The Impact of Nontraded REIT Fees on Shareholder Returns

While there is a lot of discussion around the presumed impact of the various fees charged by nontraded REITs during the stages of their lifecycle, in this article we have attempted to measure possible impacts on shareholder returns for a theoretical REIT by using a "sensitivity analysis."

Sensitivity Analysis

Sensitivity analysis is a useful tool that breaks the returns to shareholders into its component assumptions and shows how the average returns might vary as these underlying assumptions change. By conducting a sensitivity analysis we learn which assumptions about fees and other key variables in the financial performance of REITs have the greatest impact on returns to shareholders.

First, we construct a simple model of a REIT's financial performance. We build into the model many of the important fees that REITs pay to sponsors during their existence, using rates that are commonly observed in the industry. We change one assumption at a time by a small amount and measure the resulting effect on shareholder returns to illustrate how sensitive those returns are to different assumptions.

Before we review the results of our analysis, here is a quick refresher on the various fees charged by nontraded REITs.

Offering Stage Fees

From these two basic categories, Blue Vault has further delineated five sub-segments to allow more effective peer-to-peer comparisons. Each sub-segment — or "band" — is marked by certain capital raise and acquisition characteristics, as well as a specific debt profile.

Distribution coverage is generally 90% to 200% — much more palatable than in the earlier phases. Debt levels are a manageable 25% to 55%. Debt costs should be lower at this point, and the REIT will use a sophisticated blend of fixed and variable rate debt, secured and unsecured instruments, and senior debt and bonds. This debt structure should carry the REIT through the remainder of its life-cycle.

Selling Commissions – on average, investors pay 7% of the gross offering proceeds to dealer managers and their registered representatives.

Dealer Manager Fees – these fees range from 1.5% to 3% of the gross proceeds.

Marketing Costs – these fees typically range from 0.5% - 1.5%

As a result of these up-front costs, the actual dollars available to a nontraded REIT for investment in real estate may be 90% or less of the gross offering proceeds. Other things equal, a REIT's return on its shareholder's investment must overcome this initial handicap to be competitive with other investments with lower front-end transaction costs. For example, to provide investors in nontraded REIT shares with a 10% return by investing only 90% of the gross offering proceeds, the REIT managers must earn 11.1% on the net equity funds available for investment.

Operational Stage Fees

Acquisition Fees – Sponsors assess fees (typically 1% of transaction value) for services in acquiring portfolio assets. Additional acquisition expenses can total about 1.5% of purchase prices.

Asset Management Fees – This sponsor fee is usually based upon the book value of total assets owned by the REIT each quarter. These fees may range from 0.25% annually to 2.00%, with an asset-weighted average for the REITs covered by Blue Vault Partners of 0.79%. Comparable fees with other types of investments would be expense ratios of mutual funds (from 0.35% to 2.0%) and management fees assessed by financial advisors (0.5% to 2.0% annually).

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Liquidation Stage Fees

Liquidation/Disposition Fees – Some REITs pay the Advisor a fee for services in connection with the sale of properties. These fees may be based upon the brokerage commission paid. We used a beginning assumption of 2% of the transaction value in our analysis.

Internalization Fees – Internalization fees are those fees paid by a nontraded REIT to its Advisor when the board of directors makes the decision to "internalize" management and hire the staff necessary to manage the REIT without the services previously provided by the REIT's sponsoring firm. An internalization transaction usually occurs prior to a full-cycle event, and may be a signal that the REIT is planning to list its shares on an exchange. Many REITs have waived these fees recently.

Subordinated Participation Fees – Unique to nontraded REITs, these fees are paid to sponsors when certain return goals are met. They consist of a "hurdle rate" such as an average rate of return to common shareholders, and a "participation rate", a percentage of the excess returns above the hurdle rate that will be paid to the sponsor. We use a typical 8% hurdle rate and a 15% participation rate in our example.

Sensitivity Model - Beginning Assumptions

For our simplified "Sensitivity Model," we achieved the results in the table below using the following assumptions:

- Share Purchase Price = $10.00
- Annualized Distribution = 7.00%
- Holding Period = 7 years
- EBITDA* as a Percentage of Assets = 10%
- Annual Market Value Appreciation of Real Estate Holdings = 2%
- Portfolio Allocation = 100% in real estate assets, with a reinvestment of all depreciation in order to maintain a constant book value of the real estate portfolio
- Debt to Total Assets = 40%

As this analysis is hypothetical in nature, we note that any data presented here is for general discussion purposes only and does not correspond to a specific REIT or attempt to predict the annualized returns for the current universe of nontraded REITs.

Sensitivity Model – Interpreting the Data

On the first line below, the "base case" rate of return (IRR) is 9.93% which is the average compounded rate of return to common shareholders calculated using the assumptions above. On the next line, we show how the IRR would change if we decreased the financial advisor offering commissions by 1%. By doing this, we get a positive increase in returns of 0.21% and a multiplier of negative 0.21 which indicates the magnitude and direction of the impact on the average rate of return for a given change in the assumed value. A negative change in fees leads to a positive change in returns, hence a negative multiplier.

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Sensitivity Analysis

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	Average Return	Change	Multiplier	Timing
Base case IRR	**9.93%**			
1% decrease in total offering commissions rate	10.14%	+0.21%	-0.21	Up front
0.1% decrease in acquisition fees paid to sponsor	9.97%	+.0.4%	-0.40	Up front
0.1% decrease in other acquisition costs	9.97%	+0.04%	-0.40	Up front
0.25% decrease in asset management fees	10.27%	+0.34%	-1.36	Annual
1% increase in EBITDA as a % of assets	11.18%	+1.25%	-1.25	Annual
0.1% decrease in average interest rate on debt	9.98%	+0.05%	-0.50	Annual
0.1% increase in annual appreciation rate for REIT assets 0.1%	10.02%	+0.09%	0.90	Annual
Decrease in liquidation fees rate	9.95%	+0.02%	-0.20	At full-cycle
Total waiver of internalization fees	9.96%	+0.03%	0.03	At full-cycle
Lowering hurdle rate on subordinated participation by 1%	9.89%	-0.04%	0.04	At full-cycle
Lowering sponsor subordinated participation rate by 5%	9.97%	+0.04%	-0.04	At full-cycle

🟧 **Highest impact** 🟩 **Lowest impact**

While it is often assumed that front-end fees and offering expenses have the greatest impact on long-term performance, what this analysis shows us is that operating metrics such as EBITDA*, asset management fees, and market appreciation of real estate assets, have more influence over annualized returns. In fact, as illustrated above, a decrease in the annual asset management fee has a greater impact on long-term performance. For example, for each 0.25% reduction in the asset management fee, average annual returns increase by about 0.34% per year while a 1% reduction in selling commissions only increases returns by 0.21% per year.

As it relates to improving shareholder returns over time, the top four variables that have the most influence include:

1. an increase in the earning power of real estate assets (EBITDA),
2. a reduction in asset management fees,
3. a reduction in up-front selling commissions, and
4. the selection of real estate assets that have the greatest potential for appreciation.

Conversely, fees that are assessed in the liquidation stage, such as internalization fees and subordinated participation fees, have the smallest impact on average shareholder returns.

While the analysis above is focused primarily on the traditional nontraded REIT design and the average fees charged by nontraded REITs on a historical basis, over the past two years the industry has begun to change the traditional fee model by introducing pricing structures that include a reduction in selling commissions and dealer manager fees. Over time, it is our belief that these innovations will play a key role in enhancing shareholder returns but will have the greatest impact when coupled with additional changes to operational costs and improved management of real estate assets.

**EBITDA is defined as "Earnings Before Interest, Taxes, Depreciation and Amortization." For nontraded REITs, this is net income with depreciation and amortization (non-cash expenses) added back. Blue Vault reports an "Adjusted EBITDA" which excludes acquisition expenses and impairments. REITs typically are not subject to US income taxes.*

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