Non-Traded REITs

- Physician Heal Thyself

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Introduction

We spent a few years as active participants in the Non-Traded REITs industry. We now offer some insights, gleaned hopefully with the wisdom and humility that only comes with reflection and hindsight.

Non-Traded REITs raised around $11 billion in 2020 and this number is expected to more than double in 2021. This industry has been around for over two decades and was at its peak around 2013. When one is investing in a Non-Traded REIT, one is not just buying the underlying real estate but is also buying an operating business. These are equities as well as real estate, and are therefore dependent on both the vagaries of capital markets, as well as space-real estate cycles. It is as much a capital markets business as a space business. Market factors such a supply and demand, interest rates, the state of the economy, investor preferences, returns available from comparable asset classes, and competing investment alternatives are important factors that shape performance. Non-Traded REITs are not trading vehicles and should be owned for dividends and a little bit of capital appreciation over long periods.

Typical attributes to look for are quality of team in place and experienced management with demonstrated history of good judgment. A REIT's ability to continuously access both equity and debt capital are important too, for these by law, payout 90% of earnings as dividends. And new capital is needed for growth. Other important attributes include balance sheet strength, sector focus, strong local presence, a sensible conservative dividend policy and perhaps most important, good corporate governance. A lot can go wrong, and these investments are not risk-free. Risks arise from excess supply of rental space, rising interest rates, declining property values, recessions, over-building as well as other macro and local factors.

Also, REITs compete with high-yielding instruments, so their attractiveness is a function of where other instruments are relatively priced at. Differences in valuation within REITs arise from differences in their balance sheets, the way capital allocation decisions are made and management credibility. The better firms are fixated on capital recycling, figuring out ways to increase funds from operation (FFO), arbitraging value differences between the public and private markets, creatively forming joint ventures, increasing transparency, improving corporate governance, introducing new structures, and reducing fees.

Insights

Valuations

FINRA rules govern how Non-Traded REITs are allowed to report their share values in their customers' account statements for a period after the initial share offering. Given that valuations suddenly change when this period expires, investors are sometimes taken aback to learn for the first time that the actual value of their shares differ from what was being reflected all along in their account statements. There is no real single perfect way to value Non-Traded REITs and indeed the industry uses many different approaches; a NAV-based approach, price to earnings or funds from operation models, discounted cash flow etc. All of these have their strengths and limitations, for at the end of the day REITs are a crossover between equity markets and real estate. Also, some REITs pay a substantial portion of their dividends by issuing debt rather than from earnings. They do not update their share valuations to reflect decreasing NAVs, thus providing an illusion of price stability.

REITs must accurately reflect the real value of the underlying real estate holdings. This is important because some REIT sponsors artificially maintain share price stability. Since the shares don't trade, the price investors see on their statements every quarter doesn't fluctuate. Until it does. It is important to have an independent valuation agent who objectively values each property on a frequent rolling basis. Someone who reviews trends in cap rates, discount rates, interest rates, leasing rates, vacancies to arrive at realistic accurate valuations. Also, it is equally important to determine whether a material event has occurred – an unexpected termination or renewal of a lease, a drastic change in vacancies- that may have a big impact on estimated value. It is especially vital to amortize acquisition costs and expenses properly; to make sure accruals and debt service costs are properly accounted for, and contracting frictions are reflected in arriving at valuations that reflect reality. Therefore, frequent accurate valuation, even if expensive and onerous, is highly recommended.

Suitability

A criticism often levelled against them is that these securities 'are sold, not bought'. There is a some truth to this. The illiquidity and lack of price transparency has traditionally kept Non-Traded REITs from inclusion within fiduciary plans. Moreover, high selling commissions and upfront loads have dissuaded institutional investors. It is vital to bring better price transparency, lower fees, and commissions to make these attractive to institutional investors. And it is important that industry participants do this to expand reach beyond their current retail uptake segments. We also note that a large portion of fees are appropriated by broker-dealers (over 7%) as distribution commission and do not go to sponsors.

Liquidity

Non-Traded REITs are illiquid investments. As no public secondary market exists, investors are effectively unable to sell their shares even if the value of the REIT or its underlying assets decreases significantly. Though it can also be argued that illiquidity, however, can sometimes be a good thing. When investors irrationally rush for the door in a falling market, illiquidity can shield them. Limited liquidity can be desirable within a portfolio construction process too. Full liquidity introduces volatility and may exaggerate realized losses. Having a partial annual liquidity option can be even better, which is why better designed offerings enhance liquidity by expanding the amount of shares the REIT is willing to repurchase as well as by holding more liquid assets. When properly designed, investors can participate in the repurchase program only after an initial holding period, typically a year, and if there are many shareholders wanting to sell, the REIT can reserve the right to limit the number of shares that can be sold. Typically, there is a relatively close relationship or correlation between listed REIT shares and changes in the value of the stock market. This close correlation suggests that the value of shares of listed REITs may be based on a variety of factors beyond the value of the listed REITs' underlying real estate investment. Non-Traded REITs by extension capture the fundamental value of underlying real estate better, provided they are properly and timely valued.

Fees

Selling Commissions. Dealer Manager Fees. Acquisition Fees. Advisory Fees. Property Management Fees. Ancillary Service Fees. Internalization Payment. Public Listing Fees. Incentive Fees. These are just a few of the many ways the Non-Traded REIT sponsor gets paid. These fees are disclosed but buried in dense 200-page fine print offering documents. Fees greatly impact shareholder and portfolio performance. Knowing how and when these fees get paid is important. The fee structure needs be reduced and aligned closely with sponsor performance. For example, subordinating the payment of asset management fees in cash to distribution coverage, or taking these fees in stock — the value of which is realized only after shareholders have received threshold returns— promotes a further alignment of management and shareholder interests.

Life Cycles

Non-Traded REIT sponsors have a huge incentive to create perpetual infinite life structures where they sit on properties and earn management fees including the afore mentioned sources of income. REITs ought to be of finite life, with a clear focus on raising, investing, recycling and harvesting capital and creating absolute total returns over a 5-7 year period. This creates internal discipline and imposes accountability to perform. Otherwise they have a perverse incentive to grow AUM and turn the program into a 'fee machine'. There should be no over-raising of equity through follow-on offerings; offerings should end when the initial amount of equity sought is raised, or within a defined time period. Also large multi-billion dollar offerings have few natural buyers on exit. It is for these reasons offerings should be of small size - less than a few billion dollars at most. Big is not better.

Acquisition Strategies

The maxim 'do not put your eggs in one basket' does not necessarily apply here. This is because real estate is a local business requiring deep local knowledge and access to different property types. There is every kind of real estate one can think of: apartments, residential properties, retail properties, offices, industrial buildings, health-care properties, self-storage, different types of hotel categories as well as many specialist sectors such as datacenters. They all experience the cycle of depression, recovery, boom, over-building, downturn and recovery. They also have very different characteristics. For instance apartments have stable cash flows and are influenced by employment and wage growth. Shopping centers are anchored by supermarkets and sell consumer necessities. Malls are expensive to build and are not highly exposed to new competing development. Office properties are dependent on the economy and have long-term leases. Industrials are responsive to the economy and can be built and shut down relatively quickly. Healthcare properties are not economically sensitive for they are largely reliant on government reimbursement policies. Self storage is largely recession resistant. Hotels are volatile because their occupancy and therefore revenue varies daily. Also, other than for specialized REITs such as medical properties dependent on state reimbursements, there are no obvious benefits to diversifying- as REITs have proliferated, end investors can easily diversify on their own.

Moreover, the listed public markets prefer REITs with a focused strategy, rather than diversified, which more often trade at a premium to NAV. Diversified strategies by contrast typically trade at a discount. Focused acquisition strategies also signal disciplined effort. Diversified strategies can easily lead to style drift. Being all things to all people, investing across all property types is something that public markets frown upon and not the best recipe for success. There are much cheaper ways to replicate the NCREIF index. What is important is, a sector focus to building property portfolios for which there are natural buyers when exiting and which public markets reward by way of according premium to NAV.

Distribution Coverage

Some Non-Traded REITs do not generate enough recurring cash flow to fund their dividends and are forced to borrow and/or issue additional equity. Most, during the initial interim capital raise period when equity capital partially rased has yet to be properly deployed, fund dividends from equity being raised. In other cases leverage – not earnings – have funded dividends. These are all bad practices, and where they do exist, need to stop. It is important to understand the what and how of cash distributions and to guage a REIT's ability to sustain its cash distributions on a long term basis. Distributions, once a REIT is raised and deployed should come from earnings, not from debt or new equity raised - and if investors are prepared to live with it, distributions should not be made for an initial period when the fund is being raised. Also, there is a pressing case for sponsor waiver or deferral of asset management fees until distributions are covered by FFO. Management compensation should be tied to program performance and adherence to strict distribution coverage ought to be norm. Growth REITs have higher potential growth rates and tend to trade at higher prices; they offer lower dividends and are more risky but their share prices might appreciate quickly. Value or turnaround REITs provide higher dividends, but they too being composed sometimes of lower quality assets are riskier. There exists a category of bond proxy REITs which provide high dividend yield, but dosen't have growth or value characteristics . This enormous variance suggests that is important that dividend policies are in line with the characteristics of both underlying real estate and investing strategy.

Reasonable Leverage

Establishing the correct level of prudent leverage once the portfolio is fully invested has no definitive answer. However, what is incontestable is that higher leverage may result in greater interest rate risk, higher inability to roll over maturing debt, and bring in greater future need to recapitalize. Moreover, higher leverage may result in a conflict of interest as sponsors may recover more acquisition fees on higher gross purchases. Also, property specific higher leverage reduces liquidity options upon considering an exit. To their credit, Non-Traded REITs have generally done a much better job than their public peers in managing their balance sheets and low leverage has been a way of life for the majority. Very few have been forced into value destroying capital allocation decisions – expensive debt, selling properties on the cheap, issuing equity on NAV dilutive basis. This said, they do need to outline explicit parameters on, how much and what type of financing, ought to be used to acquire property.

Affiliated Transactions

Non-Traded REITs are typically serviced by a sponsor, an advisor, a property manager, and a dealer manager. Sometimes, these may be affiliated, which creates conflicts of interest. The sponsor organizes and controls the underlying properties. Advisors make investment and disposal decisions. The property manager is responsible for leasing and maintenance. The dealer manager is responsible for selling the shares to investors.The commonality of key individuals and entities in multiple aspects of a REIT's business can lead to conflicts of interest. There have been cases when one sees usage of the credit line of one REIT to finance the operations of another. Sometimes, one sees players artificially increase asset turnover to maximize compensation. Others have allocated over or under-performing assets at the expense / favor of others. One also sees cases of firms using managerial knowledge to benefit other unrelated investments. It is therefore very important for these entities to have strong governance mechanisms and set up explicit prohibitions from affiliated transactions that may harm investors.