



Alternative Investment Analyst Review

WHAT A CAIA MEMBER SHOULD KNOW

The Case for Investing in Non-Traded REITs

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1. Introduction

Non-traded REITs (NTRs), like their publicly traded counterparts, make investments in income-producing commercial real estate. They typically hold multiple properties in a single portfolio and are ordinarily categorized by the types of properties they own, such as retail, industrial, multifamily, office, and storage, among others. Certain of these REITs structure their underlying investments as net leases in which the tenant is responsible for bearing real estate costs directly, such as property taxes, insurance, operating expenses, and capital items, in addition to rent and utility payments. By distributing essentially 100% of all rent payments received by tenants, these REITs provide a durable stream of monthly income to their investors and also offer the potential for long-term capital appreciation through property value growth.

The term private REIT commonly attached to NTRs is a misnomer, as these REITs are publicly registered and are thus subject to many of the same public reporting, tax qualification, SEC regulation, and governance requirements that an exchange-traded public REIT must meet. Unlike traded public REITs, these vehicles are not susceptible to exchange-traded supply and demand-driven price volatility. Rather, price discovery happens through periodic valuations, much as in private equity real estate investing. NTRs generally provide little or no interim liquidity and usually have a five to seven-year lifespan. However, unlike public REITs, NTRs are only available to investors that meet established net worth and income standards. With interest rates at rock-bottom levels, safe yet high-yielding assets remain scarce. Investing in NTR offers these advantages:

- Potential for superior risk-adjusted returns.
- Higher dividends than traded REITs.
- Avoiding the potential inflated valuations in the traded REIT sector.
- Illiquidity premium that can be captured by the long-term investor.
- Ability to raise and invest capital at opportune times in the market cycle.
- Valuations that are not subject to public market volatility.

NTRs have started to attract considerable investor interest. We estimate that around 70 NTRs have raised and invested \$80 billion to \$90 billion in equity during the past decade, with about \$10 billion raised and de-

ployed annually in recent years. The industry is heavily concentrated, with the top 10 NTRs controlling a dominant share.

2. Determining Value

Publicly-held companies typically trade at a multiple of price to earnings (or in the case of REITs, price to funds from operations). Unlike traded REITs, where value is tied to the price at which shares trade on an exchange and is often influenced by emotions (such as fear and greed) that drive public markets, shareholders of NTRs see value equal to the cost of the asset at the time of purchase. Thereafter, the property is subsequently re-valued according to conventional real estate valuation methodologies, including comparable sales analysis, discounted cash flow analysis and replacement cost analysis. Moreover, NTRs are largely insulated from broader exchange-traded fluctuations as their net asset value, not market sentiment, drives pricing.

Exchange-listed REITs commonly trade at modest premiums to NAV (largely due to the liquidity they offer); the mean premium since 1990 has been around 3%. However, there are periods when public markets are grossly overvalued and this premium may rise to double digits. Mean reversion is a generally consistent force within financial markets (albeit difficult to time). Therefore, overvalued traded REIT prices eventually revert to the historic lower mean.

3. Risk-Adjusted Returns

Traded public REITs are subject to market risk through trading volatility. NTRs may not be subject to the same risk. Prices of traded REITs may change in reaction to changes in equity markets, not because of their fundamental exposures to systematic equity risk, but because of the buying and selling pressures resulting from broad portfolio adjustments by managers. To the degree that correlations between prices of traded REITs and broad equity markets do not reflect the systematic risk of this asset class, the required return on NTRs should contain a lower equity risk premium, which will make NTRs more attractive. The historic equity risk premium over long periods of time is around 4%. This suggests that someone investing in publicly-traded REITs ought to expect 4% greater returns for doing exactly the same thing in NTRs. Thus, assuming rational investors should demand higher returns from investing in securities with higher risk, to match a 6% return on a NTR a traded public REIT must have a return of 10% (6%

plus 4% market risk premium). This suggests that given the exact same underlying investment (in property or in any other asset), the expected return for holding it in a publicly-traded structure as opposed to a non-traded structure ought to be at least 4% higher.

Of course, the illiquidity of the NTRs is a double-edged sword. While this may lead to a reduction in the equity premium demanded by investors for investing in NTRs, it could lead them to demand a higher expected return in order to compensate them for NTRs' lack of liquidity. As discussed below, not all investors are equally averse to illiquidity, and, therefore, they may demand different premiums for investing in illiquid assets.

4. Liquidity Preferences Differ

Liquidity is measured by the ability to convert a security quickly into cash without any price discount. Traded REITs provide liquidity by virtue of trading on public stock exchanges. Again, NTRs are not traded on exchanges. Instead, limited liquidity for some NTRs is available through interim redemption programs such as tender offers with a full cycle liquidity exit event projected or attempted within five to seven years of program inception.

Liquidity preferences differ based on the investor's expected holding period. For the short-term speculator, the liquidity afforded by traded REITs is essential. However, for the long-term investor interested in unlocking

the long-term illiquidity premium following a buy-and-hold strategy, the liquidity offered by a traded REIT is of little benefit, for they arguably have no need for it. Moreover, liquidity can exaggerate losses for publicly traded REIT investors. For example, if enough investors flee a traded public REIT, the share price can drop below the value of the underlying real estate. The loss floor on a NTR investment by contrast is moderated by the inability of investors to panic sell their securities. This suggests long-term investors, for the reasons outlined above, may derive unique benefits from owning real estate in NTR formats rather than in traded REIT structures. Though long-term investors may demand a relatively small premium for the illiquidity of NTRs, these investments will need to offer a premium to compensate the long-term investors for illiquidity risk.

5. Capital-Raising Cycle

Traded REITs are subject to market movements and market volatility in their ability to raise capital. Generally, traded REITs have difficulty attracting capital when the real estate sector is out of favor (i.e., prices are low) or when there is a general perception of greater opportunities available elsewhere. They have typically raised and invested capital when real estate markets were in favor and capital markets activity buoyant—a time when property prices are also generally at their highest. NTRs, by comparison, cater to long-term investors who are usually agnostic to cyclical activity of capital markets and are seeking superior risk-adjusted yields with low

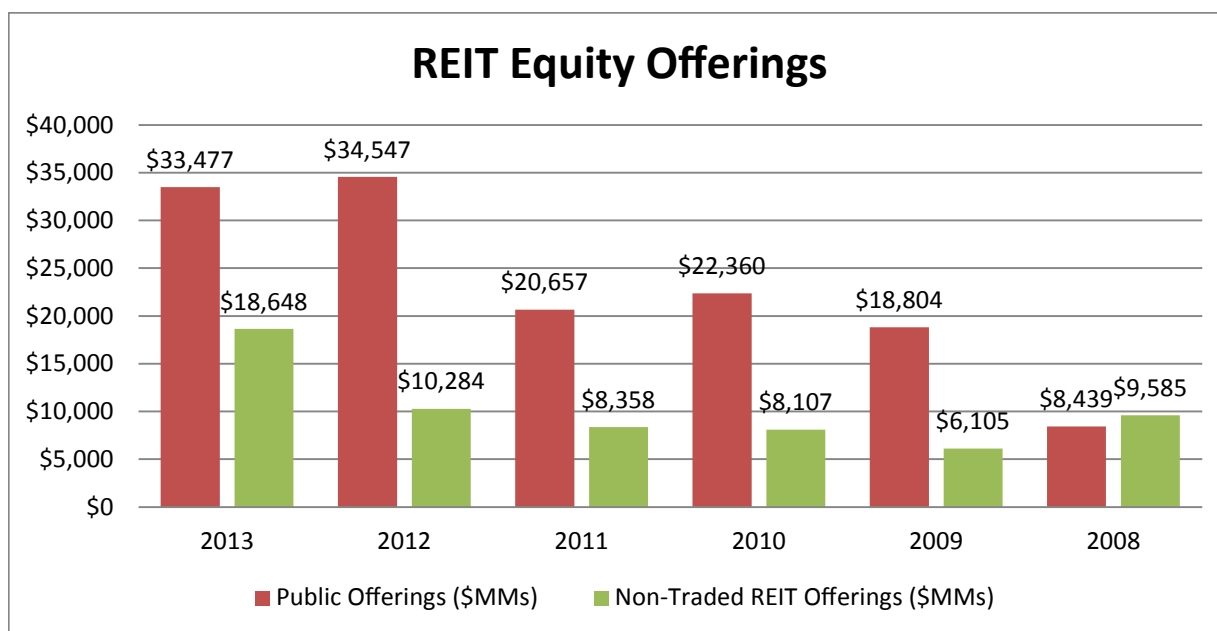


Exhibit 1 REIT Equity Offerings Source: SNL Financial

traded market correlations. This suggests traded REITs, unlike NTRs, are generally unable to raise and invest capital at times when it is most opportune to do so.

6. Managing for the Long-Term

Traded REITs must contend with the demands of analysts and speculative investors. The pressure to meet and beat analysts' forecasts, where missing earnings expectations may lead to significant stock price declines, often prompts management to focus on short-term quarterly earnings. Consequently, resources better spent on developing, acquiring, and managing properties are employed to manage earnings and meet short-term market expectations. By contrast, and to the betterment of the portfolio, NTR managers are afforded the advantage of concentrating on longer-term real estate investing opportunities because their investors share a common long-term return objective. In short, traded REITs must contend with the pressures for quarterly performance inherent within the exchange-traded market. Yet such quarterly measurement is often a mismatch with the investment characteristics of real estate as an asset class. The absence of this pressure in the private markets suggests managers of NTRs are typically more readily able to focus long term on real estate investment and meeting investors' long-term investment objectives, rather than managing quarterly earnings expectations.

7. Conclusion

NTRs typically invest in sector-specific real estate programs, targeting stable, fully occupied properties subject to long-term leases to strong credit tenants. They are thus able to generate immediate, durable, rent-driven cash flows from the inception of the investment as capital is deployed without a cash drag. Much like traditional private equity core real estate investing, they aggregate property through acquisitions and build diversified portfolios by tenant, geography, industry, and lease duration. They return value from these aggregated portfolios via asset sales, public listings, or mergers, usually over a five to seven-year timeframe. In the current environment, they afford a way to make more tactical investing calls because they allow investors to profit from the current historic high spread between low cost financing and high acquisition cap rates.

NTRs may hold a number of investment advantages over their publicly traded counterparts: notably, a valuation of shares reflecting the intrinsic underlying value of owned real estate, favorable risk-adjusted returns, ap-

propriate liquidity characteristics for long-term investors, superior capital-raising and deployment dynamics, and a heightened management focus on maximizing long-term investment opportunities.

Endnotes

Of course, some of the factors that affect public markets could eventually affect the net asset values of NTRs. For evidence on the size of illiquidity premium see Khandani and Lo (2009), "Illiquidity Premia in Asset Returns: An Empirical Analysis of Hedge Funds, Mutual Funds and U.S. Equity Portfolios," <http://web.mit.edu/Alo/www/Papers/liquidity4.pdf>

Author Bio

Sameer Jain has executive management cross-functional responsibilities at American Realty Capital, including heading risk management, firm strategy, and direction development, as well as alternative investments. He has 18 years of investing experience, where his responsibilities have included the formulation of investment strategy, the development of risk management practices and asset allocation models, creating thought leadership, and the assessment and engagement of real estate, private equity, and hedge fund managers. Prior to joining American Realty Capital Mr. Jain headed Investment Content & Strategy at UBS Alternative Investments, where he was also responsible for all illiquid investing across the platform. Prior to UBS he was at Citi Capital Advisors, Cambridge Alternative Investments, and SunGard System Access. He has written many academic and practitioner articles on alternative investments, many of which are available in the public domain at ssrn.com. Mr. Jain is a graduate of Massachusetts Institute of Technology and Harvard University.



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