The Questions to Ask about Non-Traded REITs

By Robert P. Seawright
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The attraction of high yields comes at the expense of higher risk, a time-worn lesson that should be an ongoing focus for investors in non-traded REITs.
FINRA recently issued an investor alert with respect to non-traded REITs that outlined the products' features and potential drawbacks, such as high fees and illiquidity. Those problems are significant enough that some firms and advisors are staying out of this space entirely. Given how frequently these products have been mis-sold and how high their risk levels are, FINRA's action is understandable.

FINRA's action comes at a time of increasing interest in non-market correlated assets, which include non-traded REITs. Non-traded investments often fall into this category and have characteristics that differ significantly from traded assets. Many non-traded investments have suffered impaired performance recently and, therefore, over the short-term at least, have not achieved their intended results. Moreover, in a yield-starved investment environment, assets that purport to pay out high dividends are particularly attractive.

Before you venture into the latest incarnation of a high stakes casino, here are the tough questions you must ask about this asset class.

1. What is the proposed investment's intrinsic value (or expected intrinsic value)? Estimate carefully. For example, some analysts favor using discounted cash flows, some favor relative valuation and others look at book value. Don't trust the process and the result offered by the issuer, which are rarely transparent, as the law firm Snyder Kearney recently wrote.

2. What is the margin of safety offered? Compare the issue price to your ascertained intrinsic value to make this determination. To reasonably expect a profit, this margin needs to cover up-front costs and ongoing expenses with an additional margin to spare. Your calculation should not yield a fixed number. Rather, it should reflect the uncertainty in your assessment of intrinsic value.

3. Is the sticker price too high? The underlying assets should be acquired at favorable prices in light of current market capitalization rates, occupancies, leasing rates, comparable sales, replacement costs and other key metrics. Paying too much is a primary reason that, over time, many non-traded investments (such as Wells II and Inland REITs) underperform.

4. What are the costs? Analyze these carefully. Even excellent underlying collateral can be severely hampered by the upfront, ongoing and back-end fees of an investment. Indeed, low fees are among the best indicators of future performance. With most non-traded investments, the upfront load includes sales fees and commissions, acquisition fees, origination fees, and the like. The maximum amount most non-traded vehicles can pay for offering expenses is 15% (and FINRA is seeking to cap the others at 15% too). Most issuers have offering costs in the range of 10% to 12%. Many of these products also have far too many ongoing fees. These can even be more difficult to overcome than the upfront load.

5. Are the assets what they seem? Watch for "legacy assets" — assets purchased at market highs (e.g., real estate during 2005-2007). Sometimes such assets can appear in newer deals following acquisition from a related entity.

6. Will distributions hinder performance? Although each private placement memorandum indicates the source of the funds to be used for distributions, the strongest offerings pay their distributions from operational cash flows. Look to see how and when operations create the cash flows so as to diminish and ultimately eliminate the significance of continuous fundraising to cover distributions.

7. Do your interests align with the managers? Make sure that the investment structure incents the sponsor to make its profits on the back end. Invest in funds where the managers have a significant ownership stake. Finding out which those are is much easier than it used to be. Since 2005, the SEC has required all funds to disclose manager ownership of fund shares in their annual statements of additional information. Funds with substantial manager investment significantly outperform their peers (see here, here, here and here). As Georgetown University endowment head Lawrence E. Kochard wrote, "The managers should make money only when the investors make money." David Swensen of Yale repeatedly makes the same point. If the issuer makes its money overwhelmingly via fees rather than equity, look out.

8. What is the manager's longevity? There is also a significant positive correlation between manager investment and manager tenure. Look for management with a long track record at the firm.

9. Where is his or her expertise? Make sure the investment staff, along with the executives of the fund and asset, have particular experience in the types of assets that they are acquiring. They should have a lengthy track record in that asset class, through good times and bad.

10. And how does the manager do business? Screen for issuers that meet good company criteria: solid management, good product and sustainable competitive advantage.

11. Is the time right to invest? Be extra-careful in the current interest rate environment. I recognize that it is tempting to reach for yield while rates are low. According to Ethan Penner, founder and president of CBRE Capital Partners, the global real estate firm, "There is almost no way to invest large amounts of money in today's market — specifically in today's real estate market — and not be set up for a major disappointment sometime soon." Delivering the keynote address at the recent Commercial Real Estate Investment and Finance 2012 conference, Penner continued: "The major disappointment may take the form of economic non-recovery [or] it might take the form of very, very high interest rates, which will render your returns very, very inadequate."

12. Lastly, how big is healthy? Size matters. Look for smaller deals where more assets do not keep getting added just because it is possible to do so. For example, the non-traded REITs that have cut dividends and eliminated share buyback programs have, in general, been the larger ones. This is what legendary investor Michael Steinhardt called "diseconomies of scale." Elephants cannot dance.

Overall, look for "bedrock stability" in transactions rather than "bicycle stability." A bicycle has to keep moving to stay upright and to support its rider. Some investments will only remain stable if they keep moving, i.e., if operating cash flow continues at its projected pace.

On the other hand, bedrock is solid. Only in a severe, seismic event will fund fail to support that which is built upon it. Investors are much better off with companies that could survive a setback in earnings and even lose money for a time. That is bedrock stability. In today's markets, it's well worth finding.

Robert Seawright is the chief investment and information officer at Madison Avenue Securities, Inc., a San Diego-based independent broker-dealer and investment advisory firm. His blog is rpseawright.com.

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