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Nontraded-REIT managers have little skin in the game

Broker-dealers are looking at whether execs are aligning their interests with those of shareholders

By Bruce Kelly | *November 14, 2013 - 11:40 am EST*

Insiders and managers of nontraded real estate investment trusts typically own much fewer shares of their REITS than those affiliated with publicly traded REITS, a factor that could influence whether broker-dealers decide to sell shares in non-traded REITs.

A long-held tenet of institutional investing known as “eating your own cooking” or having “skin in the game,” the practice of aligning the interests of investors and REIT managers and executives is gaining importance for some independent broker-dealers, brokerage and REIT executives said.

*(**Dive in:** Inside ownership of 11 big nontraded REITs)*

According to research conducted by SNL Financial for *InvestmentNews*, the median percentage of shares owned by insiders of nontraded REITs is 0.25%, with the average being 6.12%. Subtract two nontraded REITs where insiders own 100% of the shares, and the median ownership drops to 0.23% and the average ownership falls to 3.09%.

Insiders and managers of listed REITs typically own far more of their shares, according to SNL. The median percentage of shares owned by insiders of traded REITs is 3.58%; the average is 8.92%.

SNL based its research on 162 traded REITs and 61 nontraded REITs.

BROKER-DEALERS CARE

Most nontraded REITS don't identify the degree of skin the game in their due-diligence analysis, but to some broker-dealers, it's becoming an important part of the process they use to decide whether they want to sell shares in the investments.

About two years ago, the network of four broker-dealers under the National Planning Holdings Inc.

umbrella began to include REIT managers' share ownership as part of the criteria they use to evaluate these investments. The NPH due-diligence team said it had not rejected any sponsors yet because of a failure to meet its guidelines, but share ownership was watched closely.

“We do want management to participate in the offering and do prefer direct participation, that they buy [shares] themselves,” said Alfredo Gomez, assistant vice president for alternative investments and due diligence at NPH. “We prefer they own shares in the REIT directly, from the outset.”

The reps and advisers at the NPH broker-dealers are currently selling four nontraded REITs. Some are nearing the close of their period to raise money, so the firm is actively reviewing other offerings, Mr. Gomez said.

“A minority of REITs are doing this, but we're seeing it grow,” said Mr. Gomez. “I'm hearing that more managers from REITs are considering this. There seems to be more willingness to put money in from the get- go, but it depends on the manager and it could range from a few hundred thousand to millions of dollars. Some [REIT executives] are putting in part of their net worth.”

NOT A CONCERN

Other broker-dealer executives, however, said that management's ownership of nontraded REIT shares was not a great concern. Such REITs typically operate with an external adviser and therefore have a markedly different compensation structure, resulting in nontraded REIT managers' owning far fewer shares at the outset of an offering than the insiders of a traded REIT.

“I look at skin in the game when [there are] clear conflicts of interest at the sponsor level,” said John Rooney, a managing principal at Commonwealth Financial Network. “Say, if the sponsor has an institutional arm buying properties that the retail side is also chasing.”

“I don't put too much weight in it,” added Mr. Rooney, whose background includes doing due diligence on a variety of alternative investments. “Does Ned Johnson have money in Fidelity funds?”

Nontraded REITs began to draw the attention of regulators after the collapse of the commercial real estate market in 2007-08. Large REIT sponsors left advisers and clients bewildered as some slashed dividends and steeply reduced the valuations on their offerings.

Broker-dealer and REIT executives often point to the improvements in the product since then, including proposing rules to disclose brokers' commissions for selling the product clearly on client account statements and industry-proposed uniform guidelines for share valuations.

A RECORD YEAR

Coinciding with a recovery in the commercial real estate market, the result is that 2013 has been a record year for nontraded REIT sales. Industry executives believe that registered representatives and advisers will sell $18 billion in nontraded REITs this year, almost double the amount the industry sold last year.

Kevin Hogan, chief executive of the Investment Program Association, an industry trade group, declined to comment about the different percentages of share ownership between listed REITs and nontraded REITs.

However, he wrote in an e-mail that nontraded REIT advisers “are moving towards taking their fees in shares instead of cash and this is a positive development. “

There are clear differences between non-traded REITs and listed REITs, Mr. Hogan added. “Comparing compensation for listed REITs and nonlisted REITs requires clarity about the differences in corporate structure,” he wrote. “Traded REITs are internally run or employee-run vehicles. Because they're employees of the REIT, those executives can be compensated in stock. On the other hand, nontraded REITs are externally advised by corporate entities. The nontraded REITs don't pay executives directly. They pay the advising company, which in turn pays its executives. This is a critical distinction if you're talking about executives having skin in the game.”

Other REIT executives pointed to the considerable costs of launching a nontraded REIT, perhaps $5 million to $10 million, as an indication of a commitment by REIT managers that doesn't translate directly to share ownership. As many as two dozen REITs have failed to launch successfully since 2009, resulting in sponsors eating millions of dollars in external costs. They also stressed that serious alignment of managers' and shareholders' interests takes place after a REIT's initial public offering or fund-raising period, when sponsors and managers take fees in the form of shares and not cash.

That said, the market appears to be paying attention to skin in the game. According to investment bank Robert A. Stanger & Co. Inc., the top nontraded REIT in sales over the first nine months of this year was Griffin-American Healthcare REIT II Inc., which raised $1.73 billion. That REIT's management has a strong commitment to owning shares. For example, its chief executive, Jeffrey Hanson, takes 100% of his after-tax compensation in shares.

“We don't grant shares to ourselves,” Mr. Hanson said. “We have bought all our stock in full.”

“If you do the right thing, and align the interests of investors and management through a meaningful investment of your own net worth, it truly changes human psychology,” he said. “You make different decisions and better decisions, and the result is better long-term performance.”

The hottest selling nontraded real estate investment trust of 2013, and how much management owns.

REIT	Amount sold in 2013, through September	Total % owned by company insiders (voting)	Total number of shares owned by insiders (voting)
Griffin-American Healthcare REIT II Inc.	**$1.73 billion**	0.29	719,018
American Realty Capital Trust IV Inc.	**$1.48 billion**	0.02	16,889
Cole Corporate Income Trust Inc.	**$1.48 billion**	0.5	174,672
American Realty Capital Trust V Inc.	**$1.47 billion**	NA	NA
American Realty Capital Healthcare Trust Inc.	**$1.19 billion**	0.03	55,323
Cole Credit Property Trust IV Inc.	**$949 million**	0.12	20,000
Phillips Edison ARC Shopping Shooping Center REIT Inc.	**$934 million**	0.8	403,301
American Realty Capital New York Recovery REIT Inc.	**$869 million**	0.25	78,381
Industrial Income Trust Inc.	**$736 million**	NA	NA
NorthStar Real Estate Income Trust Inc.	**$513 million**	NA	NA
Hines Global REIT	**$466 million**	0.01	19,952
Carey Watermark Investors Inc.	**$418 million**	0.05	13,166
Carter Validus Mission Critical REIT Inc.	**$334 million**	0.15	44,000
CNL Healthcare Properties Inc.	**$285 million**	0.18	72,179
United Development Funding IV	**$267 million**	NA	NA

Sources: Robert A. Stanger & Co. Inc., SNL Financial