Understanding Real Estate Finance: The Advantages and Disadvantages of a Non-Traded REIT

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Recently, a global investment manager with $1.3 trillion in assets under management, established a non-traded real estate investment trust to raise billions of dollars in capital to purchase commercial real estate in the United States and to hold real estate-oriented securities.

It was just the latest mega-fundraising or sales event involving non-traded REITs in 2021. According to The DI Wire, non-traded REITs reached nearly $2.64 billion in sales in April alone, an all-time monthly record and the second consecutive month that fundraising had topped $2 billion. Robert A. Stanger & Co., an investment bank that tracks the market, revised upward its sales estimate for non-traded REITs in 2021 from $20 billion to $25 billion.

Amid this frenzy of activity, investors may be attracted to a non-traded REIT because they offer tax advantages, a steady cash flow, and the potential for capital appreciation. But they also come with a higher risk profile than their publicly traded counterparts.

WHAT IS A NON-TRADED REIT?

The Financial Industry Regulatory Authority (FINRA) offers the following definition of a real estate investment trust, or REIT. It is a ?corporation, trust or association that owns (and might also manage) income-producing real estate. REITs pool the capital of numerous investors to purchase a portfolio of properties?from office buildings and shopping centers to hotels and apartments, even timber-producing land?which the typical investor might not otherwise be able to purchase individually.?

Two types of public REITs are available. One trades on a national securities exchange; the other?a non-traded REIT?does not.

Like publicly traded REITs, non-traded REITs:

- Invest in real estate.
- Are subject to the same IRS requirements, including distributing 90 percent of its taxable incometo shareholders.
- Must register with the U.S. Securities and Exchange Commission and are required to makeregular disclosures, including quarterly and annual reports that are available via the EDGAR system.

DIFFERENCES WITH TRADED REITS

Unlike REITs traded on the exchanges, non-traded REITs:

- Do not trade on an exchange and are not subject to the additional regulatory requirements of an exchange
- Tend to have a limited secondary market. FINRA states: ?While a portion of total shares outstanding may be redeemable each year, subject to limitations, redemption offers may be priced below the purchase price or current price.?
- Often charge higher front-end fees. FINRA notes that the fees can be as much as 15 percent ofthe per share price, which is substantially higher than exchange-traded REITs.
- May offer a different source of anticipated investment returns. Investors may be more focused on a return from distributions over a period of years, rather than asset appreciation. Upon liquidation of an asset, the capital returned may be ?more or less than the original investment depending on those assets,? according to FINRA. In a traded REIT, investors traditionally focus upon capital appreciation of the asset as the anticipated source of their return on investment, which hopefully is reflected in the increase in share price of the REIT on the exchange.

In addition, non-traded REITs should not be confused with private REITs, which also do not list on an exchange. Private REITs are generally exempt from registration with the SEC. Because they lack public disclosures, investors may find it more difficult to research the investment and its potential risk. In general, private REITs are sold to accredited investors (which include high-net worth individuals, banks, and other sophisticated investment classes).

OPPORTUNITIES AND CHALLENGES

Non-traded REITs can be attractive to those looking for investments that are not correlated to the performance of the stock markets. They can offer an opportunity for capital appreciation, allow investors to diversify their portfolios, and provide an income stream of robust distributions.

As one real estate investment manager told U.S. News & World Report earlier this year, ?There is a great scarcity of uncorrelated income in today?s market, and [non-traded REITs] are a good fit for that.? He added that the sector?s reputation for being less transparent than traded REITs is also changing: ?Private real estate has really evolved over the past couple of decades and now offers investors more transparency, monthly liquidity, and alignment with the investment manager.?

Nevertheless, the investments can be complex and do carry risks. FINRA has created a list of issues investors should consider. Among them:

- **Distributions are not guaranteed, and they may exceed operating cashflow.** A non-traded REIT?s board of directors decides whether to pay distributions and the amount that should be paid. Payments may be suspended or halted altogether. Also, to pay distributions the non-traded REIT may borrow, dip into cash reserves, and apply proceeds of the sale of new shares to sustain or increase distributions. Higher leverage can increase the risk of default and devaluation. Devaluation, in turn, can decrease the value of shares when they are liquidated or trigger the suspension of distributions.
- **Tax consequences can occur as a result of distributions and REIT status**. As FINRA notes, ?distributions for all REITS that are from current or accumulated earnings and profits are taxed as ordinary income, as opposed to the tax rate on qualified dividends.? If a portion of a distribution constitutes a return of capital, this portion is not taxed until the investment is sold or liquidated. Capital gains rates then apply.
- **Illiquidity and valuation complexity can occur**. Non-traded REITs have no public trading market, yet most are structured as a ?finite life investment,? FINRA said, ?meaning that at the end of a given timeframe, the REIT is required either to list on a national securities exchange or liquidate.? A liquidity event does not guarantee, however, that the value of an investment will have increased. Many factors affect the valuation of a REIT, including the portfolio of assets it owns and the strength of its balance sheet.
- **Redeeming shares early may be restricted and costly**. Most public non-traded REIT offerings place limits on the number of shares that can be redeemed prior to a liquidation event, and they may require that shares be held for a period, typically one year, before they can be redeemed. Shares sold prior to a liquidity event are routinely priced lower than the purchase price.
- **Non-traded REITs can carry higher fees**. Front-end fees include selling and compensation expenses, which cannot exceed 10 percent of the investment amount, and additional offering and organizational costs (or ?issuer costs?), which are paid from offering proceeds and cannot exceed 15 percent.
- **Assets may not be specified**. Most non-traded REITs begin as blind pools that have not yet determined the properties they will purchase.

Counsel can assist investors in understanding the risks and opportunities and legal issues involved in investing in or forming non-traded real estate investment trusts. Contact us for a consultation.

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