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Investors are seeking refuge in non-traded REITs

But they should check the fine print first

By **Janet Morrissey**
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As shellshocked investors and financial advisers fret over portfolio losses, some are seeking refuge in non-traded real estate investment trusts — entities that offer stable, attractive dividend yields and aren't affected by daily stock market fluctuations.

However, before signing up, investors might be wise to eyeball the fine print and hone up on some of the quirky facets of this investment, ranging from hefty upfront loads to the difficulty of trading in and out of the trusts.

"These are extraordinary times," with massive declines of 35%, 45% and 55% in publicly traded REITs and the broader market, said Frank Muller, president of Hines Real Estate Securities Inc., the dealer-manager for Hines REIT in Houston. Disillusioned investors are now seeking "relative price stability" and attractive dividend yields through non-traded REITs, he said.

Indeed, demand for non-traded REITs is on the upswing. They raised $9.6 billion in 2008 and are expected to mushroom to $20 billion within five years and $40 billion in 10 years, said Kevin Gannon, managing director of Robert A. Stanger & Co. Inc., a real estate investment banking and valuation services firm in Shrewsbury, N.J.

"We think there's about half a trillion dollars of untapped demand in this space," if investors simply allocate 7% of their portfolios to this niche, he said.

Non-traded REITs are companies whose shares are not traded on any major stock exchange. In general, they operate like closed-end funds that buy assets and hold them for a fixed amount of time — typically seven to 10 years. At the end of the term, the REIT either sells off the properties or does an initial public offering to exit the fund and return cash to shareholders. Along the way, investors collect a dividend — typically 6% to 9% annually — and don't have to worry about sell-offs in the broader market slashing the value of their shares.

NOT WITHOUT RISK

Non-traded REITs, however, are not without risk. Any company that borrowed heavily to buy properties at frothy prices during the real estate boom that ended in 2007 could face problems if it has debt rolling over in the next year or two.

For example, a few publicly traded REITs, such as General Growth Properties Inc. of Chicago and ProLogis of Denver, made headlines last year as they frantically struggled with massive debt expirations in the frozen debt markets that threatened their survival.

Non-traded REITs are not immune to this problem. Inland Western Retail Real Estate Trust Inc. in Oak Brook, Ill., has been selling off properties and is even toying with a dividend cut as it faces $1.1 billion in debt coming due this year and another $1.3 billion in 2010.

However, Mr. Gannon noted that non-traded REITs generally use lower leverage and long-term debt when purchasing properties, which lowers their debt risk.

"We don't have any significant maturities until 2012 and beyond," said Byron Carlock Jr., president and chief executive of CNL Lifestyle Properties Inc. in Orlando, Fla. "We sold $15 billion in assets during 2005 through 2007 because the prices justified a sell."

The recession also poses a risk. Rents and occupancy in commercial properties are expected to tumble this year as corporate America lays off workers and cuts back on its real estate space.

This could potentially create leasing and cash-flow problems for REITs. For example, Inland Western faces challenges related to the recent bankruptcy filings of Mervyn's LLC, Linens-N-Things Inc. and Circuit City Stores Inc., which account for 6.7% of its annual base rent.

BUYING OPPORTUNITY

However, this recessionary lemon can be turned into lemonade. After all, a depressed real estate market can be a buying opportunity for non-traded REITs with newly raised cash.

"We are clearly in a buyer's market that we have not seen for more than three decades," said Nicholas Schorsch, chairman and chief executive of American Realty Capital Trust Inc., a non-traded REIT in New York. "But you can only do it if you have capital," he said. "Non-traded REITs are still chugging along, raising $10 billion this year," but many pension funds, sovereign wealth funds and publicly traded REITs don't have excess cash, Mr. Schorsch said.

Gordon DuGan, president and chief executive of New York-based W.P. Carey & Co. LLC, which runs four non-traded REITs, said he's seeing twice as many potential deals come across his desk than he did a year ago.

Still, experts say it's critical that investors check out a non-traded REIT's historical returns, redemption policy, front-end load and other issues before jumping into this sector.

Investors need to look at a REIT's performance, said Mr. DuGan, who noted that his firm has delivered annual average returns of 11.5% on 12 funds it has closed since 1979. They also need to be prepared to hang on to a non-traded REIT for the life of the investment. Trading out early can be difficult and costly.

Most companies offer some form of redemption plan, but such redemptions are often limited to 3% of the shares outstanding each year and often involve hefty penalties of up to 10% of the investor's principal.

"This is a long-term investment," emphasized Mr. Schorsch. "It's not something you're going to get into and out of in the next two to three quarters."

Buying into these entities doesn't come cheap either.

Front-end loads can stretch as high as 15% of a shareholder's initial investment, largely related to fat commissions paid to brokers and financial planners who sell the REIT shares to prospective investors. "It's a higher cost than an [initial public offering]," but fees have been declining over the years, noted Mr. Gannon.

Non-traded REITs are externally managed, with the REIT paying management fees of up to 4.5% of the rent roll to the outside firm.

They are usually owned by senior executives of the non-traded REIT, which can cause potential conflicts of interest between them and shareholders. For example, a spate of bitter shareholder suits against at least three REITs — CNL Hotels and Resorts Inc. of Orlando, Wells Real Estate Investment Trust Inc. of Norcross, Ga. (now called Piedmont Office Realty Trust Inc.) and Inland — left the sector with a black eye.

"I think those are mistakes of the past, not something they're doing presently," Mr. Gannon said. As public companies, non-traded REITs must comply with Securities and Exchange Commission disclosure requirements and usually have a large number of independent board members overseeing decisions, he noted.

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