

Eyeing REITs for Growth

Investing in distressed commercial real estate could pay off if advisors screen the options carefully.

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It's not just obvious signs like abandoned strip malls or boarded up factories or office buildings. The severe turmoil in the financial markets produced an abundance of distressed commercial real estate. The broad range of properties includes many solid, growth-oriented investment opportunities - if approached carefully - for financial advisors and their clients.

Although many commercial buildings are still able to pull in significant lease income, revenue streams are not nearly as lucrative as they were prior to the recession. Amid a tight credit environment and a slow economic recovery, property owners have struggled to secure traditional forms of financing.

That means commercial real estate has become a tenant's market. But for investors willing to endure some risk, the opportunity for upside growth is significant. Assuming the economy continues to improve the next few years, it's anticipated that vacant space will be absorbed gradually in many markets, the balance between renter and owner will return to historical levels, and property values will rise.

FINDING OPPORTUNITIES

It is important for advisors to distinguish among the different levels of distress. It usually refers to some form of troubled financial condition causing issues for the owners. For example, an asset may not be generating enough cash flow to cover mortgage payments or an owner may not have the capital needed for improvements. Often, such difficulties can lead to property foreclosures, even though an asset may be desirably located and an attractive investment at the right price.

The financial and economic environment of the last few years has created obvious opportunities from which savvy investors are now profiting. But with economic statistics showing growth the past two years, what factors should advisors now consider when evaluating commercial real estate investment opportunities for their clients?

•**Growth.** With commercial real estate prices having become more attractive, there is significant potential for appreciation in many sectors. History shows the highest returns for diversified real estate funds occur during or shortly after a recession.

•**Inflation hedging.** Given the risk of inflation, commercial real estate, like other hard assets, can reduce the sensitivity of a client's portfolio to rising prices. Leases structured to include annual increases reduce the risk of inflation for property owners and investors.

•**Ability to manage risk.** No investment is risk-free, of course, but many commercial real estate asset sectors are priced at attractive levels due to the number of troubled properties in the overall market. Ultimately, the key factor in managing risk is buying the right asset at the right price.

FACING CHALLENGES

While it may be easy to explain the forces that have created growth opportunities, actually investing in real estate is not as simple. Real estate requires owners to be actively involved beyond the initial purchase. Here are a few challenges most investors face:

- **All real estate is local.** Regardless of the broader forces at play, the fate of any specific property is still tied to local conditions. Every market - and submarket - differs, meaning properties must be bought and managed with that understanding. This presents challenges to many advisors and clients who cannot devote sufficient attention to understanding their local commercial real estate market, let alone other markets.
- **Turning around a poorly performing property isn't easy.** It can be costly, time consuming and unpredictable. Like any investment, it is impossible to eliminate all uncertainties. Ultimately, an active real estate investment strategy is a full-time job. Partnering with real estate professionals is a more diversified and easier to manage strategy for growth-oriented investors.
- **An individual property may not have the borrowing potential to unlock all its value.** It may seem attractive to buy and improve a single building, then sell it years later and keep 100% of the profits, but many properties simply will not command enough borrowing capability to finance a turn-around. Access to other sources of capital often is required.

NEW USE FOR REITS

For advisors who have experience with REITs, both traded and non-traded, the idea of using them to provide growth in a client's portfolio may seem counterintuitive. REITs have long been used as an alternative to bond investments, providing income but at higher yields. Over the last decade, the number of REIT providers has grown (especially in the non-traded sector, where capital invested has grown more than tenfold), and some newer REITs have been formed to meet investment objectives beyond income.

Some REITs now invest based on a growth or a hybrid growth-and-income strategy. With capital appreciation in real estate coming through a mix of patience, professional management and access to capital, REITs have a number of distinct advantages.

Non-traded REITs are registered with the SEC, but their stock is not traded on an exchange and they typically access capital through broker-dealer networks. They are managed with a long-term perspective and typically operate with a seven- to 10-year planned life cycle. At that point, the REIT may go public and trade on an exchange, or may be liquidated.

There were 61 non-traded REITs with an estimated \$71 billion in assets at the end of 2010, and 15 new funds debuted last year, according to Blue Vault Partners, an Atlanta research firm that tracks non-traded REITs. Investors put \$8.1 billion into non-traded REITs last year, a 25% jump over 2009. Blue Vault estimates the non-traded REIT sector could attract \$10 billion this year.

NON-TRADED OPTIONS

How should an advisor choose among the many non-traded REITs now available? To start, evaluate an individual REIT against a client's goals and ask:

How much experience do REIT sponsors have? Many new companies have entered the space in recent years, but few firms have managed and taken multiple non-traded REITs through all stages of an investment life cycle. Advisors should review a sponsor's record of successfully completing liquidity events that yield strong returns for shareholders. Longevity and past performance should be key factors.

Do REITs' managers have adequate experience and knowledge in buying and managing assets across particular markets? This is especially important with more REITs looking for global investment opportunities.

How do REITs' managers approach financial management? The credit excesses that led to the financial crisis demonstrated that responsible financial management, including reasonable levels of leverage, are important to keeping REITs stable.

What are REITs' investment theses? There are a variety of REITs, some focused on particular asset classes (office or warehouse, for example), and others centered on specific geographies. Regardless, advisors should check to ensure that the managers diversify within their portfolio.

Commercial real estate can provide added diversification for investors. And current market conditions suggest now is the time to seriously consider them as an option for growth.

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