



Recently, Jonathan A. Schein, publisher of *Real Assets Adviser* spoke with Sameer Jain of American Realty Capital. The following is an excerpt of that conversation.

What is the case for non-traded REITs?

In an anemic returns environment, non-traded REITs (NTRs) are expected to provide consistent durable income. They are not too different from public REITs in the sense that they own commercial real estate and pass on rental income to investors. The primary differences are that they raise capital as a blind pool, much like private equity, and they do not trade on an exchange. These are total return investments, but the majority of return is generated from dividend income prior to a liquidity event. The liquidity event through an asset sale, merger or public listing has further potential to provide capital appreciation.

Interest rates are inevitably going to rise. NTRs are less sensitive to interest rate changes than long-term bonds are. In addition, there is potential for distribution yield growth, unlike that in fixed-rate bonds. Something else, very compelling for investors, is the opportunity to tailor exposures by property type as sector specific REITs invest across retail, industrial, offices, multifamily, hotels, storage. Yet another reason is, since these do not trade on an exchange, they are less exposed to the vicissitudes of capital markets and have a low correlation with broader equity market indices. I often say that NTRs are less synchronized with the capital raising cycle. Public REITs raise and invest capital when real estate markets are in favor — i.e. when they are trading at premiums to NAV and when property prices are at their highest. Non-traded REITs raise and invest capital when it is most opportune to do so, and they do that at NAV. They also offer ways to unlock an illiquidity premium.

How much money have NTRs raised in the past 10 years?

This is an industry still in its infancy — perhaps 10 to 15 years old for the most part. Total assets stand at around \$80 billion to \$100 billion. There are around 60 REITs raising approximately \$15 billion to \$20 billion per year, even as we speak. The attraction of high, regular dividends and low price volatility are a draw to those who seek income and are conservative investors. Interestingly, legacy sponsors represent a small portion of new equity being raised every



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year as new entrants bring in more competitive differentiated offerings.

For what types of investors are NTRs best suited?

They are best suited for conservative long-term investors who seek fixed income and want an upside. These are favored by investors who want a decent yield, are often looking for a fixed-income proxy, seek to hedge inflation for property values, as replacement costs and revenues increase as inflation increases. Investors that seek portfolio diversification through less correlated assets with some capital growth also invest in them. In essence, anyone looking for durable income that is real asset backed versus just a financial security would be attracted to NTRs.

What do investors get in exchange for the illiquid nature of NTRs?

Investors typically exchange liquidity for higher yields, cash flow stability and the opportunity for a capital gain in a few years. I personally think illiquidity is a preference function and should be viewed positively. When investors irrationally want to exit investments in a falling market, illiquidity can shield them from making irrational decisions. Also, the illiquid nature of NTR shares does provide an intrinsic benefit because it removes the volatility of a fluctuating stock price. That built in stability gives REIT managers the flexibility to focus primarily on acquiring good assets and sensibly

managing the portfolio. They are able to focus on long-term capital appreciation, rather than worry about the negative effects of a widespread sell-off triggered by uncontrollable market conditions. And, because non-traded REITs control the timing of their liquidity event, they can time the market to maximize total portfolio return for their investors.

What level of regulation are NTRs subject to vis-à-vis publicly traded REITs?

These, like their publicly traded counterparts, must abide by SEC disclosure requirements, file quarterly and annual results and 8-K reports. Moreover they must abide by FINRA requirements. They file quarterly reports on transaction and balance sheet activity, in addition to regular SEC filings for all material events. In addition, their prospectus and ongoing transactional activity is reviewed by securities officials at the state level. Also, all conflicts of interest have to be extensively discussed and disclosed in the prospectus filed with the SEC. And these REITs are controlled by an independent board of directors with fiduciary responsibility to guide the actions of the management team. Both regulatory oversight and governance is comparable to publicly traded REITs.

What are NTRs' historic returns versus publicly traded REITs?

Non-traded REITs have two income components — the dividend and the capital appreciation achieved when the REIT completes a liquidity event — in other words, goes full cycle. The income component is fairly standard, and the capital gains portion varies widely between sponsors. Income is generally higher than in publicly traded REITs. I think that the only way to measure historic performance is by measuring full-cycle events, but until the recent past there had been few such events in the industry. All that is changing and we see high IRRs and MOICs in many realized programs — in many cases far better than private equity real estate, which is really what they ought to be compared with.

You have argued that publicly traded REITs are generally unable to raise and invest capital at times when it is most opportune to do so. Explain why?

Publicly traded REITs raise equity when their shares are trading at premiums to NAV and underlying property values are at their highest levels. And that's precisely the wrong time to be deploying capital. The most opportune time to raise and deploy equity is when property values are at low levels — but unfortunately for public REITs, this is also a hard time to raise capital because share prices tend to fall when underlying property values fall. NTRs, by contrast, do not have the same problem for they trade at or around NAV. They are able to raise and deploy capital at the most opportune time in the market cycle, and are able to generate value as properties are leased up, net operating income increases and property values increase.

Transparency has been an issue surrounding NTRs, but I've heard the industry has introduced initiatives to make these investments more transparent.

You are absolutely right. Some past generation NTRs have come under criticism for excessive upfront loads, large internalization fees, conflicts of interest and a lack of liquidity. In many cases, performance sucked, too. But the good news is, all that is fast changing, and much has already changed.

The next generation of NTRs has been structured to enhance price transparency through daily or quarterly NAV structures, as well as feature lower fee structures and better portfolio and corporate disclosure. There is huge pressure on lowering upfront fees, waiving asset management fees in favor of distribution coverage, eliminating internalization fees and providing compensation structures that incentivize management to provide liquidity events for shareholders. New structures have now emerged that have a clear focus on raising, investing and harvesting capital while creating absolute total returns over a 5- to 7-year period. There is a focus on covering the distribution and waiving asset management if the distribution is underfunded.

At American Realty Capital we have included many best practices across our programs. Things like a complete elimination of internalization fees and a focus on distribution coverage, which includes payment of asset management fees in the form of performance-based operating partnership units. In this instance, the units vest only if the investor realizes a return of capital plus a threshold percentage annual return. In many cases we also waive asset management and property management fees in favor of distribution coverage. We have a prohibition on related-party or affiliated transactions. So you can see that much is changing, and changing fast for the better in this space.

CORPORATE OVERVIEW

American Realty Capital is a full-service investment advisory firm sponsoring a series of investment programs with an emphasis on publicly registered non-traded real estate offerings. The firm was formed by Nicholas S. Schorsch and William M. Kahane with the vision of building a portfolio of companies focusing on sector specific and what we believe are best of class investment solutions, independently governed and distributed to retail investors over a unique multi-product wholesale distribution platform known as Realty Capital Securities.

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