Advocating Direct Investments
Through Education

Investment Program Association

Investing in Non-Traded REITs

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Overview

Real estate investment trusts (REITs) are corporations or trusts that pool the capital they raise by selling shares of common stock to invest in income-producing real estate or, less commonly, mortgages on real estate. They have become a common vehicle for retail investors to invest in this asset class.

REITs may be traded, which means their shares can be bought and sold on a national exchange, or non-traded, which means their shares are not available on an exchange and have limited liquidity. Both types of REITs must pay out at least 90% of their taxable income to shareholders to maintain their status as exempt from federal corporate income taxes.

This paper will review the characteristics of non-traded REITs and explore the factors that retail broker-dealers and financial advisors should consider in analyzing these products as investment opportunities.

I. Basics of Non-Traded REITs

A non-traded REIT is a direct investment that uses the capital it raises from retail investors to purchase and manage income-producing properties or, in some cases, mortgages on properties. A REIT's managers seek to produce a steady stream of revenue that it pays out as distributions to its investors, who are shareholders of the REIT.

A non-traded REIT may invest in a variety of property types, including but not limited to: office or retail space, multi-family housing, industrial property, leisure, healthcare facilities, or a combination of property types. It may focus on a subtype within a larger property type or invest across several types. Similarly, it may concentrate its investments in a limited geographic region or invest nationwide.

The shares of a non-traded REIT are not listed on any exchange, and there is no readily available resale market, making the shares essentially illiquid. Investors should plan to hold these non-traded securities through the estimated life span of the REIT, typically up to seven to ten years, until a planned liquidity event that is designed to return investment capital and potential capital appreciation to the shareholders.

As with many direct investments, the fact that these REITs cannot be readily traded carries a liquidity premium that typically provides a higher yield than the yield on traded REITs with similar portfolios.

Characteristics of a Non-Traded REIT

A non-traded REIT has certain characteristics that define it as an investment and differentiate it from publicly traded investments, including publicly traded REITs. It should be noted, however, that while a non-traded REIT is not publicly traded it is a public company that must register with the Securities and Exchange Commission (SEC) and make required quarterly and annual financial reports to the regulator, just as other public companies do.

- Non-traded REIT shares are available only to investors who meet suitability standards established by the state where they live.
- A non-traded REIT has a limited lifespan, often seven to ten years, before ending in a liquidity event.
- Non-traded REIT investors measure success by total return, which includes the cash distributions during the lifespan of the program plus any appreciation of investment principal as a result of the liquidity event.
- The up-front fees associated with investing in a non-traded REIT may be in the range of 12% to 15%.

II. Life Cycle of a Non-Traded REIT

A non-traded REIT goes through four distinct phases in its life cycle that make it a unique asset. The initial phase is the capital raising stage where the REIT sells shares to raise capital to fund its acquisition of assets. The second stage is the property acquisition stage. During this period, the REIT uses the capital raised in stage 1 to purchase properties. The third stage is the asset management phase, when the REIT manages the assets it owns to increase cash flow and value. The final stage is the disposition phase during which an exit strategy is implemented to return the investors' original investment and any capital gains or losses that result from the liquidity event.

In reality, however, the phases typically overlap to some extent, so that acquisition begins while capital is still being raised. Similarly, active management begins although properties are still being acquired. However, no additional new capital is typically available after the capital raising stage ends.

Phase 1: Capital Raising

The capital raising stage of a non-traded REIT begins when the SEC issues a Notice of Effectiveness of the registration process. At this point the REIT begins raising capital according to the plan laid out in its prospectus. For non-traded REITs, this plan often involves a retail broker-dealer network and financial advisors.

As investors buy shares in the non-traded REIT that their financial advisors recommend, the REIT receives the funds it will use to acquire assets in keeping with its investment plan. The capital raising phase can last from one year to three years and may be extended by the REIT's board of directors and management. Financial advisors should be aware of the significant ways in which the capital raising stage of a non-traded REIT varies from the capital raising phase of a traded REIT, which is typically a one-time initial public offering (IPO) with the potential for follow-on offerings.

As the capital raising continues, the non-traded REIT begins to acquire assets. Many non-traded REITs have properties ready to be acquired as the shares are sold so there is minimal lag between investment and the start of dividend distributions that depend on cash flow from the properties or other assets in the REIT's portfolio. A REIT may also use short-term financing, such as lines of credit, to make purchases before sufficient equity is raised so it can build its portfolio faster and potentially buy better assets.

As a result of the incremental acquisition of properties, the exact composition of the portfolio will be at least partially unknown at the time an investor purchases shares. In addition, because the acquisition period is potentially several years long, the non-traded REIT may purchase assets in different economic and real estate market conditions. The advantage of being able to acquire properties over time is that a non-traded REIT can potentially make better choices than traditional traded REITs and other real estate fund structures, which are sometimes forced to acquire assets quickly. But it is also true that an extended acquisition period means that the quality and risk profile of the assets being added to the REIT's portfolio may change over time.

Non-traded REITs have another potential advantage over traded REITs. By using a retail broker-dealer network, they can raise capital independent of traditional Wall Street-based capital markets. This may allow them to take advantage of unique investment opportunities especially in periods when the markets are flat or falling.

Early-Stage Capital Raising

Early-stage capital raising occurs during the first half of the period allotted to sell shares. For example, if the entire capital raising phase is planned to last two years, the early stage would be the first year. The extent to which a REIT's growing portfolio matches its proposed plan during the initial capital acquisition phase may indicate how successful the REIT will be during the remaining capital raising period.

Before recommending a non-traded REIT during early-stage capital raising, a financial advisor should:

- Review the assets that have been acquired to date to see whether they fit the investment and acquisition plan
- Determine when dividends and other cash distributions will begin

- Evaluate whether the REIT's acquisition and investment plan seem reasonable given the current market environment
- Analyze whether market conditions can be expected to improve or deteriorate in the capital raising window and the overall holding period of the REIT

Late-Stage Capital Raising

The late-stage capital raising phase begins once the REIT reaches the midpoint of the capital raising phase. In addition to continued attention to the key elements that were important during early-stage capital raising, a financial advisor should be aware that potential rates of return to the investor, including the sustainability of a certain distribution yield, are impacted by the REIT's ability to make successful acquisitions during the capital raising phase. Therefore, he or she should compare the cash flow from operations to the current and anticipated distribution yields of the non-traded REIT to ensure adequate coverage and sustainability.

Financial advisors should also seek answers to the following specific questions during the late stage, bearing in mind that a REIT should be self-sufficient in covering capital expenditures and other large costs by the time the capital raising phase terminates:

- Is cash flow from REIT operations, net of capital expenditures and other investments, sufficient to cover the dividend and other distributions being paid?
- What does the current status, composition, and financial strength of the portfolio look like?
- Is the non-traded REIT producing excess cash to cover the distribution yield at this point to ensure stability of payout in the future?
- Is the REIT maintaining a sufficient level of cash to fund unexpected expenses or temporary shortfalls due to tenant turnover or other such events?
- Have market conditions changed, for the better or the worse, since the REIT began acquisitions and what is the likely forecast for the REIT's projected lifespan?

The bottom line is that a financial advisor must understand that investing in a non-traded REIT during its capital raising phase involves not only reviewing the current portfolio but also assessing what properties are likely to be acquired with the balance of capital that it raises. Further, he or she should be comfortable with the potential performance of the assets for the remainder of the REIT's life.

Phase 2: Property Acquisition

In the property acquisition stage, a non-traded REIT winds down money raising and concentrates on buying properties that are consistent with the type of real estate that the firm will manage. This is also the stage where income generation begins in earnest for income REITs as rents provide cash flow.

Acquiring real property is much more complicated and time-consuming than purchasing financial assets, which can often be completed in a matter of seconds on public exchanges or through trading desks. With real estate, the process goes far beyond identifying a property and writing a check. In fact, a non-traded REIT may go through five steps during a property acquisition, including property identification, initial due diligence, price negotiation, final due diligence, and closing.

It is not surprising, then, that the services the REIT's management provides to its shareholders during the property acquisition stage are some of the most intense and time-consuming required over the REIT's lifespan.

Step 1. Property Identification

During this step, the acquisition team actively searches for potential assets to buy for the REIT's portfolio. This involves investigating properties that are being actively marketed for sale as well as forming relationships with real estate brokers and other property owners, including other REITs.

Because non-traded REITs are constantly looking for property and because they have a capital raising advantage over other types of real estate funds, including traded REITs, brokers and other sellers sometimes seek them out as potential buyers. This may give non-traded REITs an advantage over other types of real estate investors in negotiating a deal.

Step 2. Initial Due Diligence

Once a non-traded REIT has identified a potential target property, the acquisition team gathers and analyzes data on the property and the market in which it is located to decide if it should be purchased, and, if so, at what price. This often requires a site visit and meetings with the existing property managers as well as in-depth financial modeling. The REIT may also begin to pursue debt financing and obtain loan quotes if it plans to use leverage for the acquisition. In some cases, though, REITs buy with cash and add debt at a later date.

Step 3. Price Negotiation

During price negotiation, the acquisition team and the REIT's investment committee, a formal group usually composed of senior members of management and occasionally outside board members, attempt to acquire the property at the best possible price. If the REIT and the seller reach a deal, they will execute a legally binding contract at this point.

A REIT's investment committee, which may go by different names at different firms, has final power to approve any proposed acquisition. Its oversight helps to ensure that the acquisition team is being diligent and not overpaying for property.

Step 4. Final Due Diligence

Once the property is under legal contract, the REIT begins a more exhaustive and comprehensive due diligence process. This can include items such as lease reviews, appraisals, site inspections, property inspections, environmental inspections, legal reviews, and other items necessary to ensure the property is as it has been represented during negotiations. The due diligence phase marks the REIT's final chance to cancel the deal if it does not appear wise in light of information turned up during these investigations.

This step often involves significant expense, including the cost of hiring third party experts to assist the REIT's acquisition team. If the acquisition will involve debt financing, a formal loan application is made at this point.

Step 5. Closing

Assuming the investment committee has reviewed the due diligence reports and given final approval to acquire the asset, the REIT arranges a formal closing where payment is exchanged for the deed to the property. As soon as the closing is completed, the REIT is entitled to all rents and cash flows from the property and asset management formally begins.

Typically, the asset management team is involved during final due diligence to ensure a smooth transition from the seller. The entire process from initial identification to closing can take from as little as 30 days to as long as six months, although 60 to 90 days is average. Loan closing can occur simultaneously with property closing, or it can occur at a later date.

Phase 3: Asset Management

Technically, asset management begins as soon as the REIT's first asset is acquired and does not end until all assets have been sold or another exit strategy has been completed. Because of IRS guidelines for maintaining REIT status, REITs must typically hold properties for an extended period to avoid paying corporate taxes on any net gain from selling assets. Traditionally this period has been a minimum of four years. However, recent changes in the law may allow REITs to dispose of property within a shorter window.

Before recommending a non-traded REIT to a potential investor, a financial advisor should review the prospectus to ensure that the REIT has a qualified asset management team and set of practices in place that help ensure it will manage the REIT for the benefit of its shareholders. Then, during the asset management phase itself, advisors should be reviewing reports to shareholders and voting proxy shares in the way that is best for the health of the REIT and its shareholders.

The REIT has a number of responsibilities during the asset management phase. First and foremost, it must maximize operating cash flows from its portfolio properties by increasing rental revenue whenever possible and controlling expenses wherever practical. In reality, rental rates and occupancy levels are generally set by market forces and so normally beyond the control of the REIT's asset and property managers. Expenses can sometimes be lowered, or at least controlled, by an experienced management team actively handling the real property portfolio.

At the same time, the REIT should continue to make proactive capital expenditures that balance maximizing current yield against maximizing total return following the liquidity event. Some tactical expenditures that lead to long-term higher revenues or lower expenses may expand property values. Other expenditures may reduce current cash flow but yield large returns at resale.

The REIT should also prepare the portfolio and individual assets for final disposition. Since non-traded REITs seeks to execute a liquidation strategy within a specified time frame, the asset and property managers should monitor market conditions and select and time the exit strategy to maximize overall value to the shareholders.

Valuation of Shares

Under present FINRA and SEC rules, a non-traded REIT must issue a valuation of its shares within 18 months of the completion of the capital raising phase. Before this valuation is issued, shares are normally reported on a shareholders' account statement at the initial purchase price, often $10 per share.

FINRA is currently planning to change the valuation practices of non-traded REITs in order to make valuation more transparent and accurate during both the capital raising and asset management phases. The likely outcome will be some form of periodic reporting of net asset value (NAV) per share based on prescribed criteria, an independent advisory firm's determination, or both.

NAV is normally defined as the current aggregate market value of the assets in the REIT's portfolio, minus any debt or other obligations of the REIT, divided by the number of outstanding shares of the REIT's common stock.

In fact, for business competitive reasons, some non-traded REITs are already beginning to issue NAV-based valuations—or are making plans to do so—ahead of FINRA mandates. Financial advisors should review a non-traded REIT's specific plans for calculating and issuing NAV or other valuation metrics during the capital raising and asset management phases so that they can explain these plans to their clients. Financial advisors recommending investment in non-traded REITs should monitor rule changes by FINRA and other regulatory boards, as they will likely impact the way non-traded REITs do business.

Early NAV Estimates

It is worth noting that, just because a non-traded REIT issues a NAV estimate earlier than required, it does not mean that the shares are necessarily saleable or tradable at that NAV, or that the investor can otherwise liquidate the shares before the final disposition phase of the non-traded REIT. It is possible, however, that if non-traded REITs or third-party experts publish NAV estimates, this information could help facilitate a working secondary market for non-traded REIT shares.

However, until such markets exist and are proven to function, early issuance of NAV simply provides better information with which to make investment decisions during the capital raising phase while also allowing investors to better understand the performance of the shares once they have been purchased for their portfolios.

Phase 4: Disposition

Non-traded REITs are almost always designed to be finite-life entities, with an exit strategy executed at a predetermined time, or within a predetermined time frame, to return capital to the shareholders. During the capital raising phase, a financial advisor should be able to explain the various exit options that a non-traded REIT might execute, since each option could have different implications for the REIT's investors and thus affect the suitability of the investment for their portfolios.

In contrast, a traded REIT is more often a perpetual-life entity that could, at least in concept, operate forever, with shareholders timing and selecting their own exit strategies by selling their shares in the public market or participating in a firm-sponsored share repurchase program if it were offered.

The major exit strategies, or types of potential disposition, include listing on a public exchange, sale or merger of the entire portfolio, or an orderly sale of properties and assets.

1. Listing on a Public Exchange

If the non-traded REIT's management team and board of directors choose to take the REIT public, it is listed on a public exchange such as the New York Stock Exchange (NYSE) or the NASDAQ Stock Market and issued a ticker symbol. At that point the shares begin to trade continuously in the same way as the shares of any other traded REIT or stock.

At the time the non-traded REIT is listed, the existing shareholders have the option to:

- Sell all or a portion of the shares they own and receive cash to reinvest or spend
- Continue to hold the shares as before and receive dividends as usual, reserving the right to sell at any time in the future

It is important to note that once the shares begin trading, their price will be set by supply and demand and will fluctuate with market trading.

If the REIT is to be listed, a financial advisor will need to assist his or her clients in deciding which alternative to choose. Fundamentally, the investor must decide whether to sell at the current price or whether a future price may be more favorable. As a part of this process, the advisor and clients should review the current prospectus and updates from management as they did before the initial investment. It is important to note that tax planning and portfolio rebalancing considerations will have a primary influence on the client's final decision.

To List or Not to List?

It may be advantageous to list a REIT under the following circumstances:

- If shares of traded REITs are selling at premiums to NAVs, which means investors are paying more for REIT assets than the assets are intrinsically worth
- If continuing to operate the REIT has value for investors and ceasing operations would destroy value
- If the REIT investment portfolio is well understood by traded REIT analysts and market participants
- If potential private buyers for either the entire portfolio or individual assets are limited

2. Sale or Merger of the Entire Portfolio

If the board and managers of the non-traded REIT decide to sell the portfolio or merge it with another fund, such as a publicly traded REIT, they will attempt to complete the disposition in a single transaction.

In a sale, shareholders receive a specific dollar amount per share on the predetermined closing date. The payout is often called the liquidating dividend or distribution. A financial advisor will need to assist clients in reinvesting some or all of the proceeds and anticipating the income tax that will be due for the taxable year unless the assets have been held in a tax-deferred account.

In a merger, the non-traded REIT shares are converted into another form of security, such as shares in the traded REIT, on the closing date, or perhaps a combination of securities and cash. If all or a portion of the existing shares are exchanged for new securities, the advisor should assist in determining whether to hold the securities for the present or sell immediately. If cash is involved, there will be questions about reinvesting. In both situations, there will also be income tax questions if the shares have been held in taxable accounts.

Sell or Merge?

A REIT's managers and its board may find either a sale or a merger an attractive approach to liquidation under the following circumstances:

- A suitable acquirer or merger partner has been identified and is willing to complete a transaction on terms that are advantageous to the REIT's shareholders.
- Publicly traded REITs are trading at discount to NAVs, meaning stock market investors are paying less for REIT shares than their underlying assets are intrinsically worth.
- A single transaction may be the best option as it can often be executed at the lowest cost and with the highest degree of certainty.

3. Orderly Sale of Assets

A non-traded REIT's managers and board of directors may decide to dispose of its underlying portfolio of properties one-by-one or in small blocks. It is often easier to dispose of individual properties than a large portfolio of properties, in large part because single-property buyers are much more common than large- portfolio buyers. This type of sale may also be more economical, and so produce more value for shareholders than a public listing, which can be expensive.

An orderly sale of this type is likely to take from several months to several years to complete, depending on the state of the market in which the underlying assets will be liquidated. The non-traded REIT's investors will receive distributions in multiple, though not necessarily equal, payments over time that include return of capital and the potential capital gains or losses from the sales as they occur instead of a single lump sum.

Once all assets are liquidated, the REIT will issue a final liquidating distribution returning any remaining capital to the shareholders, after which operations will cease. The financial advisor's role if this option is selected is essentially identical to his or her role in a sale of the entire portfolio, although it may stretch over an extended period so the income tax issues may vary somewhat.

An Extended Sale

REIT managers and its board may find selling individual properties, or small groups of properties, advantageous under the following circumstances:

- The individual properties are too heterogeneous to be sold to one purchaser.

- The portfolio would be difficult for publicly traded REIT analysts to understand and value.
- Shares in publicly traded REITs are selling at a discount to NAV, meaning that investors are paying less than the combined intrinsic value of the assets.
- Certain properties have significantly higher or lower values than the overall portfolio and should be sold separately before other disposition decisions are made.

Choosing the Most Promising Disposition

Ultimately, the REIT's managers and board of directors should select the disposition option or combination of options that best maximizes shareholder value while providing required liquidity. Non-traded REITs almost always execute an exit strategy within a fixed time frame, though it is often a best practice for a non-traded REIT to have the flexibility to delay a pre-timed disposition if market conditions are unstable or unfavorable to an exit.

Financial advisors should be familiar with the proposed disposition plan and expected timing, both of which are laid out in the prospectus, before recommending an investment in a non-traded REIT. But they should also be aware of the possibility that the liquidity plan could be changed or even extended as part of determining a non-traded REIT's suitability for a particular investor.

III. Portfolio Construction

The sponsors of a non-traded REIT make a number of choices in designing its investment plan and choosing its management team that determine the REIT's unique nature.

Thus, before making investment recommendations, it is critical for a financial advisor to have a broad understanding of the various types of REITs within the non-traded REIT universe. In addition, as each REIT differs from those of other sponsors, even those making similar investments, an advisor should read the prospectus and other marketing material to determine the proposed nature of a specific non-traded REIT and the expertise and experience of its management team.

The advisor should also be aware that it is often a best practice to diversify any investment portfolio containing non-traded REITs by including a number of non-traded REITs from different sponsors.

Types of REITs

Non-traded REITs can be classified into three broad categories: equity, mortgage, and hybrid. All three are eligible for REIT status according to IRS guidelines, but equity REITs are the most common, and the type that most investors and financial professionals associate with the term REIT. However, it is important to keep in mind that these definitions are somewhat subjective and may not be universally applicable.

Equity REITs

An equity REIT purchases direct interests in real property and is classified by the type or types of property the fund owns and the geographic region or regions on which it focuses.

Non-traded equity REITs may specialize in a specific type of property or diversify across two or more property types. If a REIT selects one type of property in which to invest exclusively, it may also further restrict itself to one specific subtype within the broad property category. For example, a retail REIT may restrict itself to acquiring only regional malls, a subtype within the retail category.

An equity REIT may use partnerships or joint ventures to acquire its holdings, but it is generally the end owner of an equity interest in the individual properties in its portfolio and is ultimately responsible for property management. The REIT seeks to generate cash flow by renting the space it owns, and it makes income distributions after all expenses and capital expenditures are paid. The primary impact on performance is the real estate market or markets in which it acquires property.

Mortgage REITs

A mortgage REIT holds mortgages or other similar indirect interests in real property but does not own an actual equity interest in the property. Mortgage REITs generate profits by collecting interest and principal payments on the loans they own. Because mortgage REITs do not own property directly, they do not need to be concerned with property management, but concentrate on loan servicing and general asset management tasks.

Further, relative to equity REITs, mortgage REITs rarely participate in property appreciation in a particular real estate market or markets. Instead, a mortgage REIT's return is affected by changes in the interest rates in the broad economy, especially if it needs to sell or divest assets before maturity. When evaluating a mortgage REIT, financial advisors and potential investors should consider the potential for a significant change in interest rates.

Hybrid REITs

A hybrid REIT owns both equity and mortgage interests in a single fund. Thus, the REIT is subject to the forces that affect both equity and mortgage REITs and requires experience and expertise in asset management, property management, and loan servicing.

It is worth noting that some equity REITs will, from time to time, own or acquire mortgage interests that constitute a small portion of their portfolios. However, this does not necessarily mean analysts or other market participants will redefine such a REIT as a hybrid. The category is generally reserved for REITs that make an active business decision to be in both types of real estate assets.

Property Types

There are seven broad property categories in which a traded or non-traded REIT may invest. One property type is not necessarily a better investment arena than any other, as any of them may provide a profit or result in a loss in any given period. Similarly, while overall portfolio diversification has strategic advantages in managing risk, a REIT that diversifies its portfolio across property types is not necessarily a better or worse choice that a REIT that focuses exclusively on a property type or subtype.

1. Apartments or multi-family properties. Individuals and families typically rent these living spaces on a one-year basis. Apartments perform well when there is increasing demand from household creation and job growth. Sub-types of apartments can include market rate, government subsidized, luxury, student housing, and senior housing.

2. Office space. Businesses lease these workspaces, typically on a multi-year basis. Office rental properties perform well during periods of broad economic growth and job creation, especially when the growth is concentrated in the office-using employment sectors. Subtypes of office rental properties include central business district (CBD) high-rise, CBD mid-rise/low-rise, suburban office parks, professional/medical offices, and research and development properties, which may sometimes be classified as industrial facilities.

3. Industrial facilities. Businesses rent these properties, typically on a multi-year basis, to manufacture, store, and distribute goods and products. Industrial rental properties perform well when there is growth in import/export activities and broad overall economic growth. Subtypes of industrial rental properties include distribution, manufacturing, business parks, warehousing, and research and development properties, which may sometimes be classified as office space.

4. Retail space. Businesses lease these commercial spaces as retail outlets that are open to consumers. Retail rental property performs well in periods of growth in employment and consumer spending. The subtypes include regional malls, power centers, neighborhood centers, and freestanding single tenant properties. Because retail is a broad category, with the most divergent list of subtypes, it is essential to understand the particulars of the subtype(s) a REIT plans to acquire.

5. Hospitality properties. These properties rent rooms on a nightly, weekly, or monthly basis and additional revenues are derived from other sources such as food and beverage, retail concessions, and conference services. Hospitality properties, which may also be identified as leisure properties, perform well when there is growth in the overall economy and in consumer discretionary spending. Subtypes of hospitality include full service hotels, limited service hotels, resorts, amusement parks, and RV campgrounds.

6. Healthcare properties. These facilities can include specialized properties such as adult living facilities, skilled nursing facilities, treatment centers (either residential or outpatient), and hospitals, as well as senior housing and medical offices that may also be classified in other sectors. Given the diverse nature of the category, each subtype could be impacted differently by market forces. In general, medical spending and factors that tend to increase medical spending, such as an aging population, allow healthcare properties to perform well.

7. Self-storage properties. These small units are rented to individuals and businesses, typically on a month-to-month basis, and managed like an operating business, as hospitality properties are. These properties are often described as a subtype of industrial but have distinctive features that differentiate them from the larger category. Self-storage performs well during periods of broad economic growth and household creation.

An additional category, described as specialty rental property, includes assets that REITs have been known to own or specialize in but that do not fit into one of the seven major categories. Since the properties are diverse, the performance factors impacting each of them are uniquely determined. Property types could include timber, cellular towers, billboards, golf courses, data centers, prisons, and others. As an example, timber refers to acres of timberland that are harvested periodically for cash flow. Performance is a function of demand for timber, which is driven by the overall economy and the natural growth rate of the trees, which in turn is impacted by weather.

Evaluating REITs

Each non-traded REIT normally embarks on a unique strategy given its views on the real estate market and economy. It is essential for a financial advisor to assess the depth and skill with which a non-traded REIT's management team has analyzed the segment of the real estate market that is germane to its investment strategy and the economy as a whole. It can be the case that a particular subtype or sector of a property type or geographic market can substantially outperform the broad real estate or other asset markets while a general diversified strategy may underperform. The opposite is also true.

In contrast, a financial professional may be doing his or her clients a disservice to overweight the news and opinion from media outlets and other financial commentators, as it may not be applicable or relevant to a specific non-traded REIT's investment strategy.

Asking the Right Questions

When performing due diligence on a non-traded REIT before making an investment recommendation, the following questions are relevant:

- Do the REIT's sponsor and management have the experience and expertise to acquire and manage the property type they have selected?
- Is the investment thesis presented in the REIT's prospectus logical and backed up by research and market data?
- Do the current real estate market and general economic situation, as well as expectations for the foreseeable future, support investment in the proposed asset types?
- Is exposure to the specific property type appropriate and suitable for the specific investor?

IV. Assessing the Investing Environment

Two of the factors a financial advisor should consider in assessing the investing environment for non-traded REITs are the real estate market cycle and the potential income and appreciation strategies that the management team may use.

Market Cycles

Real estate markets travel through recurring cycles over time, from recession to recovery, through expansion and contraction, and back to recession as the cycle begins again. What moves a real estate cycle from phase to phase is an interaction of demand for space from the economy and supply of space provided by real estate developers and owners.

Successful real estate investment managers must be able to assess which phase the market is in and the pace at which it is likely to move to the next phase. Investors who purchase shares in a non-traded REIT are counting on the REIT's management to make appropriate buy and sell decisions for the portfolio, based in part on their assessment of the real estate cycle.

The Four Phases

Throughout the life of a non-traded REIT, the REIT management team has the critical responsibility of capitalizing on the real estate cycle in making acquisition and disposition decisions. The phases of a real estate cycle evolve from one into another based on:

- Whether rental rates and occupancy levels are rising or falling
- Supply and demand for space measured by current occupancy relative to historic equilibrium, which is the hypothetical point at which rental rates and occupancy are stable because supply of space meets demand for space

Although advisors and investors might begin their investigation of the real estate market in any phase of the market's cycle, this summary tracks its movement from the bottom, or recession, through its peak, and into contraction.

1. Recession

During the recessionary phase of the real estate cycle, occupancy levels are lower than historic equilibrium and rental rates are falling. This is generally not a good phase in which to invest unless assets can be purchased significantly below replacement costs, or the cost at which the property can be reconstructed. If that's the case, making a long-term investment when the market is in recession can be very profitable.

Non-traded REITs have had historical success buying in these markets as their ability to raise capital through the retail broker-dealer channel allowed them to make purchases when many other real estate investors, reliant on institutional capital, were unable to do so.

2. Recovery

During the recovery phase of the cycle, occupancy remains lower than historic equilibrium, but rental rates and occupancy levels are rising. Recovery is generally the best phase in which to invest as current income and property values are likely to be rising. A non-traded REIT can have a huge advantage in this phase if it is able to raise capital ahead of competitors and thus buy property at better prices. Those competitors include buyers dependent on institutional capital, which often becomes scarce during and immediately following recessionary periods.

3. Expansion

During the expansionary phase of the real estate cycle, occupancy is higher than historic equilibrium and rental rates and occupancy levels are still rising. As the recovery and expansionary phases have historically tended to last the longest, it is still potentially profitable to purchase during an expansion. However, it is better to locate markets in the earlier stages of expansion.

It is also important to be cautious not to overpay for property. Many real estate investors will have ready access to capital, so purchasing in this phase will be the most competitive for all buyers, including non-traded REITs. On the other hand, timing an exit toward the top of the expansion phase or the start of the contraction phase, if possible, is a best practice.

4. Contraction

During the contraction phase of the cycle, occupancy remains higher than historic equilibrium but rental rates and occupancy levels are falling. The challenge of contraction is that it may not be clear when the bottom will be found and how far prices and incomes may fall in the process. Acquiring in this phase is potentially profitable if property can be bought cheaply enough to mitigate the risk that market prices, rental rates, and occupancy levels may continue to fall. This is similar to buying in the recessionary phase but more risky as the decline may last much longer than anticipated.

Real Estate Cycle Summary

Different geographic regions, even different parts of the same city, can be and often are in different phases of the real estate cycle at the same time. For example, rental rates and occupancy levels can be moving up in one city while they are falling in a neighboring city. What's more, different property types and even subtypes can also move independently of each other. This means that it takes tactical skill to select the best real estate investments at any given time.

In addition, while it is meaningful to follow national trends, one must use local knowledge to make investment decisions at the property level. A financial advisor should review the REIT's investment plan for the procedures it follows to identify the best markets given any property type considerations.

There is no rule or set of criteria that determines how long each phase of a real estate cycle lasts. However, it is common for each phase to last several years. Fortunately, the phases that have historically lasted the longest by a significant margin are recovery and expansion, which are the best for all real estate investors.

Comparing Income and Appreciation Strategies

In real estate, there are two general sources of return on investment (ROI). The first is current income, or distributions in the case of non-traded REITs. The second is price appreciation, which is realized at the sale of assets in the case of a non-traded REIT.

Generally, current income strategies are associated with higher current yields and lower overall total returns, while long-term appreciation strategies are more likely to provide higher total returns with possibly lower current yields. Correspondingly, current income strategies are generally lower risk, while appreciation-focused strategies have higher relative risk. A non-traded REIT's management can explicitly select strategies to focus on current income, long-term appreciation, or a combination of the two.

When a REIT management team pursues an income strategy, it focuses on a number of factors. The team will:

- Look for markets that are relatively stable, with relatively lower prices and higher capitalization rates than markets perceived as high growth
- Seek out properties with a high level of occupancy at the time of acquisition
- Pursue properties that are slightly older—sometimes called Class B properties—which tend to be relatively cheaper and thus can provide higher yields, but are also less likely to appreciate rapidly

The management team may also use leverage to enhance current yields. In general, higher debt is associated with higher total returns and higher risk.

In contrast, when a REIT management team pursues a capital appreciation strategy, it will focus on:

- Properties with value-add potential. This means that by using aggressive management and capital expenditure, value can be increased dramatically by raising rents, reducing vacancy, or both
- Markets with high growth expectations. This will normally require paying higher prices, which, in turn, tends to reduce current yields
- Newer properties, to be able to increase rents and thus value faster over time despite pricing premiums that reduce current yield

With an appreciation strategy, however, the REIT may use debt more aggressively to increase the magnitude of the leveraged return.

A blended strategy often involves combining various aspects of the income and appreciation strategies to produce yields higher than pure appreciation strategies while still delivering total returns higher than a pure income strategy. One simple method a REIT may use to accomplish this goal is to acquire the properties described in the income strategy approach but use more leverage to achieve a higher total return. An alternative means of executing a blended strategy is to buy growth-oriented properties with low levels of debt.

In practice, many non-traded REITs present investment plans that purport to follow a blended strategy although one goal may be identified as more key than the other.

Assessing REIT Strategy

A financial advisor should review a non-traded REIT's recent and historical acquisitions to determine the strategy the REIT is actually employing. He or she should be aware that all real estate investment managers may find themselves drifting from one strategy towards another over time if the market cycle evolves to a new phase and opportunities present themselves.

If adhering to one strategy is important to the suitability of the non-traded REIT investment for a particular investor, an advisor should review the prospectus's investment plan very carefully to see what limitations or goals have been set. A financial advisor can also limit an investor's risk by recommending a diversified portfolio of non-traded REITs that employ differing strategies.

It is worth noting that allowing the non-traded REIT's manager to have some flexibility in pursuing the best properties regardless of strategy may produce the highest returns at the lowest risk.

V. Basic REIT Accounting

A significant part of conducting due diligence on a non-traded REIT investment involves analyzing its financial health and performance. Since non-traded REITs, by definition, do not trade on public markets and newer NAV reporting standards are not yet common or standardized, a financial advisor and investor must rely on examining the financial statements of a non-traded REIT during the capital raising phase to determine, in part, whether it is appropriate to invest in the fund.

The reports that a REIT makes to its shareholders provide guidance on its financial health. In general, these reports focus on items that are part of the regular, periodic filings the REIT makes to the SEC, including quarterly Form 10-Q and the annual Form 10-K. The Management Discussion &

Analysis (MD&A) section, the detailed financial statements, and all supplemental data can be particularly revealing. Careful reading of footnotes is also important as many topics are not addressed in a standardized way across REITs, and the footnotes will often give the detailed explanation needed to understand how to best interpret the numbers.

Balance Sheets

When looking at balance sheet entries, it is important to compare data on a year- over-year or quarter-over-quarter basis to assess whether a REIT's financial condition is improving or worsening. It can be difficult to define the guidelines or criteria that qualify as "good" or "bad" performance, but common sense is often sufficient to get an understanding of the REIT's health.

In general, rising levels of assets with stable ratios of debt are desirable. Conversely, falling levels of assets, particularly of cash, with rising ratios of debt may signal impending financial trouble.

Whenever a significant departure from prior results—either up or down— can be observed in any financial statement, it has likely been explained, or should have been explained, in the footnotes or MD&A. A prudent financial advisor or investor should weigh the reasonableness of the explanation against his or her own level of common sense and any outside expert analyses and opinions that are available.

Total Assets and Liabilities

Total assets and total liabilities are among the key balance sheet items a financial advisor and investor should review.

Total assets are the sum of the value of real estate assets and/or investments along with cash and other securities or miscellaneous assets that the REIT holds. In the capital raising phase, REITs are likely to exhibit growing levels of assets simply because of proceeds from shares that are being sold. A steady or slightly rising ratio of cash to total assets over time is normally a positive signal of good management. Levels of cash, especially relative to levels of debt, should be sufficient to cover shortfalls from potential market downturns or unexpected capital expenditures.

Total liabilities are the sum of short-term liabilities, long-term debt, and certain other accounting entries. A healthy, stable REIT is likely to exhibit a steady, reasonable ratio of total assets to total liabilities. In contrast, a REIT experiencing financial difficulty may exhibit a growing ratio of debt to total assets if cash is being depleted to service high levels of debt and other obligations.

A non-traded REIT will typically outline a target and/or maximum level of debt it believes acceptable and prudent. A debt level that exceeds preset maximum levels should be a warning sign.

Income Statement

Total revenue, total expenses, and net income are among the important pieces of information included in an income statement. These are sometimes described as operations items.

Revenue and Expenses

Total revenue is usually the sum of rental and other revenues, such as interest received on mortgages held. As with total assets, total revenue will likely rise year-over-year or quarter-over-quarter during the capital raising phase of a non-traded REIT simply due to the increased number of properties held.

Total expenses are generally the sum of:

- Property operating expenses, such as property tax, insurance, and maintenance
- General and administrative expenses, including costs attributable to the headquarters and senior management but not directly to the property portfolio
- Interest expense, which is the cost to service the interest portion of debt outstanding although it should be noted that any required principal payments are typically not deducted here
- Generic or miscellaneous expenses that do not directly fall into the other categories

Same-store revenue growth and same-store property operating expenses are measures sometimes used to analyze a REIT's operating performance and manager skill. Same-store revenue growth refers to the growth in revenues from the portion of the portfolio that was acquired in the prior accounting period and held through the entire current accounting period.

During early-stage capital raising, when a REIT may not have much in the way of same-store financials, it is good to determine if the existing portfolio is improving or declining each year or quarter. This can be a good indication of the REIT's asset selection and management abilities. Revenue growth may be discussed in the MD&A or other sections of a financial report if it is not directly identified in the selected financial data.

Net Operating Income

Net operating income (NOI), which is calculated by subtracting property operating expenses plus general and administrative expenses from revenue, ideally should cover interest expenses and required principal payments with a solid safety margin to prevent the REIT from becoming unprofitable during a potential downturn in operations.

Publicly registered REITs, whether traded or non-traded, are required to comply with Generally Accepted Accounting Principles (GAAP) when filing financial statements with the SEC. Unfortunately, GAAP's standard measure of profitability, net income, is potentially misleading and not considered accurate when assessing REIT operating results.

The primary issue is that the depreciation deduction, which real estate investors receive, makes interpretation of net income difficult for REITs and other real estate entities. Depreciation is a non-cash expense item, determined by congressionally authorized tax formulas, that does not necessarily reflect the actual financial performance of most real estate investments. In practice, the final value of the real estate is determined by market forces and historically is more prone to appreciate than depreciate. It is also important to note that the depreciation deduction is potentially subject to a recapture tax following final disposition of the property.

Nonetheless, it is worthwhile to look at items that have been deducted from revenue to arrive at net income. REITs will often take special write-downs or mark-ups for items described as "one-time" or "extraordinary." While it may be that such items are "non-recurring" as stated, they may, in fact, impact the financial health of the REIT and may be evidence of the true level of manager skill. It is important to read the footnotes and MD&A to assess the meaning of any such items.

Unique REIT Accounting Metrics

To correct for the shortcomings in net income according to GAAP, the REIT industry, both traded and non-traded, has created special measures of profitability that are used to assess the health and performance of a REIT, set appropriate distribution levels, and otherwise benchmark REITs against one another.

The three most common measures are funds from operations (FFO), modified funds from operations (MFFO), and funds available for distribution (FAD), which is sometimes referred to as adjusted funds from operations (AFFO) or simply net cash flow from operations.

The definition of FAD highlights the fundamental issue with these unique REIT accounting metrics: They are generally not standardized across firms and are often reported in different ways that could possibly lead to different interpretations. Financial advisors and investors need to read the individual non-traded REIT's description of each item it reports carefully to understand its meaning and thus how to interpret the REIT's overall level of health and performance.

Funds From Operations (FFO)

The National Association of Real Estate Investment Trusts (NAREIT) has defined FFO as GAAP net income deducting any gains or losses from sales of assets and adding back depreciation and amortization of non-cash items. Since FFO is commonly used to discuss a REIT's health, it is often expressed on a per share basis—total FFO divided by number of shares outstanding—to make it easier for shareholders to understand.

FFO presents a more accurate measure of the profitability and health of the REIT than traditional GAAP net income. Growth of FFO is often measured year-over-year or quarter-over-quarter to define trends in the REIT's performance. In general, positive growth in FFO is a good measure of REIT health.

Modified Funds From Operations (MFFO)

Many but not all non-traded REITs present MFFO to attempt to improve upon FFO in measuring the health of ongoing operations of the REIT. MFFO is calculated by adding back acquisition-related costs, impairments, and other items deemed one-time or extraordinary to create a more accurate picture of the operational health of the REIT going forward.

Unfortunately, MFFO is even less standardized than FFO and requires close examination to be understood. MFFO can potentially overstate the performance of the REIT as acquisition costs and even certain one-time items do impact shareholder wealth. Thus this measure should be used carefully and in conjunction with other measures of health and profitability.

Funds Available for Distribution (FAD)

FAD, like MFFO, lacks a clear definition across firms and analysts. In fact, not all REITs report FAD directly, but it can be computed from information that is always readily available. FAD begins with FFO and then deducts for recurring capital expenditures and principal payments on debt to create a measure of the amount of cash the REIT could actually have paid out to investors in the form of cash distributions. This number is useful in assessing a REIT's ability to maintain a current or planned distribution yield.

At times, a REIT may distribute more cash than was earned from operations, according to measures such as FAD, by distributing cash from liquid reserves or cash flows from investing and financing activities. In the short run, this may not adversely impact the long-term health of the REIT, but it is certainly not advisable for protracted periods of time.

When a REIT pays out more than FAD or a similar measure of cash flow, it is said to be over-distributing. This is, in effect, a diversion of cash that could have been used to acquire property, establish liquid reserves, or retire debt, and so forth. Instead, the cash was returned to shareholders, usually to maintain a steady, fixed distribution yield. In the long run, such actions do not maximize shareholder value. In fact, this practice could signal that the REIT may need to reduce distributions in the future. Advisors should exercise caution before making an investment recommendation regarding any REIT, traded or non-traded, that is perpetually issuing cash distributions in excess of cash flow from operations.

VI. Taxation of REIT-Status Firms

Real estate investment trusts (REITs) were created by the 1960 REIT Act, which provided a special taxation category, deemed REIT status, that grants qualified firms an exemption from corporate income taxes if they satisfy the requirements for being a REIT.

The intent of the law was to allow retail investors access to the real estate market without having to make large investments in private partnerships. The exemption meant distributions of profits were not subject to double taxation, as is the case with dividends paid by many traditional corporations. Most non-traded REITs intend to, and do, qualify for REIT status and so provide tax benefits to their investors.

Maintaining REIT Status

A REIT must meet four tests to maintain its special status and qualify for an exemption from federal corporate income taxes: ownership, asset, income, and distribution.

1. Ownership Test

A REIT cannot be a closely held entity. Specifically, this means that five or fewer shareholders cannot own more than 50% of the REIT's stock. Further, the REIT must have a minimum of 100 shareholders. Since institutions such as pension funds or mutual funds no longer count as a single owner, few REITs have a problem meeting this test.

2. Asset Test

A REIT must invest at least 75% of its total assets in real property, real property related assets such as mortgages, cash, and/or federal government securities. Additionally, 75% of a REIT's annual gross income must be derived from these sources. This requirement is generally not a major issue for most REITs. However, some REITs have found themselves owning related non-real estate businesses, a situation that may require special tax structuring to avoid tax issues for the entire REIT.

3. Income Test

Complying with the income test creates the most potential issues for many REITs. A REIT must earn its income from passive investment activities, such as collecting rent on property in its portfolio or interest on mortgages it holds. Active income, from activities such as selling property as inventory, as a dealer or builder does, and service-related income are not eligible for the tax shield and can be treated as 100% corporate taxable income. In practice, the prohibition on active income means that a REIT is precluded from trading or flipping property and thus makes purchases as a long-term investor.

REITs often find themselves with business units that generate corporate taxable income and often employ a strategy of creating a taxable REIT subsidiary (TRS). The TRS pays corporate taxes and passes earnings back to the parent REIT for distribution to shareholders without jeopardizing the overall REIT's tax status.

4. Distribution Test

A REIT must distribute at least 90% of its taxable net income in the form of dividends to its shareholders to maintain REIT status. While this may sound extremely limiting for building cash reserves or making capital investments in existing assets, it is not generally a binding constraint in practice.

In fact, REITs routinely pay out distributions well in excess of 100% of net income. This is possible because depreciation is deducted from earnings when calculating taxable net income in keeping with GAAP. In reality, depreciation is a non-cash expense and thus actual cash flow is much higher than taxable net income.

Taxation at the Investor Level

Because firms that meet the REIT status tests are not taxed at the corporate level, REIT dividends are non-qualified. This means that REIT shareholders pay tax on the distributions they receive at their marginal personal income tax rate rather than at the lower tax rate that applies to qualified dividends, which are subject to corporate taxation. In terms of total tax due, an individual taxed at his or her marginal rate pays less than the combined total tax paid by a non-REIT corporation and the investor who receives that corporation's qualified dividends.

However, this is not the complete picture of how REIT distributions are treated from a tax standpoint. The tax consequences depend on which of three possible ways the particular distribution is classified, which may be as dividends, capital gains, or return of capital.

Distribution Categories

A REIT designates which type of distribution is being paid and reports this information to shareholders annually on IRS Form 1099-DIV. The way a distribution is designated determines how it is taxed.

1. Dividends

Dividends are payouts of cash flow from operations and, as they are generally non-qualified, are taxed at the investor's marginal tax rate if the REIT is held in a taxable account.

2. Capital Gains

When a REIT sells properties in its portfolio and realizes capital gains on the assets, these gains (or losses) are also passed directly to the REIT shareholders and can be classified as either short-term or long-term gains (losses) according to IRS rules. Investors pay the respective capital gains tax rate on these distributions, where the rate on long-term gains is always lower than an investor's marginal tax rate paid on short-term capital gains. High-income taxpayers may be subject to an additional tax surcharge.

3. Return of Capital

Return of capital distributions are technically nontaxable at the time of payout but do reduce the investor's cost basis and thus will eventually be taxed as capital gains when the investor sells his or her shares or the REIT liquidates.

In practice, these distributions can arise from the tax shield provided by property depreciation or capital transactions, such as refinancing loans on property. The net result is often that investors pay a lower overall tax rate for returns on investments in REITs than other types of equity investments. This assists REITs in being higher yield investments.

Given the unique tax structure of REITs, an investor should discuss REIT investments with a qualified tax professional to determine an optimal tax strategy.

VII. Risks and Suitability of Non-Traded REITs

Non-traded REITs are unique investments that offer many potential benefits to individual investors, including the potential for high current yields, the potential for high total returns, and access to experienced real estate investment managers. In addition, non-traded REITs act as an asset with low correlation to other traditional asset classes. This has the potential to enhance overall portfolio return while reducing risks.

However, non-traded REITs also have unique features that may make them unsuitable for some individual investors. The primary risk, which is characteristic of non-traded REITs and other direct participation investments, is illiquidity. A related risk, derived from their illiquid nature, is that non-traded REITs are bound by law to execute an exit strategy to return invested capital and potential capital appreciation to shareholders. The timing and implementation of such exit strategies create unique risks.

Other risks that are common to non-traded REITs, traded REITs, and every other type of equity investment include market cycle risks, leverage risks, and manager/advisor skill risks. It is essential to understand the risks associated with non-traded REITs, the situations in which non-traded REITs may be unsuitable investments, and the ways to mitigate and reduce portfolio risks when using non-traded REITs.

Illiquidity Risks

The primary reason an investment in non-traded REITs may be unsuitable is the lack of secondary market liquidity. In essence, an investor should expect his or her initial investment to be unavailable for a period of up to seven to ten years following share purchase—or longer if allowed by the REIT's registration and organizational documents.

Many non-traded REITs do offer limited share redemption programs, but they are not a substitute for a liquid secondary market, such as a public stock exchange. Redemptions are often quite costly in the sense that redemption price is always a discount from the price the investor paid. Almost all early redemption programs can be suspended if market conditions dictate. Furthermore, all redemption programs are limited in the aggregate number of shares that can be redeemed within a stated time frame. While a share redemption program for a non-traded REIT is no doubt a desirable feature, an investor cannot be assured that share redemption will actually be an option if he or she needs liquidity.

In contrast, traded equities, including traded REITs, are generally saleable if the public market on which they are listed is open. However, the risk, in that case, is that the market price per share at the time of the sale is not guaranteed and could be substantially less than the price the investor paid for shares. If there is a market panic or other extreme volatility, limited demand in the face of excess supply typically drives prices down sharply.

Evaluating Suitability

The lack of the public secondary market requires that non-traded REIT investors be suited to hold such illiquid assets. The following guidelines can help a financial advisor determine if investing in non-traded REITs is suitable for a particular investor. For this to be the case, an investor should have:

- Sufficient liquid net worth to more than cover foreseeable and some unforeseeable liquidity needs for the holding period of the REIT after making the allocation to this and other direct investments
- A level of income high enough that the investor is not likely to need the investment principal during the holding period of the non-traded REIT
- A total portfolio that is well diversified across asset types and sectors to decrease overall liquidity risk if part of the portfolio does need to be liquidated to fulfill an extraordinary cash need
- Sufficient cash reserves so that, if the investor sustains loss of income from employment or other unexpected liquidity needs, he or she can cover the shortfall without needing to sell any investment assets for a short period of time

Assuming the investor has met the criteria for investing in illiquid securities, such as non-traded REITs, the following portfolio management recommendations are designed to help mitigate his or her illiquidity risk:

- Limit total allocation to illiquid investments to a reasonable percentage that does not render the portfolio largely illiquid, prevent the investor from making reallocation decisions, or limit him or her from taking advantage of unique market opportunities in other sectors
- Diversify the non-traded REIT allocation with multiple non-traded REITs, potentially from multiple sponsors, to reduce single issuer event risk
- Make periodic small investments in non-traded REIT funds instead of one-time lump sum transfers since, with most non-traded REITs, the capital raising phase can last several years. This is especially useful for still-employed investors who want to invest current earnings

Market Cycle Risks

The cyclical nature of the real estate market has a major impact on the investment return of non-traded REITs, enhancing it in some phases and depressing it in others. In addition, it is impossible to predict how long each of a cycle's phases will last or in which geographic regions or on which property types it will have the most impact.

Financial advisors should seek to recommend non-traded REITs whose management teams are capable of understanding macro- and micro-level market risk. These teams should have a history of executing tactical strategies to make quality acquisitions in the right markets while also avoiding and/or mitigating cycle risks.

The following recommendations can help mitigate the risk of loss that could result as the consequence of adverse real estate cycle conditions:

- Diversify the allocation to non-traded REITs across multiple REITs that invest in different property types, use different investment strategies, or do both
- Focus on non-traded REITs with income derived from long-term leases. This strategy is least likely to be adversely impacted by the real estate cycle, but may reduce return in exchange for reduced risk
- Carefully examine each REIT's statements about current market conditions and future expectations against common sense and other expert reports

Leverage Risks

Because income-producing real estate is generally stable and predictable, attractive debt financing is often available to real estate investors to enhance returns. Using leverage allows each dollar of equity to acquire more property and thus provide a higher total return if the property appreciates. Further, if the property yields a higher rate of current return than the cost of the debt, the current yield can also be magnified. This is positive leverage.

Of course, if the property falls in value, the property's cash flow declines, or both, the leverage can be negative and the returns less than if the property had a zero debt load. Worse, leverage can create default situations where equity investors can lose their entire investment if the REIT cannot make payments during a depressed phase of the market cycle or as a result of other exogenous shock.

Mitigating Leverage Risk

In general, non-traded REITs use relatively modest levels of debt and so this type of risk is limited. However, it is important to review the target or maximum debt levels stated in each REIT's prospectus and examine current debt levels carefully to ensure it is not taking imprudent risks.

A financial advisor can use portfolio management to mitigate leverage risks in the following ways:

- Diversify the non-traded REIT allocation of a portfolio across multiple REITs that invest using different leverage strategies
- Invest only in those non-traded REITs that do not use debt or use only low levels relative to other REITs, although this strategy may not produce the desired result if the reason for the reduced use of leverage is that the REIT carries other risks that make debt unduly expensive or unavailable
- Focus on REITs with strong debt coverage ratios, calculated as the number of times cash flow covers debt service payments, and strong current yields, as these REITs will be the relatively least likely to default
- Ensure the non-traded REITs being considered for investment are maintaining sufficient liquid reserves to cover unexpected shortfalls

Manager/Advisor Skill Risk

A financial advisor should review the histories and biographies of the people and firms sponsoring, advising, and managing the REIT to ensure adequate experience and expertise in relation to the specific investment strategy stated in the prospectus. Since the managers and advisors of the non-traded REIT will be making acquisition and disposition decisions as well as overseeing asset management, their level of skill and expertise can either aid in enhancing investor returns or serve to diminish them over time. Risk mitigation, in this case, is achieved primarily by diversifying the non-traded REIT allocation across multiple non-traded REITs from multiple sponsors.

Exit Strategy Risk

To complete a successful non-traded REIT investment, the disposition phase must be executed so that investors receive return of capital and any accrued capital appreciation. This means that, in some form or fashion, the assets of the REIT must be valued and sold whether through listing on a public exchange, a single sale or merger, or the orderly sale of assets.

Unfortunately, executing any exit strategy involves a unique degree of risk that could negatively impact shareholders if the implementation is not successful. The potential risks include the possibilities that the:

- Type of real estate in the non-traded REIT's portfolio is out of favor with other investors, making valuations low and selling difficult
- Capital markets are unstable, making financing unattractive or unavailable for potential purchasers
- Real estate cycle is in contraction or recession, thus negatively impacting portfolio performance and valuation
- Higher than expected transaction costs reduce shareholder wealth during the implementation of the chosen exit strategy
- REIT's board of directors chooses to delay exit, thus lowering total return by a time-value-of-money discount

These risks are hard to predict or measure during the capital raising phase as the disposition phase is still many years away. Only appropriate portfolio diversification techniques, such as allocating across multiple non-traded REITs that invest using different strategies and/or property types, can mitigate them.

Suitability Guidelines

Advisors should review both the suitability standards published in a specific non-traded REIT's prospectus and the goals and investment objectives of the individual investor before making any investment recommendations.

If considering an income-oriented non-traded REIT that is offering or proposing to offer a relatively high distribution yield, the investor should need, or have a use for, such distributions or have a plan for reinvestment, including the potential to reinvest dividends directly in the non-traded REIT through a published dividend reinvestment plan.

If considering a non-traded REIT that is offering or proposing to offer relatively high total returns based on increased relative risk exposure, the investor should be oriented towards equity growth investments and have sufficient time before needing the investment capital to sustain the increased risk of loss of principal.

VIII. Comparing Non-Traded and Traded REITs

From a legal and operations standpoint, there is little that separates non-traded and traded REITs. From an investment perspective, however, they can be quite different, well beyond the obvious distinction that one type is publicly traded and the other is not. In fact, although being publicly traded on secondary markets means that traded REITs have far less liquidity risk than non-traded REITs, they have several characteristics that may make them less—or more—desirable for specific investors or at particular times.

Defining Characteristics of Traded REITs

Greater price volatility, lower distribution yields, and fluctuating price in relation to NAV differentiate traded REITs from non-traded REITs. That is, traded REITs have characteristics of both real estate investments and general equities investments while non-traded REITs are more analogous to a direct investment in real estate.

1. Equity Market Volatility

As a result of being traded on a public market, such as the New York Stock Exchange (NYSE) or the NASDAQ Stock Market (NASDAQ), traded REITs have historically tended to exhibit much of the price volatility observed in the broader equity markets. Depending on the time period, listed equity REITs can have correlations with the broad stock market indices as high as 0.8 and they have tended to approach 1 in down or crisis markets. Thus, traded REITs may perform more like a sector allocation than a true asset allocation to real estate in some periods.

2. Distribution Yields

The distribution yields paid by traded REITs vary with not only the health and stability of the REIT itself, but also its ever-moving stock price. Historically, traded REIT yields have averaged several percentage points lower than non-traded REITs, but this relationship is highly volatile due to the movement in traded REIT pricing. In contrast, stability of distributions and relatively high yields are common with non-traded REITs.

3. Premium/Discount to Net Asset Value

One of the unique features of traded REITs is the likelihood that their market prices are at either a premium or a discount to NAV. This means that investors will overpay or underpay for shares of REIT stock in relation to the value of the underlying asset portfolio.

Modern portfolio theory suggests that the public market in aggregate is efficient at determining the appropriate prices for assets given all publicly available information. However, it is not rational to believe that the value of the real estate underlying a traded REIT changes as frequently or is as unstable as its price volatility implies. What is more likely being reflected on a day-by-day basis is determined jointly by underlying portfolio values and capital market demand for REIT investments.

Investor Suitability Concerns

The illiquidity of non-traded REITs may make them unsuitable investments for many individual investors, especially those who have small portfolios, have taken on excess risk, or need access to their investment capital. For these investors, traded REITs may, in fact, be a suitable option for gaining exposure to investment real estate.

However, for investors who have significant equity market exposure already, overweighting traded equity REITs may not provide the risk-reducing diversification benefits they are seeking. If illiquid investments are suitable for these investors, then non-traded REITs may be an appropriate option.

Comparison of Fees/Costs

The two types of REITs are also differentiated by the upfront fees investors pay and those they pay on an on-going basis while they hold the shares.

With a traded REIT, the upfront costs, in addition to the share price, are the commission paid to the brokerage firm through which the purchase was made. The commission varies from firm to firm, but could be as high as 5.5% if the investor purchases a front-end load REIT mutual fund. If the REIT is held in a managed account or the investor has purchased a REIT mutual fund, annual asset-based fees apply and are subtracted before investment return is reported. For example, mutual fund expense ratios vary from sponsor to sponsor and may range between 1% and 2%, though some are lower. Sales of REIT shares or shares of a REIT mutual fund may also incur a commission or sales charge.

With a non-traded REIT, the upfront fees, typically 12% to 15% of the purchase price, include sales commissions. Acquisition, asset management, disposition, and incentive fees may apply during the REIT's term of up to seven to ten years.

Financial advisors should consider the impact of fees and other expenses on their investors' returns when considering alternative options and making investment recommendations for their real estate allocations. FINRA is presently looking at the topic of fees, and changes may be coming to the non-traded REIT industry. This requires financial professionals to stay abreast of any major announcements or rule changes from FINRA or the SEC.

Comparison Summary

Some REITs are publicly traded and others are non-traded, though both are regulated by the SEC and file quarterly and annual reports with the agency. The chart below summarizes some important similarities between the two varieties and also major differences.

	Traded REITS	Non-Traded REITS
Investment Objective	Current income and share price appreciation	Current income and eventual capital appreciation
Liquidity	May be bought and sold at any time. Either listed on an exchange or traded over-the-counter (OTC)	Investors should plan to hold through planned exit event
Volatility	Daily share price volatility based on supply and demand	No daily share price volatility until re-pricing 18 months after close of offering period, when underlying value of real estate holdings may fluctuate up or down
Investors	Available to any person or entity with a brokerage account	Available only to qualified investors through a professional financial advisor
Fees	Trading commissions at purchase; annual asset-based management fees	Front-end fees of 12% to 15% of investment; acquisition, asset management, disposition, and incentive fees during term