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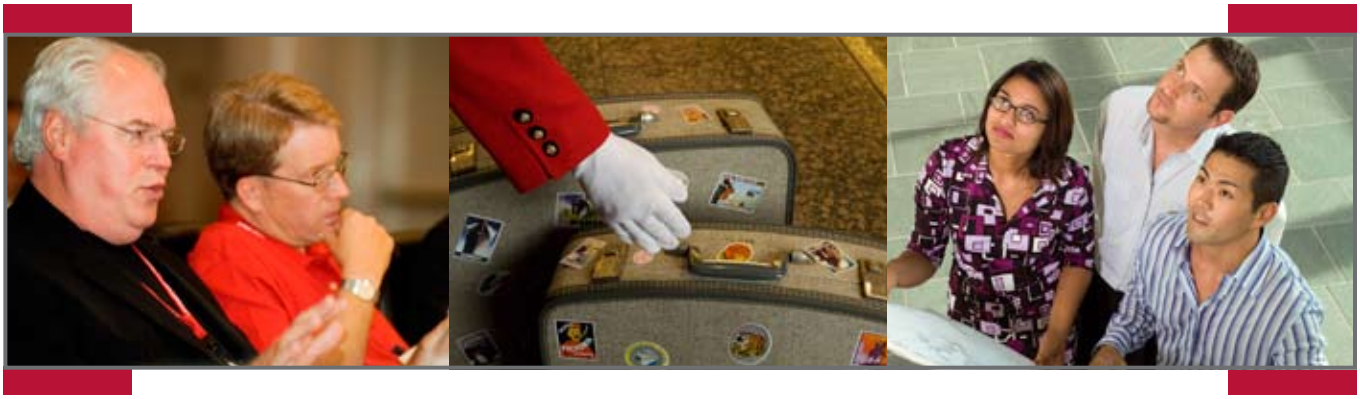

Nontraded REITs: Considerations for Hotel Investors

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by John B. Corgel, Ph.D., and Scott Gibson, Ph.D.

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EXECUTIVE SUMMARY

Nontraded REITs are an attractive buy-and-hold investment for income-oriented investors. Sold through broker-dealers, shares in these real estate investment trusts do not trade on public exchanges, promise relatively high returns, and contain specific triggers for liquidating the trust. In the first such study of nontraded REITs, an examination of the comparative effects of a long holding period and a short holding period shows that investors who purchase hospitality REITs early in the cycle see a diminished return as a result of subsequent sales. In effect, the early investors subsidize the commissions paid to the dealers who sell to late-term investors. This effect is an unintended consequence of the fact that the REITs' share prices are fixed, regardless of the value of the underlying assets. The REITs' high dividend structure somewhat mitigates the effect, but those high dividends mean that some REITs' payout exceeded the amount cash they took in (as measured by funds from operations). While these characteristics do not mean that investors should exclude nontraded REITs from their portfolios, would-be investors should apply due diligence. This report offers recommendations to help guide that process.

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Private equity funding for hotel real estate investment in the U.S. historically comes from small hotel companies, individual investors, and pension funds. These sources remain dominant today, as evidenced by the recent wave of hotel public-to-private company transactions (see Exhibit 1).[1] The first opportunity for individual U.S. investors to purchase shares in publicly traded portfolios of hotel property occurred in 1960, with enactment of a law establishing real estate investment trusts (REITs). The REIT concept has proliferated in recent years as other countries have adopted similar laws.

Investment in REITs expanded during the early 1990s, when real estate fund sponsors began raising money directly from individual investors using broker-dealer channels. These sponsors make investments for individuals in hotels and other properties of sizes and quality levels that individuals would have difficulty investing in for themselves. Replicating marketing networks established by mutual fund groups, sponsors offer real estate investment programs to the broad population of investors who use the services of local financial planners (mostly individuals).

A chief attraction of REITs for real estate sponsors is the favorable income tax treatment that goes along with this ownership form. Thus organized, the sponsors that use broker-dealers operate as private companies known as nontraded REITs. Even though these firms do not sell shares on public exchanges they must follow Securities and Exchange

[1] An evaluation of private equity investment in hotel companies can be found in: J.B. Corgel, "Private Equity Investment in Public Hotel Companies: Recent Past, Long-Term Future," *Cornell Hospitality Report*, Vol. 8, No. 10 (June 2008), Center for Hospitality Research, chr.cornell.edu.

Exhibit 1

Selected public-to-private hospitality transactions, 2004 to present

Date	Public Company Target	Private Company Acquirer	Price*
2004	Extended Stay America	Blackstone	$2.0B
	Prime Hospitality	Blackstone	$790M
	Boca Resorts	Blackstone	$1.1B
2005	Wyndham International	Blackstone	$3.2B
	Raffles*	Colony Capital	$1.0B
	La Quinta Corporation	Blackstone	$3.4B
2006	Fairmont Hotels & Resorts	Kingdom and Colony Capital	$3.9B
	Meristar Hospitality Corporation	Blackstone	$2.6B
	Kerzner International	Investor Group	$3.8B
	Boykin	Westmont and Caisse de depot	$416M
	Jameson	JER Partners	$371M
	Intrawest Corporation	Fortress	$2.8B
	Four Seasons Hotels	Kingdom and Cascade and Triple Holdings	$3.4B
2007	CNL Hotels & Resorts*	Morgan Stanley Real Estate	$6.6B
	Inkeepers USA Trust	Apollo	$1.5B
	Highland Hospitality Corporation	JER Partners	$2.0B
	Eagle	Apollo	$237M
	Crescent Real Estate Equities	Morgan Stanley Real Estate	$6.5B
	Harrah's	Apollo and Texas Pacific	$17.1B
	Hilton Hotels	Blackstone	$26B

**Notes*: This table presents reported transactions involving publicly companies mostly in the U.S. that were sold to private equity investors during past past three years. Price may not reflect assumption of debt. Raffles is not a U.S. public company. CNL Hotels & Resorts is technically not a public company, but as an unlisted REIT, CNL followed all SEC reporting requirements and attempted an IPO in 2005. *Sources*: Bear Stearns, PKF Hospitality Research.

Commission (SEC) rules for disclosure of information about their activities and financial performance, because of the way in which they raise money from the public. A closely related type of REIT, known as private REITs, avoids broker-dealers by raising money even more privately by soliciting family members. These REITs fall outside the disclosure rules of the SEC. A more complete description of the differences between public, nontraded, and private REITs appears in Exhibit 2, overleaf.

In this report, we focus on nontraded REITs because of the huge volume of equity these companies raised in recent years and the important position that three nontraded hotel REITs, namely, Apple, CNL, and Inland, maintained in the hotel property market during the current decade.[2] The amount of equity controlled by REITs is considerable. In 2003, for example, all nontraded REITs raised $7 billion through broker-dealer channels, while all publicly traded REITs raised $8.1 billion through public stock offerings. By 2007 the amount of money raised by nontraded REIT sponsors reached over $11 billion, while publicly traded REITs managed to raise more than $13 billion.[3]

This report provides general information about how nontraded REITs operate. We offer both positive and negative aspects of nontraded REIT investing from the perspective of individual investors, special emphasis is placed on hotel investment opportunities available through broker-dealers. In particular, we explain one of the negative aspects, which involves reduced returns for those who buy early, as

[2] CNL Hotels and Resorts was acquired by Morgan Stanley Real Estate and Ashford Hospitality Trust in 2007 for $6.6 billion. Apple and Inland continue to operate as nontraded REITs.

[3] Robert A. Stanger & Co. tracks nontraded REIT financial flows. Publicly traded REIT financial flows come from the National Association of Real Estate Investment Trusts (NAREIT).

Exhibit 2

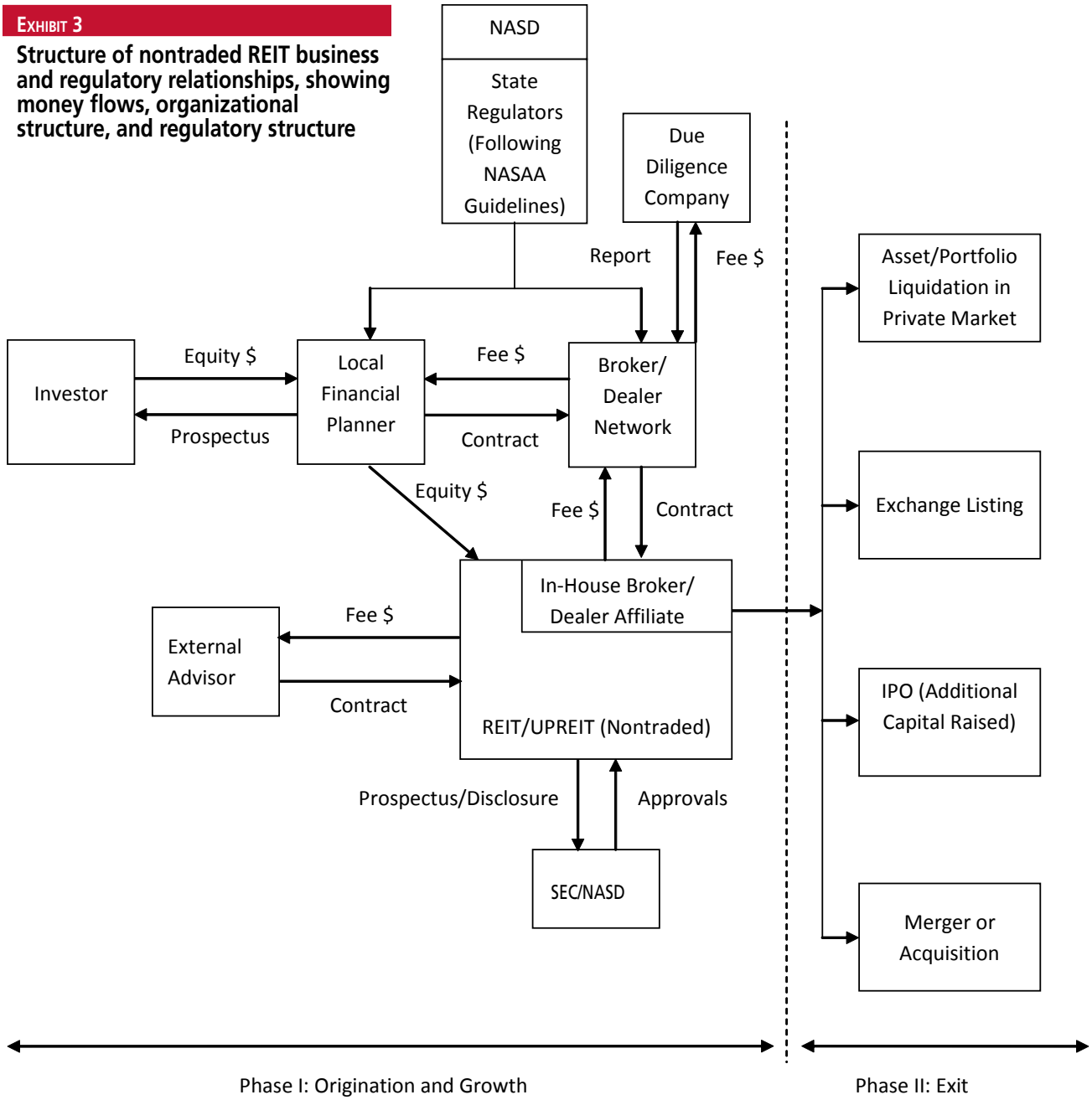
Comparison of REIT characteristics

	Publicly Traded REITS	Nontraded REITS	Private REITS
Overview	Registered with the SEC; shares trade on national stock exchanges.	Registered with the SEC; shares do not trade on national stock exchanges.	Not registered with the SEC; shares do not trade on national stock exchanges.
Liquidity	Shares are listed and traded on major stock exchanges, like any other publicly traded stock. Most are listed on the New York Stock Exchange (NYSE).	Shares are not traded on public stock exchanges. Redemptions are limited and usually subject to a minimum holding period. Investor exit generally linked to a required liquidation deadline or the listing of the stock on a national stock exchange.	Shares are not traded on public stock exchanges. Existence of, and terms of, any redemption programs varies by company and are generally limited in nature.
Transactions	Brokerage costs the same as for buying or selling any other publicly traded stock.	Typically, fees of 10 to 15 percent of the investment are charged for broker-dealer commissions and other up-front costs, in addition to ongoing management fees and expenses. Back-end fees may be charged.	Varies by company.
Management	Typically self advised and self managed.	Typically externally advised and managed.	Typically externally advised and managed.
Minimum Investment	One share, at market offered price.	Typically $1,000 to $2,500.	Typically $1,000 to $25,000; higher for REITs designed for institutional investors.
Independent Directors	Stock exchange rules require a majority of directors to be independent of management. NYSE and NASDAQ rules call for fully independent audit, nominating, and compensation committees.	Subject to North American Securities Administrators Association (NASAA) regulations, which require that independent directors comprise a majority of the board and of each board committee.	Not required.
Investor Control	Investors re-elect directors.	Investors re-elect directors.	Investors re-elect directors.
Corporate Governance	Specific stock exchange rules on corporate governance.	Subject to state and NASAA regulations.	Not required.
Disclosure Obligation	Required to make regular financial disclosures to the investment community, including quarterly and yearly audited financial results with accompanying filings to the SEC.	Required to make regular SEC disclosures, including quarterly and yearly financial reports. (The requirement comes from the use of third-party broker–dealers.)	Not required. Money is raised privately and independent of third parties.
Performance Measurement	Numerous independent performance benchmarks available for tracking public REIT industry. Wide range of analyst reports available to the public.	No independent source of performance data available.	No public or independent source of performance data available.

Source: Modified from: Allen Kenney, "Choices, Choices, Choices: Investors Have More Ways to Buy and Sell Real Estate than Ever Before," *Real Estate Portfolio*, March-April 2008, pp. 35-40..

Exhibit 3

Structure of nontraded REIT business and regulatory relationships, showing money flows, organizational structure, and regulatory structure



compared to those who do not hold for such a long term. The information in the report should be a resource for anyone contemplating investment in hotels through one of these programs and for anyone contemplating hotel real estate fund sponsorship as a nontraded REIT. Herein, we profile Apple, CNL, and Inland REITs.

Institutional Detail

As far as we know, this is the first professional and academic report to analyze the nontraded REIT structure. Consequently, we provide in this section some essential details about how these businesses operate.[4] As shown in Exhibit 3, the ownership entity is embedded in a complex network of relationships with service providers and regulators. The chain that connects REITs to investors is our main inter-

[4] No mention of nontraded REITs was found in the following reviews of the academic REIT literature: J.B. Corgel, W. McIntosh, and S.H. Ott, "Real Estate Investment Trusts: A Review of the Financial Economics Literature," *Journal of Real Estate Literature,* Vol. 3, No. 1 (1995), pp. 13-43; and E.N. Zietz, G.S. Sirmans, and H.W. Friday, "The Environment and Performance of Real Estate Investment Trusts", *Journal of Real Estate Portfolio Management,* Vol. 9 No.2 (2003), pp. 127-165.

est. This chain begins with the establishment of an in-house broker-dealer affiliate that develops contractual relationships with national and regional managing dealers, such as A.G. Edwards.[5] Local financial planners acting as soliciting dealers for national and regional broker-dealers then sell investment programs of nontraded REIT sponsors to mostly individual investor clients of financial planners. Prior to agreeing to sell their investment programs, managing brokers typically acquire due diligence reports from third-party companies that inform about the capability, competency, and integrity of nontraded REIT sponsors.

Individuals invest as little as $1,000 after being given the prospectus prepared by the nontraded REIT. The number of dollars actually invested in hotel real estate out of the $1,000 is net of the fees owed to the network, including the in-house broker-dealer. For example, a 10-percent fee, which is not atypical, results in $900 invested in the real estate. Again, investment programs qualify as securities and therefore must conform to requirements set by the SEC.[6] Additionally, the actions of broker-dealers in their relations with the public must conform to North American Securities Administrators Association (NASAA) requirements, and fall under the regulatory power of the National Association of Securities Dealers (NASD). External advisors—usually subsidiaries of nontraded REITs—carry out day-to-day operations including relationship management with regulators, attorneys, and accountants.

Nontraded REIT prospectuses contain language about how companies will exit the arrangement to provide investors with a return of capital. Sometimes the prospectus gives a specific date ("on or before"). In other instances the language gives nontraded REITs considerable flexibility for this exit. As shown in Exhibit 2, any of the following four discrete exit events could occur: private market liquidation of properties, exchange listing, IPO as the combination of exchange listing with public capital infusion, or merger or acquisition. In all cases, management hopes to capitalize on a favorable private-market-to-public-market arbitrage opportunity late in the investment period. In 2007, for example, CNL Hotels and Resorts did just that. At the height of the private equity investment cycle, CNL's board approved a partial sale to a private equity fund sponsored by Morgan Stanley Real Estate, with other assets sold to Ashford Hospitality Trust. CNL Hotels and Resorts is profiled in the box on page 11.

[5] Similar broker-dealer networks are now used in the U.S. to facilitate tax-free exchanges through tenant-in-common (TIC) funds. For an overview of TIC investment, see: Michelle Napoli, "TIC Business Booms," *Real Estate Forum*, February 2005.

[6] A landmark U.S. Supreme Court case in 1946 established that an investment in real estate in which the profit to investors is determined by the activities of a promoter constitutes a security. See: *SEC v. Howey Co.*, 328 U.S. 293 (1946).

Investor Appeal and Criticisms

Logic suggests that the sizeable flow of equity capital moving into nontraded REITs occurred because these investment programs contained features appealing to individual investors. The features cited as being attractive to investors include the following.

High dividend—Nontraded REITs promise an annual dividend of between 6.0 percent and 7.75 percent based on capital contributed. During recent years, this dividend payout ratio far exceeded the dividends offered by other investment programs available through financial planners. As we show in later in this report, the hefty dividend promise resulted in nontraded REIT payout ratios exceeding 100 percent of funds from operations (FFO), while listed REIT payout ratios equaled approximate 70 percent of FFO during the same periods.[7]

Collateral—Individual investors receive no guarantees that dividend payments will continue throughout the planned investment period. However, they recognize that their money is placed in assets with an active secondary trading market should liquidation become necessary.[8] Also, the continued growth of sponsoring companies sends investors a signal of increasing financial strength.

Return of capital—Despite restrictive share-redemption policies, having a planned exit written into the prospectus provides assurances to investors that sponsors will return capital upon exiting the investment.

Fixed share prices—Nontraded REITs offer a vehicle for individual investors who want to invest in institutional grade hotel real estate without the volatility of publicly traded REITs.

Critics contend that the the benefits of nontraded REITs come at considerable cost. The critics typically cite the following expenses as disadvantages of investing in nontraded REITs.

Selling, service, and acquisition fees—The selling, service, and acquisition fees paid to nontraded REIT sponsors and dealers are typically in the range of 10 percent to

[7] Funds from operations (FFO) is the way in which the REIT industry typically records earnings or net income. This calculation is made without a deduction for depreciation. The REIT industry claims that such deductions would reduce earnings by too much relative to companies without as many highly valued depreciable assets, thus making REITs comparatively less attractive investments from an earnings perspective.

[8] Nontraded REIT prospectuses shown to investors often contain pictures and financial performance statistics for large, high quality properties previously purchased by the nontraded REIT. Direct investments in quality properties for a little as $1,000 would be well beyond the means of most individuals in the absence nontraded REIT and TIC programs.

Nontraded Hotel REIT Profiles

CNL Hotels and Resorts

CNL Hotels and Resorts, Inc. (formerly known as CNL Hospitality Properties, Inc.), was a nontraded REIT located in Orlando, Florida, and part of CNL Financial Group, Inc. This company was founded in 1996 to lease properties across the United States to operators of limited-service, extended-stay, and full-service hotel chains and to operators of restaurant chains. As the second largest hotel REIT in 2006, CNL maintained 59 luxury, upper upscale, upscale, and mid-scale hotel properties in the U.S. (excluding 32 hotels held for sale) and one property in Montreal, Canada. In April 2004, CNL Hotels and Resorts registered with the SEC for an underwritten offering of common and preferred stock shares. Management abandoned this attempt at an initial public offering several months later citing poor market conditions.

In January 2007, CNL Hotels and Resorts announced it would be acquired by Morgan Stanley Real Estate (a private equity fund). Coincidental to this transaction, CNL closed the sale of the held-for-sale hotels to W2005 New Century Hotel Portfolio, LP (an affiliate of Whitehall Street Global Real Estate Limited). The Morgan Stanley Real Estate deal, valued at $6.6 billion, was completed in April 2007 for outstanding common stock and assumption of outstanding debt at $20.50 per share in cash. With this transaction, Morgan Stanley Real Estate assumed a portfolio of eight luxury properties located throughout the U.S., including the Arizona Biltmore Resort & Spa, Ritz-Carlton Orlando, and Grand Wailea Resort Hotel & Spa. Concurrently, CNL sold the remaining 51 properties to Ashford Hospitality Trust, Inc., for approximately $2.4 billion. These properties included 24 full-service and upper-upscale hotels, and 27 premium select-service hotels.

At the end of FY 2006, CNL Hotels and Resorts, Inc., reported funds from operations of $132,188,000, an increase of 46.13% over FY 2005. It also had a FFO payout ratio of 117.65%.

Throughout the life of this nontraded REIT the company continued to pay shareholders a high dividend (managing a high FFO payout ratio) and exited at the peak of the property value cycle. The $20.50 per share paid by Morgan Stanley was approximately twice the original price paid by individual investors.

Inland American Real Estate Trust

Inland American Real Estate Trust, Inc., of Oak Brook, Illinois, is a nontraded REIT that is part of Inland Real Estate Group of Companies, Inc., which also include a publicly traded REIT (IRC). Inland American was founded in 2004 to acquire and develop all types of commercial real estate. Inland completed a public offering of stock in August 2005 by listing 500,000,000 shares of common stock at $10.00 per share, and 40,000,000 additional shares at $9.50 per share under its distribution reinvestment plan. Its second public offering commenced under the same terms on August 1, 2007. These listings essentially created a public REIT and the nontraded REIT that exists today. The shares of the public REIT have traded in the range of $15 to $17 since the initial listing, indicating a positive investment for initial shareholders. At the end of FY 2007, the Inland nontraded REIT portfolio consisted of eight multifamily, 61 industrial, 26 office, 546 retail, and 76 hotel properties. The lodging properties include hotels franchised by Marriott, Hilton, IHG, and Choice, totaling 10,411 rooms.

Inland's nontraded REIT real estate investment grew 206% from FY 2006 to 2007. Funds from operations grew 387%, from $48,088,000 to $234,215,000 from FY 2006 to 2007. The ratio of loans to assets rose from 1.75 in FY 2006 to 3.42 in 2007. For FY 2007, Inland American's dividend payout ratio was 435%.

Since the end of FY 2007 Inland made three large hotel acquisitions. First, Inland nontraded REIT completed the acquisition of RLJ Urban Lodging Master LLC, an affiliate entity of RLJ Development, LLC. In this deal, Inland paid $466.42 million in cash and assumed $429.14 million in debt and secured ownership of 22 full- and select-service upscale hotels, totaling 4,061 rooms. The properties, Hilton, Hyatt, and Marriott franchises, are located mostly in major urban areas, including Boston, Chicago, and Washington, D.C.

Second, Inland acquired Richmond-based Apple Hospitality Five for $14.05 per share, totaling $678.3 million. Apple Hospitality was composed of 28 extended-stay hotel properties (Hilton and Marriott franchises) with 3,717 rooms. Third, Inland took Raleigh-based Winston Hotels private by paying $15.00 per share and assuming $243.64 million in debt. Winston comprised 53 limited-service hotel properties (also Hilton and Marriott franchises) with 7,205 rooms.

15 percent of initial investments, a fee structure some critics view as excessive. Fitch, for example, shows that the average fee from a $10,000 investment in a nontraded REIT equals $1,358, while a dollar-equivalent trade in a comparable publicly traded REIT costs $29.95.[9]

Industry representatives counter with the argument that the costs of raising capital through broker-dealer networks exceed the costs of bringing in money through traditional channels.[10]

[9] S. Fitch, "Blind Faith," *Forbes,* September 1, 2003 (www.Forbes.com).

[10] For example, see: B. Johnson, "Let's Set the Record Straight on Nontraded REITs' Success," *National Real Estate Investor,* September 1, 2003 (letter to the editor).

The structure of nontraded REITs leads to perverse policies that produce dividends in excess of funds from operations.

Redemption policies and exit strategies—Nontraded REIT sponsors have come under criticism for restrictive redemption policies and vague prospectus language regarding exit strategies. The issue of exit strategies has been mitigated by such events as the timely sale of CNL Hotels and Resorts and the successful public listing of a portion of Inland Real Estate Company's commercial real estate portfolio. (A profile of IRC appears on the previous page.) This company made several important hotel property and company acquisitions during the past four years which it now holds in a nontraded REIT.

Fixed share prices—As we hinted above, fixed share prices are marketed as beneficial to investors as a way to avoid the volatility of publicly traded REITs. As we explain next, however, this policy of maintaining fixed share prices in companies that continually offer shares at the same or similar fixed prices throughout the investment cycle will have adverse consequences to investors who buy into programs early in the cycle.

Unintended Consequences of Fixed Share Prices

The emergence of nontraded REITs as highly visible participants in the commercial real estate markets may be the result of relatively small investors rationally responding to the attractive investment opportunities offered by these firms. We just mentioned the criticism from the financial press and executives of publicly traded REITs that nontraded REITs maintain high fees.[11] Less commonly heard is criticism that focuses on financial outcomes of the ongoing contractual relationship between individual investors and sponsors. We believe that those financial issues are more insidious than fees, as we explain next.

Nontraded REITs sell shares at a price of approximately $10 that either remains fixed or may be modestly adjusted throughout investors' holding periods. This feature differentiates nontraded REITs from publicly traded REITs, which can guarantee neither share price nor dividend payout. Inexperienced investors in particular may feel more secure with an investment that pays relatively high dividends and maintains a constant share price. As Fitch notes, the apparent advantage of a fixed price structure may instead represent a disadvantage to investors because they cannot share in the investment's appreciation unless the asset is liquidated or the company is sold.[12] Sharing among investors in future appreciation of property values in proportion to their initial investment lies at the core of this issue.

We argue that the fixed price feature of nontraded REITs potentially diminishes returns for investors who contribute capital early in the funding cycle, even considering dividend payout. Our financial economics model shows that a continuous investment opportunity at fixed share prices effectively transfers wealth to sponsors and soliciting dealers in the form of fees paid on the sale of shares to later-term investors. This contractual feature represents a flaw in the nontraded REIT structure. Although this wealth-transfer effect is moderated by the relatively high dividends, those payouts exacerbate the financial stress when nontraded REITs make payouts in excess of current cash flow. By contrast, should nontraded REITs elect to periodically mark share prices to market using either real estate appraisals (following commingled funds) or some other method, the nontraded REIT's business would continue without economically disadvantaging long-term investors.

Summary of Model Results

For those interested in the development of the financial economic model that forms the basis of our analysis, we refer to our article in *Journal of Property Investment and Finance*, which tracks returns for nontraded REIT investors through the ownership cycle assuming a fixed share price.[13]

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[11] See, for example: R.A. Smith, "Private Commercial REITs Get into the Game," *Wall Street Journal*, February 19, 2003, p. B12; R.A. Smith, "Questions and Answers about Private REITs," *Wall Street Journal*, March 19, 2003, p. B8; Fitch, *op.cit.*; C. Ostrowski, "The REIT Wars," *Real Estate Forum*, May 2004, pp. 60-66; and C. Farrell, "Private REITs Dividend Draw," *Business Week*, February 13, 2006.

[12] Fitch, *op.cit.*

[13] See: J.B. Corgel. and S. Gibson, "Real Estate Private Equity: The Case of U.S. Nontraded REITs," *Journal of Property Investment and Finance,* Vol. 26, No. 2 (2008), pp. 132-150.

Specifically, we examined how long-term investors—those who invested early in the life of the nontraded REIT—do in a market with property prices appreciating and one with property prices declining. In this report we give the results of our analysis.

We found that the long-term investors do not benefit in either type of market. Because the share price does not adjust with the changing fortunes of the property portfolio, returns to long-run investors are capped and fees earned by sponsors and brokers as subsequent investors sign up to enter the REIT come out of the returns that would otherwise have been earned by the long-term investors. Furthermore, even though long-term investors will not fully participate in the "upside" when property prices rise, they fully participate in the "downside" when property prices fall. Full downside participation occurs when the nontraded REIT sponsor must exit according to the investment agreement, property prices have fallen during the investment period, and the proceeds from the company listing or property sales are not sufficient to pay investors the entire fixed price for every share they own.

The comparatively large dividends paid to long-term investors over extended periods by nontraded REITs help mitigate the loss of upside opportunity from appreciation. However, we show that these dividend payouts are so high relative to dividends paid by publicly traded REITs that they cannot be sustained without placing nontraded REITs in financial distress.

Perverse Dividend Policy

How dividend policy influences the value of firms and cost of equity capital remains one of the more intriguing areas of financial economics. Because REITs operate under regulatory constraints regarding dividend payout, REIT data frequently are used in controlled experiments to test hypotheses related to corporate dividend policy.[14] Two studies specifically address differential dividend payout ratios among REITs. The first paper presents evidence that REIT payout ratios are highest when expected cash flow volatility is lowest, and, by the same token, payouts are lowest when cash flow volatility is highest.[15] Strong market fundamentals in recent years suggest low expected cash flow volatility and high dividend payout, but that concept does not explain why differences may occur between nontraded REITs' payouts and those of publicly traded REITs. The second study found that corporate performance explains dividend payout and yield.[16] That study showed that ineffective management with respect to producing share price growth instigates higher dividend payout to appease disgruntled investors.

We conclude that too little time has passed in the life of nontraded REITs for investors to effectively evaluate the effects of either cash flow volatility or the ability of management to increase portfolio values. Instead, we are left with an explanation that the dividend policies of nontraded REITs derive from motives related to rapid asset growth, system fee generation, and the need for a defense mechanism against wealth transfer created by the fixed-share price structure.

Empirical Evidence of Dividend Policy Distortion

Let's examine why nontraded REITs' structure leads to perverse dividend policies. These policies produce dividends well above those of comparable listed REITs, often in excess of 100 percent of FFO. All data come from SNL Securities and cover the three-year period 2003 through 2005.[17] We start with 2003 because prior to that time the nontraded REIT data were not considered adequate to form broad enough cross-sections by firm size and property type. The

[14] The REIT Modernization Act of 1999 changed the dividend payout requirement to 90 percent of taxable income from the previous requirement of 95 percent. Some publicly traded REITs payout more than 100 percent of taxable income, but typically do not payout more than 70 percent of FFO.

[15] M. Bradley, D.R. Capozza, and P.J. Seguin, "Dividend Policy and Cash-Flow Uncertainty," *Real Estate Economics,* Vol. 26 No. 4 (1998), pp. 555-580.

[16] C. Ghosh, and C.F. Sirmans, "Do Managerial Motives Impact Dividend Decisions in REITs?," *Journal of Real Estate Finance and Economics,* Vol. 32, No. 2 (2006), pp. 327-355.

[17] As mentioned earlier, nontraded REITs follow SEC reporting requirements despite not having publicly traded stock. Hence SNL is able to assemble data on these firms to track their performance.

Exhibit 4

Sample nontraded REITs

Company	Year Established	Sector	2005 Total Assets ($000)	2005 Regular Dividend
Apple Hospitality Five, Inc.	2001	Hotel	$413,447	$0.88
Apple Hospitality Two, Inc.	2001	Hotel	$638,176	$0.80
Berkshire Income Realty, Inc.	2002	Multifamily	$425,662	$0.00
CNL Hotels & Resorts, Inc.	1996	Hotel	$5,688,782	$1.10
CNL Retirement Properties, Inc.	NA	Health Care	$3,838,761	$0.71
Dividend Capital Trust Inc.	2002	Industrial	$2,057,695	NA
G REIT, Inc.	2001	Office	$887,499	$0.75
Inland Retail Real Estate Trust, Inc.	NA	Retail	$4,268,088	NA
Inland Western Retail Real Estate Trust, Inc.	NA	Retail	$8,085,933	$0.64
T REIT, Inc.	1998	Office	$48,322	NA
Wells Real Estate Investment Trust, Inc.	1998	Office	$4,398,565	$0.61

Note: REITs and selected characteristics as reported by SNL Securities.

Exhibit 5

Dividend payouts of nontraded REITs and shadow portfolios of listed REITs, 2003–2005

REIT Categories:	Nontraded REITs	Publicly Traded REITs: Sector	IPO Date	Small Size	Large Size
Number of REITs	11	41	23	17	30
2005	106.04%	73.12%	71.32%	66.06%	76.02%
2004	125.45%	73.74%	70.71%	61.51%	75.03%

Note: Percentages shown are based on funds from operations. Source is SNL Securities.

table in Exhibit 4 presents the sample of eleven nontraded REITs. All of these companies were started after 1995 and represent every major property type. Total asset size ranges from well under $1 billion to $8 billion. This list includes three hotel REITs: those being CNL Hotels and Resorts and two Apple Hospitality companies. (Details about the various companies launched by Apple appear in the box on page 15.)

The comparative analysis of nontraded REIT and listed REIT dividends during the sample period begins with the formation of four shadow portfolios. The first portfolio (sector portfolio) consists of forty-one listed REITs spanning every property type represented in the nontraded REIT sample. The firms were selected to achieve a balance by asset size. To eliminate age bias, we formed a second shadow portfolio (IPO portfolio) that includes twenty-three firms with IPOs after 1996. This portfolio also is balanced by property type and asset size. Finally, we assembled two similarly balanced portfolios of differing sizes (small size and large size). The small size portfolio has seventeen REITs with net asset values (NAVs) falling in the range of $400 million to $700 million and the large size portfolio consists of thirty firms with NAVs ranging from $1.2 billion to $3 billion.

Exhibit 5 provides comparisons of average dividend payout as a percent of FFO for the nontraded and listed REIT portfolios during 2003, 2004, and 2005. The dividend payout ratios for listed REITs fall within a normal range for REITs of between 60 percent and 75 percent.[18] Average payout ratios for the sample of nontraded REITs not only exceeded those of listed REITs by a sizeable margin, but were greater than 100 percent during all three years. This means that nontraded REITs paid out more in dividends than they received in cash flow over the three-year period in question. Logic dictates that such a perverse dividend policy is unsustainable.[19]

[18] Farrell, *op.cit.*

[19] An extension of the same analysis for 2006 and 2007 produced nearly identical results.

Nontraded Hotel REIT Profile

Apple REIT Companies

Apple REIT Companies, located in Richmond, Virginia, has launched several nontraded REITs during the past ten years. The series began with the initial capitalization of Apple Suites, Inc., in March 1999. Over a two-year period, with capital raised through the issuance of nontraded common stock, management acquired 17 Homewood Suites consisting of 1,922 suites in 12 states. Apple Hospitality Two was initially capitalized in January 2001. Two years later, Apple Hospitality Two merged with Apple Suites. The merged entity was sold to ING Clarion Partners in 2007 for approximately $877 million. Apple Hospitality Five was incorporated and capitalized in September 2002. Management began purchasing hotel properties totaling 28 Marriott and Hilton hotels, with 3,717 rooms. In October 2007, the company was acquired by Inland American Real Estate Trust for $14.05 per share. Four Apple REITs currently operate. Apple REIT Six has been the most active, having acquired 68 hotel properties during the past few years.

Nontraded REIT Apple REIT Six was formed to invest in hotels and other selected U.S. real estate. Initial capitalization and the first hotel acquisition occurred in 2004. At the end of FY 2007, the company owned 67 hotels acquired for $845 million. As an example, the company purchased a Hilton Garden Inn hotel in Roanoke Rapids, North Carolina, for $15.4 million in 2008.

Apple REIT Seven, Inc., is another nontraded REIT formed to invest in hotels and other selected real estate. The company began operating in May 2005 and acquired its first property in April 2006. By year-end 2007, the company owned 44 hotel properties in 17 states, with a gross purchase price of $773 million. In 2008, the company completed purchase of three hotel properties, with a gross purchase price of $79 million, in addition to entering into contracts for the purchase of four additional hotels.

Apple REIT Eight, Inc., is an nontraded REIT formed to invest in hotels, residential apartment communities, and other real estate in selected U.S. metropolitan areas. This company's first property acquisition occurred during November 2007. In FY 2007, Apple REIT Eight acquired six hotel properties totaling $85 million. During 2008, the REIT purchased 23 hotels for $311 million. During this period, Apple REIT Eight also entered into contracts for 24 additional hotels.

Nontraded REIT Apple Nine was formed in 2007 to invest in hotels, residential apartment communities, and other income-producing U.S. real estate. At the end of 2008, the entity held $504,000 in total assets and $493,000 in total liabilities. As of 2008, Apple REIT Nine held no properties and maintained no source of revenue. (From Apple REIT's website, www.applereitcompanies.com/aboutus.htm.)

Conclusion

Returning to the creation of REITs in 1960, the idea to provide federal tax-exempt status to business trusts that invest in commercial real estate became law due to the efforts of a diverse group of industry and government interests. Beyond the motivations of these groups to increase capital flows for real estate investment and rehabilitation was the intent of making available to individual investors certain advantages previously reserved for investors with greater resources. These advantages include diversification through pooling of funds, access to the benefits of professional investment advisors, and the ability to collectively finance properties of a scale that most individual investors could not undertake by themselves. As the REIT market matured, firms became larger and more public. Average investors seeking these opportunities found themselves in the public securities environment, which many found neither familiar nor completely trustworthy.

Recognizing that a segment of the investor population was not comfortable with prevailing commercial real estate investment options, sponsors of nontraded REITs reached individual investors through existing broker-dealer channels. The programs of nontraded REIT sponsors, therefore, directly align with the spirit of the original U.S. REIT legislation. In addition, these programs demonstrated substantial appeal as evidenced by the amount of capital flowing to nontraded REIT sponsors. We've noted that several nontraded REITs focused at least partially on making investments in hotel property. A subset of these companies currently provides opportunities for individual investors to own shared interests in and receive attractive dividends from nationally branded and independent hotels.

We have identified one structural flaw present in nontraded REIT investment programs—that being the fixed share price. The model solutions using a fixed-share-price assumption provide several insights. First, opportunistic, short-term investors participate only during appreciating real estate markets as the underlying value of shares rises above fixed share prices. Second, during periods of rising property values, opportunistic investors will buy shares as long as intrinsic share value exceeds fixed share price, driving long-term investors' profit to the level of dividends. As our model indicated, profits in excess of dividends are absorbed by participants in the broker-dealer network. Third, a high contractual dividend level does mitigate the wealth transfer away from long-term investors. As we said, a comparative analysis of the dividend payout behavior of listed and nontraded REITs during recent years reveals that nontraded REITs have paid dividends relative to FFO well in excess of listed REITs and also approximately 110 percent of their own FFOs. This perverse dividend policy follows from the fixed-share price structure adopted by these firms.

We want to emphasize that the basic structure of nontraded REITs has many desirable features that should be preserved, but we suggest modification of the fixed share price feature to limit investor conflicts. One possibility is the commingled fund, which forms a convenient parallel to nontraded REIT unit investment in commercial real estate.[20] Ennis describes the institutional arrangement as follows:

> In a straightforward process each asset in the commingled fund is appraised periodically. The value of the properties is then added together to arrive at the value for the fund. As properties change in value, the fund value is adjusted. Commingled fund values are quoted as if the properties were sold at appraised value (at least on average across the properties in the fund). … Intrinsic value is determined only by the asset appraisal methodology controlled by the fund manager.[21]

Analysts who follow publicly traded REITs use simple, low cost (relative to appraisals) NAV calculations to mark the values of REIT assets to market. Regardless of the approach taken, the nontraded REIT business model needs adjustment to avoid the undesirable consequences arising from fixed offer pricing.

[20] See: J. Fosheim, "Private REITs: Commingled Funds with a New Name," *Special Report*, Green Street Advisors, August 1995.

[21] J.L. Ennis "Real Estate Commingled Fund Valuation: Disconnected from the Public Markets," *Real Estate Finance,* Vol. 12, Winter 1996, p. 36.

Recommendations for Individual Hotel Investors Buying Shares in Nontraded REITs

We see no reason that individuals should avoid investing in nontraded REITs that own and operate hotels. These REITs offer appealing opportunities for individuals to become owners of shares in high quality real estate. Hotels performed well in recent years, allowing sponsors to pay investors large dividends and then exit and return capital with relative ease. We do not anticipate that the near-term future income productivity of hotels will equal that of the recent past, but hotels should continue to provide relatively attractive income streams. That said, the negative features of nontraded REIT investment, as outlined in this report, will likely persist. Consequently, we offer the following general and hotel-specific recommendations to guide individual investors.

General Recommendations for Investing in Nontraded REITs

- *Study the track record of the company and management*. Previous success certainly does not ensure future success, but experienced investment managers likely will not make major errors. Past performance regarding payment of dividends and exiting investments to return capital remain the most important considerations. Investors also should inquire from brokers about disputes between sponsors and investors, and search for any regulatory actions against nontraded REIT sponsors.
- *Read prospectuses*. The focus here should be on sections that discuss fees, dividend payment, return of capital, and risks.

Nontraded REITs offer appealing opportunities for individuals to become owners of shares in high quality hotel real estate.

- *Examine the fee structure*. Before investing money, investors should have a clear understanding of how much of their money will be invested in real estate and how much will be extracted for fees.
- *Review dividend payment policies*. Before investing money, investors should have clear understanding of conditions under which the sponsor can discontinue dividend payments.
- *Clarify exit strategies*. Before investing money, investors should have clear understanding of the language that describes the options available to the sponsor for selling real estate at the scheduled end point of the investment period.
- *Study tax regulations*. As with any investment, individuals should clearly understand the tax implications of nontraded REIT investments. For most investors, tax treatments are the same regardless of whether the REIT lists or does not list shares.
- *Evaluate holding periods*. The fixed share price allows investors to rest easy about day-to-day changes in share prices. However, as described in this report, investing early in the scheduled investment period exposes these investors to wealth transfer when real estate prices are increasing. Investors may consider the length of time the investment is open and if possible delay commitments until late in this period.

Specific Recommendations for Investment in Hotel REITs

- *Examine the sponsor's history*. The track record of the sponsor as a buyer and seller of hotels is critical to the individual investor's commitment decision to an nontraded REIT. Hotels are a special case of commercial real estate. Experience with office, retail, residential, and industrial real estate does not easily translate to hotel investment.
- *Evaluate performance*. If the nontraded REIT already owns some hotels, data presentations regarding occupancy and ADR will be informative about the ability of the sponsor to buy hotels and select managers. Investors should focus on financial performance trends, whether the statistics indicate if the hotels operate above the average for that market and competitive set, if the hotels are located in top markets, and if the hotels have affiliations with established national brands.
- *Critically assess promises and representations*. If this nontraded REIT has not yet acquired hotels, look carefully at what the sponsor promises.
- *Pay attention to management*. Investors should be concerned about who will manage the property (including reservations, expense management) and who will manage assets (including renovations tracking real estate market trends). ■

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