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Explosive Growth for Still-To-Be-'Stress-Tested' Untraded REITs

[By Lisa Harbatkin]

For the past few years, untraded REITs, publicly-traded and true private REITs have been competing with pension funds, international capital and entrepreneurial money for the same properties. Does the market need yet another investment vehicle funneling capital into real estate?

Untraded REITs raise other areas of concern, such as whether or not they are overpaying for properties and driving up values; what the sector's impact is likely to be, now and going forward; and whether or not their lack of liquidity and high upfront fees may ultimately prove harmful to less experienced, small investors.

(Note: widely referred to as private REITs, these vehicles should more accurately be called non-traded, untraded, or unlisted [see box, below]. These terms will be used interchangeably in this article.)

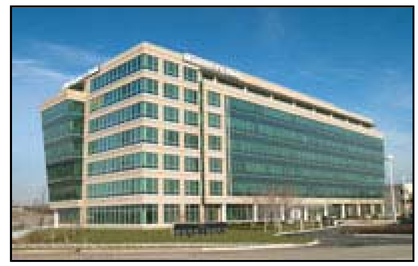
Unlisted REITs raised $1.3 billion in 2001 and have grown explosively since then, raising $7 billion in capital in 2003, reports Robert A. Stanger & Co., which tracks direct investment securities markets for the Investment Program Association (IPA), an industry group. That rapid growth reflects a shift as investors looked to diversify after 2001.

Untraded REITs have been around for about 10 years, but have more than doubled the value of their acquisitions in two years, according to Real Capital Analytics senior associate **Dan Fasulo**. By contrast, traded REITs acquired just over $35 billion in assets in 2004, about four times the acquisitions made by untraded REITs at just over $8 billion, Fasulo said. Both are requiring essentially the same rate of return, with 2004 cap rates of 7.7 percent for traded REITs and 7.6 percent for untraded REITs.

Untraded REIT players point out that their main difference from publicly-traded REITs is simply that they're not listed.

All are publicly registered, said **Larry Goff**, executive vice president for accounts at CNL Capital Markets and chairman of the IPA. "The intention is to move to a listing at a later date," Goff said. "List or liquidate" dates impose a certain discipline, commented **Donald A. Miller**, chief real estate officer for Wells Real Estate Funds. At least one untraded REIT, from Inland, has made the transition to the stock market, and there are indications that a few others may be preparing to do so.

Impact on Real Estate Markets



Following the high-tech crash, "investors became more interested in real estate and untraded REITs have provided a way to channel this money," said NAIOP Distinguished Fellow **Steven Ott**, John Crosland, Sr., Distinguished Professor of Real Estate and Development at the University of North Carolina, Charlotte. "There's capital in the marketplace looking for investments and the untraded REIT has been able to perform," said **Brian Brennan**, director of real estate acquisitions at Allianz of America.

"It's a great sign that there's more competition for real estate as part of a balanced, mixed-asset portfolio," commented **Doug Herzbrun**, senior managing director at CB Richard Ellis Investors. "It's a sign that real estate has become a respected investment."

The increased competition among capital sources "has been driving relative returns down and values and prices up," Herzbrun said. "Interest rates going up will drive cap rates up. But improving market fundamentals will lessen the impact of higher cap rates so there won't be a devastating effect on property values."

Looking ahead, Stanger managing director **Keith Allaire** noted that "the competitive position of real estate will still be strong. In the short term investors will want to be safe and avoid the risk and volatility of the stock market."

The untraded REIT, Herzbrun said, "is a way of acquiring institutional-quality real estate assets. Specifically, they have the advantage of low volatility because they're not publicly traded."

With their low correlation to other asset classes, untraded REITs deliver "a strong diversification benefit," for investors who want to avoid that volatility, said Miller. "Financial planners see this as a reason to put their clients into the untraded REITs." Given the ever-present chance of the stock market going down, "There's always a place for investments that are non-correlated to the market," Goff said. It's not unreasonable for direct investments, including the untraded REITs, which hold most of the money in these programs, to account for 10 to even 30 percent of an investment portfolio, investment professionals say.

"Real estate is becoming an income product rather than a growth product, and that's probably what it should have been all along," Miller said.

Freedom from Wall Street's scrutiny gives these non-traded REITs the ability "to concentrate on long- term decisions without responding to market gyrations," Herzbrun added. "You're not under pressure to show earnings growth every quarter."

Some industry observers suggest that this gives the unlisted REITs more flexibility in choosing investments. The untraded REITs may also be more likely "to take on lower-profile properties in smaller markets," Ott said.

"Non-traded REITs have bought more frequently in smaller markets than publicly traded REITs," Miller said. "We aren't consistently paying homage to quarterly scrutiny." But untraded REITs could shift that approach as they reposition themselves to go public, he said.

"You can buy with a longer-term horizon," Goff said. "You do have the opportunity to buy good value, but less glamorous assets. You're not as concerned about Wall Street's opinion."

Impact on Investors

Many people drawn to the untraded REITs appear to be approaching retirement and may be changing their investment strategies as they do. "They want income-producing investments, as opposed to taking the risk on growth investments," Allaire said. "The untraded REITs are useful for relatively small investors. This is not a high-roller product."

Average investors in Wells' two untraded REITs are in their late 50s, Miller said, and two-thirds are re-investing their dividends. Wells has $1,000 minimums and no plans to raise those minimums. CNL is increasing its minimums to $5,000. "I don't think clients should be looking at untraded REITs unless they have at least $75,000 to $100,000 in investable assets," Goff said.

"As individuals become more concerned about funding their own retirement in the same way as institutions become more concerned about funding their liabilities, there's clearly a need for income-producing investments with some appreciation potential. Certainly commercial real estate fills that bill," Herzbrun said. "The industry needs more vehicles to allow private individuals to invest in quality commercial and institutional real estate."

The untraded REITs provide that channel. But there are questions about the trade-offs. "Real estate returns are attractive to a broad group of investors, especially in the current time frame," said **Laler DeCosta**, portfolio manager with Invesco Real Estate. "The untraded REITs do give them access. But the question is, what is the optimal vehicle for individual investors?"

Dr. Ott pointed out that "It's easy and expensive to get into a non-traded REIT and often difficult and expensive to get out." Untraded REITs offer returns, tax benefits, diversification advantages, access to management and access to properties, Brennan explained, but that flexibility comes at a price. "There has to be a premium paid for flexibility, and that's liquidity," said Brennan.

By contrast, "the traded REITs' distinctive advantage is liquidity," Brennan said. At the same time, "the public REIT is more tied to the public market and has less ability to diversify."

With either vehicle, of course, if real estate performs badly, people could sustain losses. Is there more chance of that with unlisted REITs?

"Combine overpaying for performance with high upfront fees and that could be a recipe for disaster," Ott said. "What if real estate doesn't meet expectations? High fees will exacerbate poor investment performance in the future. Untraded REITs are such a new phenomenon that we don't have the data to compare their performance with the public sector."

More broadly, as relatively recent investment vehicles, untraded REITs have not yet had to cope with much in the way of market bearishness. "The untraded REIT as an industry has not been stress-tested," Brennan said. "I don't wish for that. I don't want to see an economic downturn. But an enduring business model has to be stress-tested and these REITs have not been."

"Real estate is not always a long-term investment, DeCosta said. "The market changes over time, and it could be an advantage to have liquidity. The non-traded REITs have guaranteed returns, but that guaranteed return is only as good as the financial structure. If it does well, that's good. But if one of the vehicles is not generating its guarantee, you can't get out."

Whatever comfort the investor may get from the guaranteed return, DeCosta added, "may not be there through the entire investment cycle because the performance might not be there."

Vocabulary Malfunction...?

The term "private REIT" has caught on in referring to the investment vehicle discussed in this article. But that confuses two

Lisa Harbatkin is contributing editor of Development.

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