E-GUIDE

DEMYSTIFYING NON-TRADED REITS

A guide for RIAs to better understand a popular alternative investment vehicle.

April 2021

ALTERNATIVE INVESTMENTS IN GOOD ORDER

Introduction

REITs (Real Estate Investment Trusts) have become a popular investment vehicle due to the potential for diversification, regular income stream, and access to institutional grade real estate investments. But not all REITs are the same. There are three main types of REITs, each of which must be evaluated to ensure they are a worthwhile investment that fits within the investor's desired investment strategy.

In this E-guide, we break down the differences between types of REITs, review important trends, and highlight what financial professionals need to know before recommending REITs to clients.

Understanding the Different Types of REITs

WHAT IS A REIT?

A REIT is a tax-advantaged investment vehicle created in 1960 as part of the Cigar Excise Tax Extension with the purpose of buying and holding real estate. They are able to generate risk adjusted returns primarily through rental income, but also through the appreciation of held real estate assets.

REITs are required to return **90 percent of earnings** to investors in the form of dividends. To qualify as a REIT, the controlling entity must be managed by a board of directors or trustees, have at least 100 shareholders after its first year, have no more than 50 percent of its shares owned by five or fewer individuals, and must derive at least 75 percent of its gross income from real estate related sources.

REITs are not taxed on most of their earnings, as the taxes are paid by investors when they claim dividends as income. However, because 90 percent of income goes straight to investors, REITs often have lower growth rates than other investment vehicles, as they are only allowed 10 percent of their earnings to reinvest in growth.

WHAT IS A NON-TRADED REIT?

While some REITs are traded on public exchanges like NYSE and NASDAQ, non-traded REITs are sold by brokers and advisors. By remaining off of exchanges, non-traded REITs experience lower volatility and are less correlated to the stock market.[1] Because of this, the value of a non-traded REIT is dictated by the valuation of its assets rather than by market sentiment, giving investors a better idea of the true material value of the investment. This also means that managers are able to focus on long-term investment goals without the risk of upsetting investors who may watch for daily price changes in the market.

Unlike many non-listed investments, non-traded REITs are available to the public, with no accreditation limitations. As such, they are still subject to the same SEC reporting and regulations as those listed on exchanges, and should not be confused with fully private REITs, which are exempt from registration with the SEC.

The trade-off comes in liquidity risk. Because of the lack of a secondary market, shares of non-traded REITs are significantly more difficult to sell. Non-traded REITs usually have a five to seven year hold period, whereas publicly listed REITs can more or less be bought and sold at will. While some non-traded REITs have limited redemption programs, many still require a minimum hold period before those programs become available.

Non-traded REITs can give retail investors access to real estate that would otherwise be inaccessible. They have the potential to generate income for investors through the distribution of earnings gained through rent payments. REITs with assets that have fully occupied properties, long-term leases, and reliable tenants may be positioned to generate income through recurring dividend distributions. Long-term investors in REITs with regular payouts can re-invest their dividends, which can potentially help further grow the trust and generate attractive risk-adjusted returns.[2]

PUBLICY-TRADED REITS

Investing in a publicly-traded REIT is done via a similar process to investing in other exchange traded public securities. Shares can be bought and sold on exchanges like NYSE and NASDAQ, making them highly liquid with standard trading fees. Additionally, there is no accreditation requirement which means anyone can invest.

Understanding the Different Types of REITs

Because these REITs are listed on the public market, valuation is determined by the market and changes daily. This also means that publicly-traded REITs are highly correlated with the stock market and are subject to market volatility. As a result, managers of traded REITs may have more of a focus on producing short term earnings rather than long-term growth. The trust must be registered with and is regulated by the SEC. This means they are required to make regular disclosures, including quarterly and annual audited financial reports.

PRIVATE REITS

Unlike those that are publicly-traded and non-traded, private REITs are not required to register with the SEC and are not subject to the same reporting requirements. While they are not regulated by the SEC, private REITs are required to conform to Regulation D.[3] Private REITs are only available to accredited investors, have high investment minimums, and are highly illiquid. Much like non-traded REITs, private REITs are often sold by broker-dealers and may feature high fees. They are not correlated with the stock market, and are valued based on an appraisal of assets. There is usually little-to-no information about private REITs that is made available to the general public, including management strategy, performance, and fee structure, all of which vary from investment to investment.

OTHER CONSIDERATIONS

Advisors need to consider their investors' goals and risk tolerance when deciding if they want to allocate to REITs. As with any investment, there is no guarantee of success, and there are real estate specific risks associated with REITs.

While REITs often make regular distributions, in order to maintain the regularity of distributions REIT managers sometimes subsidize those distributions with debt or even investor principal. Additionally, advisors will want to remind investors that distributions are usually taxed as normal income, rather than capital gains, which may mean a different tax rate applies than usually expected from their investments.

While non-traded and private REITs have a reputation for their ability to produce attractive risk-adjusted returns, advisors need to strongly consider the risks associated with illiquid real estate investments and weigh them against the risks of market correlation and daily price fluctuations that come with publicly traded REITs.

Recent Developments Breathe Life into Non-Traded REITS

After years of decline, the non-traded REIT market is back on the rise thanks to a combination of changes in regulation, product innovation, and stronger alignment of interests between product sponsors, advisors and investors.

According to data from investment banking firm, Robert A. Stanger & Co., non-traded REITs raised 10.8 Billion in 2020. Although this remains lower than the market peak in 2013 when fundraising for the sector reached nearly $20 billion, fundraising at this level exceeded nearly everyone's expectations during the COVID-19 pandemic.

In fact, 2020 fundraising is only 8.5% lower than 2019. By the end of 2020, we saw non-traded REIT sales top $1.1 billion in December and this momentum continued into 2021 with March topping $2 billion. In an article from April 2021, Kevin T. Gannon, Chairman and CEO of Robert A. Stanger & Co., Inc said that he expected fundraising to continue to strengthen and projected non-traded REIT sales to reach $20 billion in 2021, up from his previous projection of $15 billion in February.[4]

Let's review some factors that contributed to the decline in non-traded REIT fundraising beginning in 2013 and then discuss what might be driving a resurgence in the asset class.

At the asset class's peak in 2013, $19.6B flowed into non-traded REITs. By the end of 2016, fundraising in the sector declined by 77% to under $5B. The decline continued in 2017 and only in the last few years have things begun to pick back up.

FACTORS THAT LED TO THE DECLINE

Issues with Fiduciary Rule

The Department of Labor (DOL) Fiduciary Rule introduced in 2015 had initially precluded certain asset classes, including non-traded REITs, from being purchased into retirement accounts.

> *Non-traded REIT sales are projected to reach $20 billion in 2021.*

Brokers have long sold non-traded REITs to retirees as a way for clients to potentially create an income stream. This has been a sought-after benefit in recent years as interest rates hovered near zero. Retirement accounts historically accounted for about 40 percent of sales in the sector.[5]

In the final version of the fiduciary rule, the DOL eliminated its list of asset classes, opening the door for non-traded REITs to be placed in those accounts once again. However, the damage was already done. The uncertainty around the rule led brokers and advisors to seek alternative vehicles into which they could allocate their clients' capital.

High Fees

Non-traded REITs have historically been known to charge high upfront fees intended to cover selling commission and other costs associated with the funds' formation. The sector has struggled to move away from high fees. Throughout the lifecycle of a non-traded REIT, property acquisition fees and asset management fees racked up. Fees of 10 to 15 percent of the gross investment amount were common.[6] In reality, this meant that only 85 to 90 percent of an investor's commitment would be put to work. However, investor statements still reported the REIT value at par before fees. This was referred to as the REIT's Net Investment Amount (NIA), rather than the Net Asset Value (NAV).

CONSIDERATIONS FOR FINANCIAL PROFESSIONALS

After the non-traded REIT market peaked in 2013 at nearly $20 billion, the market entered a steep decline, dropping by $15.5 billion over the following 4 years. In 2018, however, spurred by changes in fee structure and how non-traded REITs were valued, the market posted 9.5% growth over 2017. That minor increase may have been the first indicator of a larger resurgence. 2019 saw the non-traded REIT market grow by an astounding 156%, reaching its highest point since 2014. Although the COVID pandemic played a role in slowing that growth in 2020, momentum seems to be back as a post-COVID economic picture becomes clearer.[7]

While investment bank Robert A. Stanger & Co., is already projecting $20 billion in 2021, the popularity of non-traded REITs may be boosted even further if the market were to stop relying on outdated, manual investment processes, and instead adopt tech-enabled processing. Unlike it's publicly traded counter-parts, which can be subscribed to online with a few clicks of a mouse, non-traded REITs still largely use paper subscription documents mailed or faxed between brokers or advisors, investors, and sponsors. This paper process comes with numerous drawbacks, including costs, security concerns, investor satisfaction and more. Two of the most prevalent concerns are NIGO error rates on documents and prolonged investment cycle-time.

NIGO ERRORS

Paper investment processes are known to be highly error-prone due to complex subscription documents. These documents can be several dozen pages long, and contain sections that may not be relevant to a given investor, leaving it up to brokers and advisors to decipher what information is needed, and what is not. Sometimes the same information is required in several different places. If at any point in the document there is a miscalculation, mismatch of information, omission, or some other type of error, the sponsor will reject the investment as "not-in-good-order" or NIGO and send it back for correction. It is not uncommon when dealing with real estate alternatives to see NIGO error rates over 30%.* This results in more work for financial professionals and can extend the already lengthy cycle-time of the investment.

CYCLE-TIME

Even without a NIGO error, an investment into a non-traded REIT can take as long as 3 weeks from origination to approval. The order entry process alone can take hours. For investors who are used to transacting at the click of a button, this process can seem interminable. Investor frustration can be further exacerbated when, during those 3 weeks, the investment becomes fully subscribed and they miss out on the available equity.

STRAIGHT THROUGH PROCESSING TECHNOLOGY

While non-traded REITs still largely rely on these manual processes, technology platforms are available to streamline the process and address the problems associated with paper. Electronic documents allow financial professionals to avoid costs and delays associated with mailing. Intelligent information collection workflows can help simplify the order entry process by only presenting relevant fields and identifying typos before the information gets mapped to the subscription document. Straight through processing solutions like Altigo has been shown to reduce NIGO rates to 5% or less, saving financial professionals hours of rework. And with straight through processing technology, the entire process can take days instead of weeks, which means investors don't miss out on equity and their money gets put to use more quickly.

Recent Developments Breathe Life into Non-Traded REITS

Transparency of the valuation of underlying real estate
On April 11, 2016, FINRA published Notice 15-02[8], announcing that the SEC approved proposed amendments to NASD Rule 2340 and FINRA Rule 2310 that require general securities members to provide more accurate per share estimated values on customer account statements, shorten the time period before a valuation is determined based on an appraisal, and provide various important disclosures. The resulting transparency surrounding the underlying value of the real estate held in a customer's account shed light on the fee drag associated with high upfront fee structures.

Prior to 15-02, the general industry practice was to report the par value of REIT securities as the per share estimated value during the offering period, which could continue as long as seven and a half years. This price would typically remain the same on customer account statements during this period even though fees reduced the investor's principal and the value of the underlying real estate may have been reduced.

With 15-02 in place, the increased transparency forced sponsors and advisors back to the drawing board. Both sides of the market had to create innovative solutions to continue to meet investor demand for the asset class and make sure that product economics remained attractive.

FACTORS LEADING TO NON-TRADED REIT RESURGENCE

Changes in fee structures create stakeholder alignment
In most industries, regulation inspires innovation, and the non-traded REIT sector is no exception. The reasons for including REITs in a well-diversified, thoughtful portfolio never went away. The income-driven, inflation sensitive, semi-uncorrelated nature of the asset class continues to make a strong argument for inclusion in sophisticated portfolios.

While advisors may have shied away from the structural uncertainties of the sector, fundamental demand remains. As a result, sponsors like Blackstone, Griffin, and Cantor Fitzgerald began to engineer new REIT products that embraced the move toward greater transparency around value, fees, and performance.

By eliminating acquisition, disposition, financing and/or development fees from the overall fee structure and by reporting the NAV instead of the NIA, sponsors created a greater alignment of interests between sponsors, advisors, and their investors. Sponsors continue to be paid management fees and a performance incentive over an annual return hurdle while investors benefit from more frequent reporting, increased competition between product sponsors, and a greater portion of their investment "in the ground." Attractive share repurchase plans are an added benefit, offering the potential for improved liquidity to shareholders over the non-traded REIT products of the past and strengthening the case for higher portfolio allocation.

More sponsors are following suit and creating non-traded NAV REITs with multiple share classes that make the asset class more accessible through a variety of channels. Broker-dealers and RIAs can offer the same product via different share classes with a transparent selling commission made available to selling brokers. Some sponsors are selling directly through RIAs and have the opportunity to attract retail investors directly.

From a tax perspective, the timing is opportune. The Tax Cuts and Jobs Act of 2018 afforded REIT investors with a 20 percent tax reduction on the pass-through income earned.

Recent Developments Breathe Life into Non-Traded REITS

According to Accounting Today, "Individual REIT investors who file jointly with taxable income less than $315,000, or file individually with income less than $157,000, may enjoy a 20 percent deduction on REIT dividends as qualified business income. REIT investors with higher taxable income — up to $415,000 jointly or $207,000 individually — also may enjoy a tax deduction on a reduced scale."[9]

With the Biden Administration now in office and Democrats in charge of both houses of the legislature, there is reasonable risk that these favorable tax provisions could be rolled back. However, with Congress focused on keeping COVID at bay and propping up the economy, it seems unlikely that changes to the treatment of tax advantaged real estate holdings will be a priority.

Technology solutions create efficiencies

Sponsors and advisors are embracing new fee structures of non-traded REITs but are also incorporating technology solutions to streamline costly back office operations. In 2017, the North American Securities Administrators Association (NASAA) developed guidance on the use of electronic signatures for non-traded REITs. This has paved the way for straight through processing technology, which allows advisors and sponsors to save time and money by creating efficiencies in a traditionally error-prone and paper-laden investment process.

According to DLA Piper, NASAA's newly adopted Statement of Policy "will allow investors to sign subscription and related documents electronically, thereby increasing the likelihood that investor paperwork will be filled out and executed correctly and the investor's subscription processed quickly and efficiently."[10] This not only means that investments can be completed more quickly with less work, but also provides a much simpler signing experience for investor clients.

Low interest rates driving development and investors to seek higher yields

It's no secret that interest rates are at rock-bottom. This is great for those looking to utilize the debt markets to fund development and add leverage to real estate offerings. However investors continue to be starved for yield and are increasingly looking outside the traditional fixed income markets to find it. Non-traded REITs can offer the possibility of regular distributions. Real estate is also considered a real asset and as inflation expectations continue to rise, many investors may consider increasing their allocations to inflation sensitive asset classes.

These exciting changes pave the way for advisors to give non-traded REITs a second look. As with any real estate investment, there are a number of risk factors that should be considered, such as loss of principal, illiquidity, declines in market value, local economic conditions, operating costs, natural disasters, and more.

CONCLUSION

Non-traded REIT investments offer investors potential for diversification, regular income stream, and access to institutional grade real estate investments.

While they provide a compelling set of benefits, it should be noted that, like any investment, non-traded REITs come with risks, including illiquidity, loss of principal, real estate risks, and more.

If you'd like to learn more about how our technology platform, Altigo, can streamline the order entry and subscription process for alternative investments like non-traded REITs, please contact us:

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altigo
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Note: There are material risks associated with investing in real estate and real estate securities including illiquidity, tenant vacancies, general market conditions and competition, lack of operating history, interest rate risks, the risk of new supply coming to market and softening rental rates, general risks of owning/operating commercial and multifamily properties, short term leases associated with multi-family properties, financing risks, potential adverse tax consequences, general economic risks, development risks and long hold periods. There is a risk of loss of the entire investment principal.

WealthForge Holdings, Inc. is a diversified financial services company focused on providing alternative securities transaction solutions to our customers. WealthForge Holdings, Inc. includes subsidiaries that specialize in providing technology solutions including Altigo and facilitating alternative securities transactions. WealthForge Holdings, Inc. is the parent company of WealthForge Securities, LLC and WealthForge Technologies, LLC. WealthForge Holdings, Inc.; WealthForge Securities, LLC; and WealthForge Technologies, LLC are separate but affiliated companies.

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