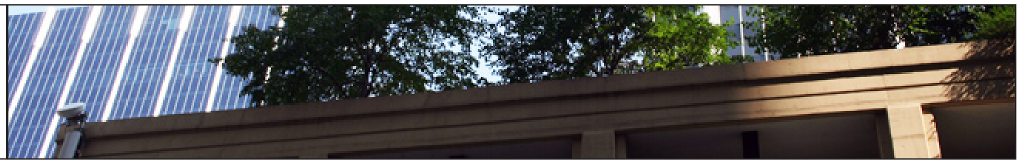
NAREIM
Real Estate Investment Managers



May 2011

Public Non-Traded REITs:
The Democratization of Institutional Real Estate?

Ask several real estate professionals to describe a public, non-traded Real Estate Investment Trust (REIT) and you likely will receive several different answers. While much investor attention has focused on publicly traded REITs, which were created by Congress through the REIT Act of 1960, public non-traded REITs celebrated their 20th year of existence in 2010.

To better understand how this unique form of commercial real estate investment works, we spoke with members of the National Association of Real Estate Investment Managers (NAREIM) who lead several public non-traded REIT programs. Jeff Holland, EVP of Capital Markets for Cole Real Estate Investments, George Pandaleon, President of Inland Institutional Capital Partners and Chuck Schreiber of KBS Realty shed quite a bit of light on the non-traded REIT sector and helped explain why it makes sense for a particular type of investor.

No single view can reveal all the answers. Commercial real estate in these times requires multiple perspectives to be understood and acted upon. The National Association of Real Estate Investment Managers, (NAREIM) thought it would be useful for various members to share their perspectives on the commercial real estate market – and perhaps provoke some thought, discussion and insight. That's why NAREIM is sponsoring a series of articles that examine commercial real estate from the Investment Managers' point of view.

Just like publicly traded REITs, whose shares are traded daily on public stock exchanges, non-traded REITs are registered with the Securities and Exchange Commission (SEC) as public companies, but their shares are sold through registered financial advisors rather than on stock exchanges.

Despite the recent economic downturn, non-traded REITs have proven popular with investors. Last year, the sector raised an estimated $7.6 billion, compared with $6.4 billion in 2009. Nationwide, there are 57 non-traded REITs with $70 billion in assets, or about 20% of the total market capitalization for all publicly registered REITs.

Designed for the Retail Investor

Why doesn't the little guy have access to private institutional quality commercial real estate? It is an attractive asset class, since it produces a consistent and somewhat reliable cash flow and it tends to have a low correlation to most other major asset classes. That's why pension funds have long invested in it and why most retirees, whether they know it or not, have a significant exposure to institutional quality real estate in their retirement plans. But as defined benefit pensions become less common and individuals must take control of their own retirement income, can the independent investor make institutional real estate investments? Baby boomers can't retire on tech stocks. They need income-focused investments.

That's where non-traded REITs come in, since they are specifically designed to provide investors with a long-term, consistent stream of income.

Pandaleon of Inland pointed out that, "Individual investors want income to live on, they want a shock absorber for volatility, and they want diversification. Institutional quality commercial real estate fills that bill."

So what are the commercial real estate options for an individual? It's possible to invest in smaller, but less institutional properties such as small apartment buildings or retail strip centers – but most investors aren't able to or interested in managing commercial property. Plus, without institutional quality tenants, the smaller properties can be subject to more frequent turnover, resulting in greater portfolio and income volatility.

What about publicly traded REITs? The growth and general acceptance of this asset class in the last two decades does seem to promise investors an easy path to institutional real estate investing. REITs acquire and hold diversified portfolios of commercial real estate, but because of their special tax status, don't pay corporate taxes. They are limited in the amount of leverage they can take on, are required to pay out 90% of their taxable income as dividends every year and, unlike any other type of real estate investment, anyone can purchase, hold and trade a REIT stock at any time. In other words, publicly traded REITs have made commercial real estate very liquid.

But in the process, they may have changed the very nature of the returns. When REIT stocks are traded every day, they tend to rise and fall with the rest of the market, being subject to the day-to-day volatility associated with open exchanges. According to Pandaleon, "We have seen a number of institutional investors reducing their public REIT portfolio allocations because they don't bring true real estate exposure characteristics. They behave more like small cap stocks." That means publicly traded REITs, while in many cases an outstanding investment, can't act as a "shock absorber" against volatility in a portfolio.

The Tradeoff – Liquidity vs. Stable Income

There is another option: keep leverage at a manageable level, keep the institutional quality assets, keep the tax advantages and dividends, but take away the day-to-day volatility that is often a result of trading on an open exchange. That describes public non-traded REITs, which in the last 20 years have grown to about 20% of the total REIT universe according to Blue Vault Partners. As Holland with Cole puts it, "With non-traded REITs, the individual investor is able to invest in the hard assets that institutional investors like to include in their own portfolio, plus they get the same level of diversification that any institution enjoys. Where else can you get direct access to institutional real estate in a bite-size chunk?"

As a result of the long-term nature of the investment, dividends from non-traded REITs are much more attractive than those from traded REITs. While publicly traded REITs average an annual 3.5% payout, non-traded REIT dividends range from 6% to 8% and often grow throughout the term of the investment, while experiencing little volatility at the same time.

Schreiber with KBS sums up the attraction of non-traded REITs this way: "An individual can invest $20,000 or $40,000 in the same quality asset that a $60 billion public pension fund invests in. They get the same cash flow, same risk and same return. There is a lack of liquidity, but the non-traded REIT investor isn't looking for their money right away. They need the return, the dividend and they don't want to open the newspaper to see that their stock has crashed."

The Tricky Part: Startup, Costs and Risks

Managing a successful non-traded REIT is not easy. In addition to the typical challenges of building and maintaining a successful real estate investment strategy, there are other significant barriers to entry. Offering prospectuses have to be approved by the SEC and approved by the independent broker-dealers, the sole source of investors for non-traded REIT's. A large financial reporting team is required, and there are significant costs in the first year or two before the portfolio generates enough income to cover the dividends to the investors as well as the management fees. That may be why only approximately half of the 25 sponsors in this sector are able to raise significant funds and only a few are able to raise more than $250 million.

The costs associated with non-traded REIT programs are significant. According to Pandaleon, "This is a very expensive distribution model. The broker/dealer network charges 7 – 8% on top of any management fees. That means that in the early stages of the fund, the load could be in the 12 -13%

range. Once it is fully subscribed, that could go down to around 10%. Some non-traded REIT sponsors have loads as high as 20%...but at that level it is doubtful you will get your money back."

This is where much of the criticism of non-traded REITs is often focused – how can you make promised dividend payments and cover fees during the ramp-up phase when there are only a few assets in place to generate cash flow?

All of the industry leaders we spoke with are focused on being very transparent with investors about fees, keeping those fees low and the promised dividends realistic – especially in the early months of a new REIT. Pandaleon continued, "We typically waive our management fees entirely until the cash flows from acquisitions can cover first the dividend and then our fees. While not required to do so, we have historically put ourselves behind the investors when it comes to the distribution of cash flow."

Schreiber added, "Our load and costs are identical to that of a pension fund investment plus the broker-dealer commission. Their level of due diligence on fees has increased dramatically in the last 10 years and they are doing close comparisons of load, base fees, annual fees, costs and dividend coverage. This is driving loads down throughout the industry."

Non-traded REITs tend to be less volatile than their publicly traded counterparts, but they are also designed for long-term investors seeking consistent returns rather than day-to-day liquidity. As Holland notes, "Commercial real estate lends itself to long-term investing. While this asset class is very similar to other asset classes, you have to take the time to understand the features and the benefits. It's not a magic bullet, but it's a very useful tool."

It is important to keep in mind that like any other investment non-traded REITs have their risks – and some investments fail. This sector is still somewhat new and all the standards aren't in place. There is a bit of a Darwinian process taking place where some REITs will not get the necessary traction and won't be able to succeed. Many firms that are having trouble gaining that traction promise too much and should be watched closely.

According to George, "Like a traditional life insurance policy, there are significant up front costs. But if it is structured correctly, and you select a good sponsor, it works well over time. It pays to stick with stable, well known commercial real estate investment firms with sustainable business models, and to do the due diligence. The REIT has the potential for some bonus based on residual value at the end, while the regular dividends make this a high quality income alternative. Now, real estate is still a cyclical business, and if you bought in 2007 and 2008 you are likely to have had some problems. But on the whole, the institutional quality of the real estate in the best non-traded REIT's, and their regular dividends make this very attractive."

The Future

As the market for non-traded public REIT's matures, issues of standards, transparency, accessibility and costs will continue to be addressed and improved. This is still a young asset class, some issues will be resolved through a natural market selection process and others through innovation. As Holland pointed out, "There are good actors and bad actors in this space, but it is important not to paint the industry with too broad a brush. We are constantly trying to create more transparency for investors, with daily valuations, lower fees and other ways to open this product up to a broader range of investors."

One factor does serve to strengthen the overall quality of funds active in this area: it is exceedingly difficult to start one of these vehicles. According to Pandaleon, "There are some real challenges to getting one of these started, everything from the SEC requirements to dealing with the broker/dealers. It is a long (2 year) and expensive process. There are about $5 million to $15 million in upfront costs before you find out if you will raise a nickel of capital. All in all, the barriers are much higher than institutional equity funds – and of course, far higher than purchasing REIT stocks. But despite all the barriers, we've had a rash of new entrants – approximately 30 new groups are trying to raise money in addition to the 5 to 10 veteran players. Very few of the new entrants will be successful."

Schreiber added: "This market will continue to grow, but it won't likely double. The average investment is still around $30,000, just as it was 5 years ago. If that doesn't change, it limits the amount of growth that can happen. You have to increase the amount of individual investments made – not just increase the amount of each investment. I would predict a growth rate of 10% or 15%."

Thanks to high barriers to entry, a track record of reasonable growth, high transparency and less volatility, non-traded RE-

ITs offer institutional-quality investing for the little guy. Conducting due diligence on the sponsor of any fund, however, is essential. As Pandaleon noted, even as this investment option continues to mature, "if investors continue to be pleased, this market will continue to improve and grow."

The National Association of Real Estate Investment Managers (NAREIM) is the leading association for companies engaged in the real estate investment management business. NAREIM members manage investment capital on behalf of third party investors in commercial real estate assets. Investment sectors include office, retail, multi-family, industrial and hotels. NAREIM members serve the investment goals of public and corporate pension funds, foundations, endowments, insurance companies and individuals — domestic and foreign. Collectively, they manage over $1 trillion of real estate investment assets around the world.

NAREIM members range from the largest institutional firms in the world with fully integrated service platforms to specialized entrepreneurial firms.

For more information contact

Tom Klugherz, President of NAREIM

202.789.4374

tklugherz@nareim.org

www.nareim.org