Private REITs – Not All REITs Are Created Equal

REAL ESTATE SECTOR REPORT

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If you have any questions, please contact a local Edward Jones financial advisor, or write to: Edward Jones,12555 Manchester Road, St. Louis, MO 63131.

There are important differences between public REITs that trade on a stock exchange, and private/nontraded REITs. We suggest clients consult with their financial advisor regarding any private and/or publicly registered nontraded REIT holdings. Edward Jones currently does not provide our clients with secondary market prices and/or assist in the sale or re-registration of private/nonpublicly traded REITs currently held outside of Edward Jones.

Private/Nontraded REITs

While many investors are familiar with publicly traded equity REITs, there are also a number of private and publicly registered nontraded REITs. While these private/nontraded REITs generally are required to meet the same rules and regulations as publicly traded REITs (including payout of taxable net income as a dividend), there are also important differences between public REITs and private/nontraded REITs. Several of the important differences between public REITs and private/nontraded REITs are highlighted below:

Liquidity – Publicly traded REIT shares are bought and sold on traditional stock exchanges, providing the investor with daily liquidity at a reasonable cost (stock-trading commissions). A number of private/nontraded REITs provide limited liquidity for investors. For example, several private/nontraded REITs offer share redemption programs where the private/nontraded REIT will repurchase shares from investors. However, these redemption programs typically limit the number of shares the private/nontraded REIT will repurchase in a given year, and many redemption programs set the repurchase price at a discount to the original issuance price. In addition, redemption programs are subject to revision and are often changed.

Market Scrutiny – Private/nontraded REITs are generally not subject to the same level of public disclosure as REITs traded on traditional stock exchanges. The different level of public disclosure provided by many private/nontraded REITs can reduce the ability of investors to react in a timely manner to news and developments. This is compounded by the absence of a liquid trading market, as highlighted above. Because investors in private/nontraded REITs often have limited ability to quickly sell their shares, we feel management teams at private/nontraded REITs are subject to a lower level of discipline and scrutiny from investors and industry analysts.

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Please see important disclosures and analyst certification on page 3 of the report.

Selling commissions, dealer-management fees, and offering expenses – When purchasing private/nontraded REITs, investors typically pay selling commissions and dealer management fees and often reimburse the REIT for offering expenses. The magnitude of these commissions, fees and expenses can be significant, often ranging from 9%-11% of the share offering price. For example, for every $100 invested in a private or nontraded REIT, often only $89 - $91 is invested in real estate, with the remaining $9 - $11 going to pay commissions, fees and expenses. Typically, the only trading costs incurred by investors purchasing publicly traded REIT shares are trading commissions.

Fees to affiliated entities – In many cases, private/nontraded REITs utilize affiliated entities to provide property and asset-management services to the REIT, resulting in additional fees for the sponsoring entity. Additionally, a number of private/nontraded REITs pay acquisition and disposition fees to affiliated entities; these fees are often in addition to real estate brokerage commissions. The vast majority of publicly traded equity REITs do not pay material amounts of fees to affiliated entities.

Transparency – Publicly traded REITs provide investors with quarterly earnings reports and 10-Q filings, and they also file 10-K and annual reports. Publicly traded REITs are also required to file 8-K reports whenever the company has updated information or news to share with investors; in most cases, these news items and events are also disseminated to the market via a press release. In addition, publicly traded REITs file annual proxy statements detailing the company's executive compensation policies and stock ownership of management and board members. Virtually all publicly traded REITs conduct quarterly earnings conference calls, which provide investors and industry analysts with the opportunity to gain additional insight into the REIT's recent operating results and management's strategy for the future. Finally, most publicly traded REITs participate in real estate industry conferences, allowing additional opportunities for investors and analysts to interact with company management.

While the publicly registered nontraded REITs are bound by the same disclosure requirements as public REITs, we note that private REITs are not required to provide the same level of disclosure as public REITs. Investors generally are not given regular updates on earnings, the balance-sheet position, executive compensation, and the properties owned by the private REIT. As a result, private REITs are typically not subject to the same level of investor and analyst scrutiny regarding their earnings, operations, executive compensation, and future strategy.

In addition to these issues, we note many publicly registered nontraded REITs have historically reflected the value of their common shares on investors' statements at the initial share offering price (which is typically around $10 per share) despite significant changes in economic and commercial real estate conditions. While we support efforts to compel publicly registered nontraded REITs to provide updated valuation information to investors, we believe this issue provides another example of a lower level of transparency of the publicly registered nontraded REITs versus the publicly traded REITs.

Timing of Real Estate Investments - Many private REITs raise the bulk of their equity capital by selling new common shares over a relatively short time period (often two to five years). As this new capital is raised from shareholders, the private REIT generally attempts to invest this capital as quickly as possible into assets that will generate income so the private REIT can pay dividends to its shareholders. We note this scenario can result in a private REIT investing a significant amount of its capital in a relatively short time period. If asset values are high when the private REIT is investing capital, this can result in the private REIT potentially investing at or near "the top of the market." If a private REIT invests the bulk of its capital at a peak valuation point, the private REIT (and its investors) could see a decline in asset values as prices decline.

In contrast, most publicly traded equity REITs enter the public markets with an existing portfolio of properties that were built and/or acquired over a number of years. In addition, most publicly traded REITs are constantly buying and selling assets, resulting in these REITs acquiring properties at different points in the real estate cycle. We would compare the investment activity at most publicly traded REITs to the concept of dollar-cost averaging in an investment portfolio - in other words, make investments at different points in the cycle to smooth out the peaks and valleys.

Insider ownership - In our analysis of public REITs, one area of focus revolves around the ownership of stock in the REIT by company insiders, including senior management and members of the board of directors. As a general rule, we prefer to see the insiders at

REITs own a significant number of shares in the REIT, because we believe the ownership of shares by insiders creates proper alignment of interests between company insiders and the REIT shareholders. In other words, both shareholders and company insiders could potentially benefit from decisions that positively impact the REIT. In contrast, our research has shown that many publicly registered nonexchange-traded REITs have limited insider ownership. In our view, this should be an area of concern for any investor considering an investment in a publicly registered nonexchange-traded REIT.

Minimum investment amount and net worth requirements – Investors purchasing shares in publicly traded REITs are generally not required to make a minimum dollar investment. Many private/nontraded REITs require investors to make a minimum initial investment. The amount of this minimum investment varies by company and can range from as little as $1,000 up to $50,000. A number of private/nontraded REITs also require prospective investors to meet minimum net-worth thresholds.

Summary

In addition to publicly traded REITs, there are also a number of private and publicly registered nontraded REITs. While these private/nontraded REITs are generally required to meet the same general rules and regulations as publicly traded REITs, there are also important differences between public REITs and private/nontraded REITs. These differences include very limited liquidity compared with publicly traded REITs, high selling commissions, dealer-management fees and offering expenses, significant property and asset-management fees paid to affiliates of the private REIT, and less transparency and public market scrutiny compared with publicly traded REITs.

Analyst Certification

I certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers; and no part of my compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report.
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