPOSIT PREMIUMS IN M&A TRANSACTIONS



Source: JP Morgan, SNL Financial

1031 Exchanges Gather Low-Cost Core Deposits

Banks generally consider the deposits they hold for 1031 exchange providers as stable, low-cost funding. Although funds come in and out daily, based on transaction activity, balances tend to remain fairly stable over time. As such, 1031 exchanges are increasingly interesting and valuable to banks seeking core deposits. Acquisitions of 1031 exchange providers come without the common bank acquisition challenges of branch overlap and integration. Indeed, 1031 exchange providers operate at a relatively low efficiency ratio. Further, a bank can earn considerably more on the deposits an independent 1031 exchange provider holds, either by deploying those funds into loan production or by reducing the need to secure deposits in the market.

Recent Transaction Activity – Pace is Quickening

Qualified intermediaries have several positive attributes that are attractive to investors.

- Indirect, low-cost origination strategy through networks of brokers, attorneys, and accountants.
- Asset-light business model with low capital requirements. Intellectual barriers to entry are high.
- Excellent operating leverage: interest income can increase significantly without a commensurate increase in costs. Profitability expands considerably with higher interest rates.
- Outstanding returns on equity.
- Recent codification of IRC Section 1031 in the Tax Cuts and Jobs Act stabilizes the legislative and regulatory environments.
- Rising interest rates are providing a significant earnings uplift for established participants.

These positive attributes have caused transaction activity to pick up, and we expect the pace to quicken further over the next 18 months. A selection of recent M&A transactions is presented below, which includes transactions in the title insurance sector, an adjacent market to the 1031 exchange sector.

Date	Target	Buyer	Comments
Pending	Stewart Information Services (NYSE: STC) Houston, TX	Fidelity National Financial (NYSE: FNF)	STC owns Asset Preservation, and FNF owns IPX 1031 – two of the largest QI's
Dec-2018	Chicago Deferred Exchange Company Chicago, IL	Wintrust Financial (NASDAQ: WTFC)	Chicago Deferred Exchange was owned by Prairie Capital, a private equity firm, and management.
Jul-2018	American Equity Exchange Dillon, MT	Accruit (Private)	American Equity Exchange is a leading 1031 exchange provider
Apr-2018	Alliant National Title Insurance Longmont, CO	Presidio Investors	Alliant does business in 22 states and has $120MM in revenues
Feb-2018	Agents National Title Insurance Company Columbia, MO	Incenter Mortgage Solutions Saint Paul, MN	Incenter is a Blackstone Group portfolio company. Agents National Title Insurance is also a 1031 qualified intermediary
Nov-2017	PaySAFE Escrow, Inc. Bellevue, NE	Accruit (Private)	Accruit bought PaySAFE's assets, including its web-based escrow technology
May-2017	Deutsche Bank's 1031 Exchange Business New York, NY	IPX 1031 (Sub. of NYSE:FNF)	Deutsche Bank decided to exit the LKE market when the president of the division passed away
Feb-2017	RELTCO Inc. and National Assurance Tampa, FL	Live Oak Bancshares (NASDAQ: LOB)	RELTCO and National Assurance are national title companies that offer full escrow processing services
Jan-2017	Bankers Escrow Corp. Denver, CO	Accruit (Private)	Bankers Escrow is one of the largest full service escrow companies in Colorado
Sep-2016	TitleOne Corp. Boise, ID	Title Resource Group (Realogy Holdings, NYSE: RLGY)	TitleOne is a full-service title agency and Sec. 1031 qualified intermediary operating in Idaho
Apr-2015	RPM Investments	Opus Bank (NASDAQ: OPB)	RPM Investments is a leading accomodator for commercial 1031 exchanges
Sep-2011	North Star Deferred Exchange Company Chicago, IL	Accruit (Private)	North Star is a leading 1031 exchange provider

The recent acquisition of Chicago Deferred Exchange Company by Wintrust may signal a new wave of acquisitive banks pursuing qualified intermediaries to gain permanent access to the deposits controlled by these firms. The cost of acquiring deposits is increasing; and qualified intermediaries generate significant core deposits at a lower cost than by banks pursuing traditional deposit-gathering strategies.

Conclusion

Qualified intermediaries generate significant earnings from an asset-light business model based on deep technical expertise and strong referral relationships with brokers, attorneys, and accountants and others. Strategic and financial buyers have shown interest in the sector, but banks seeking a low-cost source of deposits have the strongest incentive to enter the industry at this point in the economic cycle. We expect that many 1031 exchange owners will seek to monetize their investments in the next 18 months, now that conditions for the like-kind exchange industry are favorable**.**

Colonnade advised Chicago Deferred Exchange Company on its sale to Wintrust

December 2018. Wintrust Financial Corporation (Wintrust) (Nasdaq: WTFC) announced the acquisition of Elektra Holding Company, LLC (Elektra), the parent company of Chicago Deferred Exchange Company, LLC (CDEC). CDEC is a premier provider of Qualified Intermediary services (as defined by U.S. Treasury regulations) for taxpayers seeking to structure tax-deferred like-kind exchanges under Internal Revenue Code Section 1031. Under IRC Section 1031, a taxpayer may defer the gain on the sale of certain investment property if the taxpayer utilizes the services of a Qualified Intermediary.

CDEC has successfully facilitated more than 8,000 like-kind exchanges in the past decade for taxpayers nationwide. These transactions typically generate customer deposits during the period following the sale of the property until such proceeds are used to purchase a replacement property. These deposit flows result in a source of low-cost deposits. During 2018, deposits from CDEC customers averaged over $1 billion.

For more information on the Section 1031 like-kind exchange sector, please contact:

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