

LISTED AND NON-LISTED REITs: EXPLORING THE COST DIFFERENCE

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Publicly available Real Estate Investment Trusts come in two flavors: listed, and non-listed. The difference between the two is simple, yet important. Listed REITs trade on exchange while non-listed REITs do not.

Non-listed REITs carry both a cost and an advantage to investors. Because non-listed REITs are not traded on an exchange, they are not liquid. But also because non-listed REITs are not traded, they are closer to pure plays in real estate than listed REITs. They are, in a sense, a hybrid product. They give retail investors the ability to invest in real estate with a vehicle that in some ways mimics a privately held partnership. As such, one could argue that non-listed REITs are less correlated with the stock market than listed-REITs, although testing that proposition is not the focus of this paper.

The focus here is whether non-listed REITs cost investors more than listed REITs. Green Street (2012) has argued that the initial

offering fees charged by non-listed REITs are high relative to listed REITs, and that the general and administrative expenses for non-listed REITs are high, as well¹. Jack Corgel and Scott Gibson (2008) argued that “[we] found that REIT returns for long-term holders diminish as a result of fixed share prices, which do not change even when the value of underlying assets appreciate. Those gains are absorbed by commissions and fees when new investors enter the picture.”²

Two non-listed REITs—Cole Capital and KBS—asked us to investigate differences in costs between the two REIT vehicles.³

In this brief we address the fundamental question: When an investor invests a dollar in new shares on any REIT, listed or non-listed, how much of that dollar flows through to a real estate investment? We then test whether there is a statistical difference in the net received by investors.

DEFINITIONS

By definition, there are three categories of REITs: (1) traded REITs (tREITs), (2) non-traded REITs (nREITs), and (3) private REITs. This is the terminology most commonly used by industry (particularly NAREIT), media, and policy leaders. Some readers may point out that all REITs can in fact be traded, with some far more liquid than others. This is true. Nevertheless, the terminology remains standard. REITs as a corporate structure have existed since the 1880s in the trust industry that morphed into the mutual fund business following the Great Depression. While extensive lobbying and size ensured the survival of the mutual fund trusts, real estate trusts were prohibited in the United States for 20 years after the Great Depression. However, the REIT Act of 1960 re-created the corporate tax exemption that made the REIT structure profitable, but it did so with significant restrictions on company investment and management. Since then, several updates to REIT legislation have begun to loosen these restrictions, allowing REITs to adopt some practices from their real estate operating company (REOC) competitors.

Traded REITs are firms that issue equity and debt securities traded over recognized exchanges. They are available to accredited, non-accredited, and institutional investors who can purchase as little as one share (typically \$10-\$50) in the company. They must register with the SEC and meet the listing requirements of a major exchange. Of all the Real Estate Investment Trusts, tREITs must disclose the most information to the public. Traded REITs are available for purchase through any retail securities broker or online discount brokerage, and recently their institutional ownership has eclipsed that of traditional industrial stocks. As opposed to non-traded REITs, traded REITs usually have quarterly distributions of income to investors. The first REIT traded on the New York Stock Exchange was the Continental Mortgage Investors REIT in 1965, and their market has grown to a market capitalization of \$450 billion as of 2011⁴. Traded REITs must abide by all regulations and listing requirements of their exchanges in addition to SEC filing and disclosure

regulations. Unlike many non-traded REITs, traded REITs host publicly available quarterly earnings release calls. Almost all traded equity REITs already own considerable assets before going public, unlike non-traded REITs and many traded mortgage REITs.

Non-traded REITs are firms that issue equity and debt securities that are not traded on recognized exchanges. Securities for these firms have no guaranteed secondary market. Small dealer networks can buy initial investors out of non-traded REITs, but typically at a steep discount and only for the largest issues. Non-traded REITs also have share-buyback programs, but these are extremely limited – typically 5% of shares are redeemable per year. These programs can also be suspended indefinitely with little notice, and this happened in most non-traded REITs over the last few years. Investors in non-traded REITs are overwhelmingly individual investors who do not invest in such securities as their principal occupation. Non-traded REITs are typically issued at \$10 per share. As opposed to traded REITs, non-traded REITs usually have monthly distributions of income to investors. As best as we can tell, the first non-traded REIT was Wells REIT I in 1990⁵, and since then the market capitalization of the entire non-traded REIT sector has grown to over \$78 billion (as of 6/11 per Blue Vault Partners). Non-traded REITs also must comply with all SEC disclosure regulations, but many do not host quarterly earnings release calls. There are additional regulations and requirements of exchanges that non-traded REITs also avoid. The minimum investment amount in an nREIT is typically between \$1,000 and \$2,000, although considerable investor asset and income tests usually apply to investors in nREITs. Sometimes nREITs pay dividends in excess of funds from operations by borrowing money or redistributing current equity proceeds. This is quite common in the early stage of a non-traded REIT seeking to maintain a minimum dividend rate. The typical nREIT is a blind-pool investment trust, similar to a private equity fund, in which investors do not know what assets will be acquired before committing money to the firm. Almost all traded REITs already have large existing real estate portfolios.

Private REITs are not listed on public exchange or registered with the SEC. They may be referred to as closely held REITs, which are the only type that can be held by fewer than 100 individuals. However, there are widely held private REITs that represent the vast majority of firms qualifying as REITs in this country, although they trail traded REITs in total assets under management. These are largely unregulated and disclose little information publicly, less even than most hedge funds. Their investors range from wealthy families and individual investors (accredited only) to large public institutions (banks, insurance companies, pension funds). Private REITs are frequently confused with non-traded REITs in the popular press, despite their completely different organizational structures.

A REIT also can be classified by type of assets. (1) Equity REITs primarily invest in real estate properties and at times real estate-related equity securities. An equity REIT can be abbreviated as eREIT (2) Mortgage REITs primarily invest in real estate debt and debt securities, both in residential and commercial sectors. A mortgage REIT can be abbreviated as mREIT. (3) Hybrid REITs invest in both real estate equity and real estate debt. These are fewer in number than (1) or (2), and are usually abbreviated as hREIT. In this study all traded and non-traded REITs are equity REITs. Any non-equity REIT mentioned is explicitly referred to as a mortgage REIT or hybrid REIT.

METHOD

Our goal was to compare the share of raised equity that in fact goes toward equity real estate in both tREITs and nREITs. This involved setting aside two key issues: how much money investors pay in fees at the time of an initial REIT offering, and how much money it costs to operate a REIT.

To compare on an equal basis, we needed to convert Gross Operating Proceeds (GOPs) into Net Operating Proceeds (NOPs). GOPs simply reflect total funds raised in an offering. NOPs are proceeds after underwriting expenses are paid.

We have examined GOP, and then reduced it to NOP by looking at the various expenses involved in underwriting a REIT at origination. The largest expense is the gross spread, or the fees underwriters receive to arrange an offering. To estimate other fees, we relied on information from the Securities Data Company⁷. These include printing and engraving expenses, legal expenses, transfer and registrar fees, and the ever-popular miscellaneous expenses. We subtracted these expenses from GOP to get NOP, and then divided NOP into GOP to get a percentage, which is the share of investors proceeds available for use.

Let's look at an example. Simon Property's IPO began in December of 1993 and closed in January of 1994. In that time, 43,412,500 shares were sold to the public at \$22.50 per share, raising a GOP of \$965,928,125. The gross spread was \$58,179,000, and other expenses were \$16,073,850. As a result, the NOP for Simon was \$891,675,275, and the NOP percentage was 92.3 percent. All of this is quite straightforward.

But we are not done. Another essential cost is operations management. The nature of the real estate business and differences in reporting make this calculation difficult.

Management expenses for a real estate company work at two levels – corporate and property. To the extent that the expenses are property, they should be attributed as an operating expense rather than as an overhead expense for that property. Yet within the rules of financial reporting, this expense could be attributed at one place or another. This makes it difficult to get a good handle on total G&A expenses. Consequently, we will tackle this issue from several angles.

Both reporting and leverage influence management expenses across all REITs. However, it's important to note there was considerable variation in the reporting of management expenses across similar REITs, drawing skepticism about the consistency of reporting methods.

Hence, while we present results based on reported management expenses in SEC filings, we council caution in the meaning for individual firms. On the other hand, we have no particular reason to think that reporting practices vary with REIT type.

Leverage influences management expenses because more levered REITs own more properties, and more properties require management. Relative to equity raised, REITs with higher leverage have higher management expenses. So we reported management expenses that reflect average leverage, and then estimated what management expenses would hold leverage constant across REITs. We did this by performing a regression analysis to explain all expenses (both offering and operating) after controlling for firm size, leverage, and firm type (either nREIT or tREIT).

Finally, it's not clear whether managed equity brokers fees should be considered an expense for traded REITs; to address this, we estimated expenses both with and without the fees.

Management expenses are flows, while equity raised is a stock. In order to make the outgoing expenses comparable to the equity offering, we took the discounted value of the management expenses over a holding period of 10 years at a discount rate of 10 percent. The "asset cost" of the management

expenses under this scenario is 6.14 times the average annual cost of the management expenses.

RESULTS

We began by presenting NOP results based on SDC or SEC data for 45 REITs –23 traded and 22 non-traded.⁸ .⁹ Table I presents NOP by type. The average NOP for a tREIT is 2.5 percent higher than for an nREIT, a difference that is both statistically significant and economically important. This means that at the point of offering, investors in tREITs have more money available for investment than investors in nREITs.

We next examined the present value of management expenses with and without controls. Basing expenses on financial reports to the SEC, we assumed owners of tREITs pay a managed brokerage fee of 1.35 percent per year. As explained above, we took the average expense to equity ratio over the life of the REIT, then discounted that average over 10 years at a discount rate of 10 percent. We found that the capitalized value of expenses for nREITs is 7.8 percent lower than for tREITs, which is substantially greater than the difference in nets to nREIT and tREIT investors at the time that a REIT is offered. Taken at face value, this suggests that investors in nREITs would have more of their

Table 1
NOP by REIT

REIT Name	REIT TYPE	NOP	REIT Name	REIT TYPE	NOP
<i>American Realty Capital Trust</i>	<i>Non-Traded</i>	<i>88.4%</i>	American Assets Trust	Traded	91.5%
<i>Apple REIT 6</i>	<i>Non-Traded</i>	<i>89.8%</i>	American Realty Capital Props.	Traded	89.8%
<i>Apple REIT 7</i>	<i>Non-Traded</i>	<i>89.8%</i>	AvalonBay Communities	Traded	92.9%
<i>Apple REIT 8</i>	<i>Non-Traded</i>	<i>89.9%</i>	Boston Properties	Traded	93.0%
<i>Apple REIT 9</i>	<i>Non-Traded</i>	<i>89.8%</i>	Brandywine Realty	Traded	89.5%
<i>Behringer Harvard Multifamily REIT I</i>	<i>Non-Traded</i>	<i>88.8%</i>	Campus Crest Communities	Traded	92.6%
<i>Behringer Harvard REIT I</i>	<i>Non-Traded</i>	<i>88.8%</i>	CoreSite Realty Corporation	Traded	91.2%
<i>Chambers Street Properties</i>	<i>Non-Traded</i>	<i>91.3%</i>	DCT Industrial Trust	Traded	92.6%
<i>CNL Lifestyle Properties</i>	<i>Non-Traded</i>	<i>87.0%</i>	DDR	Traded	92.0%
<i>Corporate Property Associates 16 (WPC)</i>	<i>Non-Traded</i>	<i>90.1%</i>	Digital Realty Trust	Traded	89.5%
<i>Corporate Property Associates 17 (WPC)</i>	<i>Non-Traded</i>	<i>89.2%</i>	Douglas Emmett, Inc.	Traded	93.8%
<i>Dividend Capital Diversified Property Fund</i>	<i>Non-Traded</i>	<i>90.8%</i>	DuPont Fabros Technology	Traded	91.9%
<i>Dividend Capital Trust</i>	<i>Non-Traded</i>	<i>87.5%</i>	Equity Residential	Traded	92.1%
<i>Healthcare Trust of America</i>	<i>Non-Traded</i>	<i>89.9%</i>	Extra Space Storage	Traded	91.3%
<i>Hines Real Estate Investment Trust</i>	<i>Non-Traded</i>	<i>89.5%</i>	First Potomac Realty Trust	Traded	91.0%
<i>Industrial Income Trust</i>	<i>Non-Traded</i>	<i>87.8%</i>	General Growth Properties	Traded	91.5%
<i>Inland American Real Estate Trust (I)</i>	<i>Non-Traded</i>	<i>89.7%</i>	Pebblebrook Hotel Trust	Traded	91.6%
<i>Inland Real Estate Corporation</i>	<i>Non-Traded</i>	<i>89.9%</i>	Piedmont Office Realty Trust	Traded	90.8%
<i>Inland Retail Real Estate Trust</i>	<i>Non-Traded</i>	<i>87.2%</i>	Retail Properties of America	Traded	90.8%
<i>Inland Western Retail Real Estate Trust</i>	<i>Non-Traded</i>	<i>89.2%</i>	RLJ Lodging Trust	Traded	92.3%
<i>Wells Real Estate Investment Trust I</i>	<i>Non-Traded</i>	<i>87.5%</i>	Simon Property Group	Traded	92.3%
<i>Wells Real Estate Investment Trust II</i>	<i>Non-Traded</i>	<i>89.1%</i>	Summit Hotel Properties	Traded	90.6%
			Vornado Realty Trust	Traded	93.0%
Mean NOP		89.1%			91.6%
Variance NOP		0.0135%			0.0124%

money invested in equity real estate than investors in tREITs.

There are, however, several ambiguities to consider. First, it is not clear that investors need to hold tREITs in managed accounts. The present value of a 1.35 percent managed account fee over ten years at a ten percent discount rate is 8.3 percent of the value of the real estate. Essentially,

the managed account fee explains the difference in management expenses between tREITs and nREITs. One could assume that some tREIT investors would prefer to have their holdings in managed funds. It does appear the appropriate cost to assign to the managed account fee is somewhere between 0 and 8.3 percent.

Second, there may be leakages in which expenses

Table 2

Discounted General and Administrative Expense by REIT (Traded REITs Include Managed Brokerage Account Expenses)

REIT Name	REIT TYPE	G&A	REIT Name	REIT TyPE	G&A
<i>American Realty Capital Trust</i>	<i>Non-Traded</i>	17.6%	American Assets Trust	Traded	36.1%
<i>Apple REIT 6</i>	<i>Non-Traded</i>	5.1%	American Realty Capital Props.	Traded	34.7%
<i>Apple REIT 7</i>	<i>Non-Traded</i>	6.3%	AvalonBay Communities	Traded	13.0%
<i>Apple REIT 8</i>	<i>Non-Traded</i>	5.9%	Boston Properties	Traded	18.3%
<i>Apple REIT 9</i>	<i>Non-Traded</i>	9.4%	Brandywine Realty	Traded	14.3%
<i>Behringer Harvard Multifamily REIT I</i>	<i>Non-Traded</i>	19.3%	Campus Crest Communities	Traded	25.4%
<i>Behringer Harvard REIT I</i>	<i>Non-Traded</i>	18.5%	CoreSite Realty Corporation	Traded	26.8%
<i>Chambers Street Properties</i>	<i>Non-Traded</i>	14.5%	DCT Industrial Trust	Traded	24.3%
<i>CNL Lifestyle Properties</i>	<i>Non-Traded</i>	20.3%	DDR	Traded	24.1%
<i>Corporate Property Associates 16 (WPC)</i>	<i>Non-Traded</i>	9.4%	Digital Realty Trust	Traded	24.5%
<i>Corporate Property Associates 17 (WPC)</i>	<i>Non-Traded</i>	21.7%	Douglas Emmett, Inc.	Traded	15.7%
<i>Dividend Capital Diversified Property Fund</i>	<i>Non-Traded</i>	22.0%	DuPont Fabros Technology	Traded	13.9%
<i>Dividend Capital Trust</i>	<i>Non-Traded</i>	7.3%	Equity Residential	Traded	14.0%
<i>Healthcare Trust of America</i>	<i>Non-Traded</i>	19.4%	Extra Space Storage	Traded	34.1%
<i>Hines Real Estate Investment Trust</i>	<i>Non-Traded</i>	20.1%	First Potomac Realty Trust	Traded	28.5%
<i>Industrial Income Trust</i>	<i>Non-Traded</i>	31.0%	General Growth Properties	Traded	11.0%
<i>Inland American Real Estate Trust (I)</i>	<i>Non-Traded</i>	10.7%	Pebblebrook Hotel Trust	Traded	15.1%
<i>Inland Real Estate Corporation</i>	<i>Non-Traded</i>	21.2%	Piedmont Office Realty Trust	Traded	14.2%
<i>Inland Retail Real Estate Trust</i>	<i>Non-Traded</i>	5.0%	Retail Properties of America	Traded	13.1%
<i>Inland Western Retail Real Estate Trust</i>	<i>Non-Traded</i>	10.8%	RLJ Lodging Trust	Traded	16.9%
<i>Wells Real Estate Investment Trust I</i>	<i>Non-Traded</i>	6.6%	Simon Property Group	Traded	44.3%
<i>Wells Real Estate Investment Trust II</i>	<i>Non-Traded</i>	14.0%	Summit Hotel Properties	Traded	23.7%
			Vornado Realty Trust	Traded	25.0%

Mean G&A

14.4%

Mean G&A

22.2%

that should be attributed to management are assigned to properties. We are not in a position to judge this, nor do we have reason to believe that this potential reporting issue is more problematic for one type of REIT.

Third, we are looking at G&A as a fraction of equity, but companies that have more leverage will also have more property to manage, and this increases expenses in the numerator for not equity in the denominator. Think about two companies with equal amounts of book equity, but one was no book leverage, and the other has fifty percent leverage. The second company will have twice

the operations management expenses as the first for the simple reason that it owns twice as many properties. This in no way reflects badly on its operations efficiency. In order to deal with this issue, we perform two versions of the following regression:

IOP means investable offering proceeds, and is proceeds available for investment after discounted G&A expenses are taken out of NOP. We control for assets in order to take into consideration economies of scale in REITs, and leverage for the reasons stated above. The two versions include

one where a managed account fee is included in the tREIT expenses, and one where a managed fee is not included.

The parameter of interest is β_4 , which indicates whether the REIT form has an influence on IOP or, conversely, cost. In the case where managed portfolios fees are counted as part of tREIT expenses, The coefficient on β_4 is positive but

$$IOP = a + \beta_1 \text{Assets} + \beta_2 \ln(\text{Assets}) + \beta_3 \text{DebtRatio} + \beta_4$$

small and not different from zero at customary levels of statistical confidence. In the case where such expenses are excluded from tREIT expenses, the coefficient on β_4 is negative but small and just significant at the ten percent level of statistical confidence.¹⁰ This underscores the point that whether tREITs have a cost advantage relative to nREITs depends on how one treats managed account fees. Surprisingly, larger firms seem

to have lower IOPs, as do firms with more book leverage.

CONCLUSION

This study sought to determine whether nREITs are at a cost disadvantage to tREITs. We were unable to reach a definitive finding, largely because of the nature of reporting. Also, it is unclear how to evaluate the impact of fees at managed brokerage accounts. Owners of tREITs can use discount brokers, but they often chose not to, indicating that they value the service provided by active management. Managers of nREITs perform a similar function for investors.

In any event, our analysis shows that Green Street's (2012) and Corgel and Gibson's (2008)

Table 3

Regression Results Explaining Investable Proceeds (Gross Proceeds less Organizational Expenses Less Discounted G&A Expenses)

	Regression Excluding Managed Brokerage Fee for tREITS	Regression Including Managed Brokerage Fee for tREITS
Intercept	1.15 (0.10)	0.400 (0.055)
Log (Book Assets)	-0.014*** (0.004)	-0.014*** (0.004)
Debt Ratio (Book)	-0.15* (0.08)	-0.15* (0.08)
nREIT=1	-0.049* (0.026)	0.033 (0.025)
N	41	41
R ²	0.262	.297

* Significant at 10 percent level of confidence. *** Significant at 1 percent level of confidence.

claims that non-traded REITs are unambiguously more costly to investors than traded REITs are overstated.

REFERENCES

1. See http://www.greenstreetadvisors.com/pdf/sample_research/Nontraded_REIT_Excerpt.pdf.
2. <http://www.hotelnewsnow.com/Articles.aspx/333/Cornell->

Disadvantages-of-nontraded-REITs.

3. The firms provided compensation to graduate students working on the project and made a donation to the

Ross Minority Program in Real Estate, and to the executive education program of the USC Lusk Center for Real Estate.

4. See <http://www.reit.com/DataAndResearch/US-REIT-Industry-MarketCap.aspx>.
5. We thank Jessica Thorsheim for this information.
6. All data and sources are available in a spreadsheet posted at www.usc.edu/lusk.
7. We omitted Cole Capital and KBS REITs because they are research sponsors.
8. Study details are available on the USC Lusk Center for Real Estate Web Site. www.usc.edu/lusk.
9. We ran a number of specifications of this regression, examining the market value of debt as well as book value. No matter how we specified the regression, the basic result with respect to the nREIT coefficient was the same – its sign depended on how we treated managed brokerage accounts as an expense.

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