To Trade, or Not to Trade?

Non-traded REITs' newfound muscle creates some interesting choices for investors looking to get into the REIT space

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At the end of September, Phoenix-based Cole Real Estate Investments filed two registration statements with the Securities and Exchange Commission: one for Cole Advisor Retail Income REIT, the other for Cole Advisor Corporate Income REIT. The offering for each was up to $3.5 billion, for an aggregate $7 billion.

Cole is a non-traded REIT—one of the most prolific, in fact, in terms of fundraising. Yet the capital markets met its announcement with the barest of acknowledgements. By contrast, if a publicly traded REIT made a play for a capital raise of $7 billion, the market would still be talking about it weeks later, says Keith D. Allaire, managing director and head of Robert A. Stanger & Co.'s Financial Advisory Services Group.

To state the obvious, there are key differences between non-traded and publicly traded REITs: how they raise capital and from whom, as well as how that capital is invested and how those investors are repaid.

In this particular example, $3.5 billion is the highest amount Cole thinks it can realize, though there is no guarantee that it will. The offering can be extended for as long as three years and is not dependent on the ups and downs of the equity market; no non-traded REIT would shelve a planned offering because the market suddenly turned, as many publicly traded REITs have done.

Until recently, these differences hardly mattered, since non-traded REITs were just a blip on the investment radar screen. But now these vehicles are pulling in unprecedented volumes of capital from investors intrigued by their ROI and stability, especially in light of the wild gyrations of the stock market.

Their unique position—non-traded REITs have been described as one part stock, one part bond and one part annuity—has attracted many new investors that want to own quality real estate and still receive income, Allaire says. "Non traded REITs can deliver a return that's 250 to 300 basis points higher than safe fixed-income alternatives," he relates. "Their dividends are often 6% to 7%, compared to the 2% to 3% of publicly traded REITs. Those numbers have created demand for a safe investment."

There are also some longer-standing demographic trends accounting for their popularity, says Tom Roberts, president of the real estate group for Cole in Phoenix. "Baby boomers are retiring in record numbers and need income-oriented investment products that don't correlate to the daily fluctuations of the equity markets," he says. Additionally, he points to the growing number of financial advisors who have transferred to the independent broker-dealer channel and are able to offer NTRs to their prospective clients.

Whatever the source and motivation of the funds, the bottom line is that this influx of capital is having an impact on investment sales and pricing for specific assets.

"Because they raise so much capital, they're very active participants in the market," says Paul H. McDowell, chairman and CEO of New York City-based CapLease. "When they pursue individual transactions they can be formidable competitors because of perceived low cost of capital."

Of the 53 non-traded REITs currently in the market now, 36 are fundraising versus 17 that are closed to new investments, says Vee Kimbrell, managing partner of Blue Vault Partners in Cumming, GA. And they are spending as well, she says. "They aren't leaving this capital idle on the balance sheet; that's not a good strategy for non-traded REITs."

Why Non-Traded REITs?

There are two essential differences between publicly traded and non-traded REITs that are important to investors, says Kevin M. Hogan, executive director of the Investment Program Association in New York City.

Correlation: Advisors and investors like non-traded REITs because they are not correlated to swings of the market. Investors can more easily diversify a portfolio even within the same asset class such as real estate, Hogan says. He attributes this factor to the rise in investment flows to non-traded REITs. "Sales will be up close to 30% year-over-year in September, and that is because the stock market has been so dismal."

Yields Are Higher: "The dividend structures in non-traded REITs are based on the long-term structure of product," says Hogan. "There is a seven- to 10-year hold period that allows for the REIT manager to provide some stability in the portfolio." According to Blue Vault Partners' Nontraded REIT Industry Review, the median distribution yield was 6.75% in the second quarter. The highest was 8%, by Apple REIT Nine; the lowest, 5% by Behringer Harvard Opportunity REIT II.

NTR Prospectus: Reading Between the Lines

Both non-traded and publicly traded REITs should be part of an investor's portfolio, says Ray Lucia, principal of the San Diego-based RJL Wealth Management and author of the book "Buckets of Money Retirement Solutions."

Each plays a complementary role, he says. "The publicly traded REIT acts like a stock and has the same level of volatility. The non-traded REIT is one-part stock, one-part bond and one-part annuity. It gives you more stability and the yields are higher." Some, of course, are more stable and better-suited for investors than others, he says. Besides the usual due diligence, investors should consider the following:

1. Don't Get Sidetracked by the Load. Most NTRs have 10% to 15% front-end load. "That's a negative because only 85% of the investor's dollar goes into a brick-and-mortar investment," says Lucia. "Or, you can say both non-traded and publicly traded REITs have loads, which are reflected in the dividend payment." The top publicly traded REITs, such as Vornado or Boston Properties, are boasting dividends of about 3% right now, he notes, compared to a typical 5% to 6% for non-traded REITs. In short, he says, the load can easily mislead investors.

2. Do Dig to See What Investments May Be in the Pipeline. Investors need to ascertain if the properties the non-traded REIT is buying are supportive of and accretive to the dividend once the property reaches stabilization, Lucia advises. "For example, a non-traded multifamily REIT might be paying a 6% dividend. But let's say the REIT has a tendency to buy apartment buildings with very low occupancy rates. Sooner or later, it will not be able to cover the 6% dividend if it is buying apartment buildings with 40% occupancies," he says.

3. Ask About Yield After Stabilization. "If a non-traded REIT is paying a dividend of 7% and buys a property at a 7% cap rate, after the load they will probably not be able to cover the dividend," relates Lucia. Of course, investors can query the broker-dealers that sold or are trying to sell them the property. Another way to get at the issue is examining the company's funds from operations, Lucia said. "That must be able to cover the dividend at full stabilization."

According to Blue Vault Partners' Nontraded REIT Industry Review, the median year-to-date distribution/FFO coverage ratio in Q2 was 156%. On one end of the spectrum is Behringer Harvard Opportunity REIT II, with 68%; on the other is Cole Credit Property Trust III, with 411%. s.

4. The Prospectus Is Only a Start. While any investor should read an investment's prospectus or offering memorandum, these are not necessarily a definitive guideline, says Keith D. Allaire, managing director and head of Robert A. Stanger & Co.'s Financial Advisory Services Group. He points to the recent Cole registration filings. "You can't assume they will launch both of the products," he says. "If they do, they might decide to sell them in different distribution channels." Unless Cole says definitely what its plans are, any analysis about the filings is mere speculation, Allaire says. Cole declined to discuss its plans with Real Estate Forum, citing SEC regulations.

The amount of capital flowing into this sector, despite its huge increase, is still relatively small given the aggregate, which means they are not going to impact pricing on an entire asset class, such as core multifamily product. But, says one financial analyst, when a non-traded REIT enters the bidding process for any individual asset, the impact can be huge.

"The best thing for a seller these days is to have a non-traded REIT become interested in a deal," said the analyst, who did not wish to be identified. "It might bid higher than the market price just to get the asset on its books as quickly as possible. Nothing kills a non-traded REIT quicker than non-deployed capital."

Some NTRs take issue with this characterization. "It's true that many over-distribute in order to keep investors," says Byron Carlock, president and CEO of CNL Lifestyle Properties in Orlando. "We, however, have been under-distributed in terms of modified funds to operations by nearly $38 million since inception and under-leveraged by 26% debt to total capital. We have $165 million cash on our balance sheet."

There is also the investor base to consider. The source of the capital is what creates the differentiation in investment approach, according to Jeff Hanson, president and chief executive officer of the Santa Ana, CA-based Grubb & Ellis Equity Advisors. "Generally, non-traded REITs are an income product, and one of the differences is that our investors want non-correlation to equity markets," he explains. "They are also looking for stable income vis-à-vis the dividend."

To meet those needs, Grubb's non-traded REITs look for stabilized properties. "You won't see us buy assets that are only 75% occupied," says Hanson. "You can't get yield out of a 75% occupancy rate."

But NTRs' longer hold period and the fact they are not subject to the fluctuations of the stock market do give them a little more wiggle room as they approach a particular acquisition, says Tony Thompson, chairman and CEO of Thompson National Properties. Non-traded REITs "are not under the constant public scrutiny of analysts," he comments. "A publicly traded REIT may choose to use surplus cash to pay down debt because that's what the market rewards. They need to take certain measures to support their stock price." By contrast, non-traded REITs are more concerned about long-term total returns; that is, the ultimate value of the stock, its yield and the embedded growth.

Public non-traded REITs sometimes have a slight advantage because they can lever up a little more compared to their publicly traded counterparts, Thompson says, which are expected to be lower-leveraged. Then there is the issue of long-term valuation, an important component for investors. That too, often gives NTRs an advantage when they can cover their dividend.

"Most real estate is not priced 'mark-to-market' on a daily basis, the way traded REITs are," notes Tim Seneff, CEO of CNL Capital Markets Corp. This can lead to advantages when developing an investment strategy. For example, CNL aggregated a seniors-housing portfolio that in 2006 was sold for $5.3 billion; at the time, it was the largest healthcare REIT transaction in history, Seneff says.

CNL Lifestyle targets asset classes that are out of favor within the entertainment sector and, thus, has been able to buy at cap rates much higher than those for core assets, says Carlock. For example, the REIT has done well with marinas. Cap rates for such assets traded down during the boom years as they were redeveloped into 'dockominiums,' he states. "Now they're back to being rental properties for boat slips and the cap rates are going back up."

He points to the firm's acquisition of four California marinas for $55 million in March. The portfolio was originally under contract for $82 million but the previous would-be buyer couldn't get financing, Carlock says. The seller, Almar Management Inc., continues to operate the properties under long-term, triple-net leases.

From a bigger, perhaps more philosophical, perspective, the investor surge in non-traded REITs is also seen by some as a chance for redemption for the commercial real estate industry, whose image has suffered a massive blow in the financial crisis. But interest by investors and the positive associations with the real estate industry could also prove to be a double-edged sword, some fear.

The problem, critics say of the vehicles, is that non-traded REITs are not always safe. "The reason they are attracting so much capital is because they promise non-correlation with the stock market and a return on investment," says one REIT executive who did not wish to be named. "But it's not true, and if there's a big blow up again, it'll give the industry yet another black eye."

Indeed, several non-traded REITs have dismayed their investors by cutting dividends, including Behringer Harvard REIT I, Inland America Real Estate Trust, Inland Western Retail Real Estate Trust and Piedmont Office Realty Trust.

Other criticisms focus on their potential to become illiquid investments or the specified timeframe in which investors are able to redeem their REIT shares. It is not uncommon for a non-traded REIT to be tied up for up to seven years. There is less information publicly available about them, leaving investors to rely on the broker-dealer who sold the product for information.

But in the end, for most investors, the potential problems associated with non-traded REITs are outweighed by their promise of dividends. ◆

Look Who's Raising

Of the total 53 non-traded REITs reviewed in the second quarter by Blue Vault Partners, 36 were raising capital from individual investors while 17 were closed to new investments. Total industry assets grew to $67.3 billion as of June 30, 2010, up 3.9% from the previous quarter. Gross capital raised by nontraded REITs in Q2 totaled $2.2 billion, compared to $1.8 billion raised in Q1.

It is anticipated that there will be 40 non-traded REITs raising capital from individual investors by the end of the third quarter. The following are NTRs that are currently fundraising and have closed on more than $100 million in property acquisitions through the first half.

Cole Credit Property Trust III, $656.8 M

Behringer Harvard Multifamily REIT I, $362.6 M

Corporate Property Assoc.–17 Global, $327 M

Wells Real Estate Investment Trust II, $321.7 M

Healthcare Trust of America, $252.2 M

Apple REIT Nine, $226.8 M

American Realty Capital Trust, $179.5 M

CB Richard Ellis Realty Trust, $167.3 M

Source: Blue Vault Partners' Nontraded REIT Industry Review, Q2 2010