What Are NAV REITs? Answers to Some Frequently Asked Questions

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This article answers frequently asked questions about net asset value real estate investment trusts.

Alternative investment vehicles raised a record $86.1 billion in 2021, according to Robert A. Stanger & Co., Inc., an investment banking firm focused on alternatives.[1] Stanger finds that non-traded real estate investment trusts ("REITs") were the largest component (42 percent) of the alternative investment market with $36.5 billion in 2021 fundraising. Stanger projects non-traded REITs will raise $45 billion in 2022.[2] Among non-traded REITs, most of the new capital is being raised by NAV REITs.

This article answers frequently asked questions ("FAQs") about NAV REITs.

WHAT IS AN NAV REIT?

An NAV REIT is a type of REIT that is not publicly traded on a stock exchange, regularly calculates and discloses the net asset value or "NAV" of its shares, conducts offerings of its stock at prices based on the NAV per share, and repurchases its shares of stock at prices based on the NAV per share. Typically, an NAV REIT will offer multiple classes of its shares with different fees, which vary for different investor types and share distribution channels.

The main benefit of an NAV REIT over a traded REIT is that the NAV per share tends to be less volatile than the share price of a traded REIT, which frequently will trade below or above NAV. For many investors and advisors, this relatively greater price stability enables NAV REITs to serve as a vehicle to reduce risk in a diversified portfolio. In addition, as discussed below, an NAV REIT is an investment vehicle that offers investors preferential tax treatment.

An NAV REIT is not a registered investment company, but in some ways operates like a registered investment company. Recently, a few public offerings have been launched by continuously offered, closed-end registered investment companies that elect to be taxed

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REITs, continuously offer shares at prices based on their NAV, and repurchase their shares pursuant to quarterly tender offers. For the purposes of this article, we do not consider these companies to be NAV REITs, but we do discuss the pros and cons of that alternative structure in the last FAQ below.

WHY DO NAV REITS CHOOSE TO BE REITS?

A real estate investment trust, or a REIT, is an investment vehicle that primarily invests in real estate. It enjoys preferential tax treatment provided certain requirements are satisfied.

Specifically, a REIT is an entity taxed as a domestic corporation (e.g., a corporation[3] or a limited liability company ("LLC") that elects to be treated as a corporation). Corporations (including entities that elect to be treated as corporations) are generally subject to an entity level tax. However, by electing REIT status, such corporations or LLCs can generally avoid the corporate entity level tax provided they annually distribute all of their income and gain to their stockholders and satisfy certain other requirements.

Therefore, like limited partnerships ("LPs") and LLCs that are taxed as partnerships and typically favored as investment vehicles for private equity real estate investors, REITs offer their investors a similarly tax-efficient vehicle to invest in real estate that also avoids "double taxation" treatment. An added tax advantage of an REIT as compared to LPs and LLCs is that REIT investors enjoy simpler tax reporting. REIT investors receive a Form 1099 and do not need to deal with the complexity of a K-1.

CAN NAV REITS BE PRIVATE COMPANIES?

NAV REITs can be public or private companies. If an NAV REIT only offers its shares in private, unregistered offerings and does not register its shares under Section 12(g) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"),[4] it will remain a private company and avoid the significant auditing, reporting and compliance costs of being a public company. This may be a good option for sponsors when launching a new NAV REIT if they believe the REIT can raise sufficient capital without having to make offers to unaccredited investors. Once the private NAV REIT is large enough to bear the burden of the expenses of being a public company without significantly diluting its NAV, it can pursue a public offering and raise more capital by offering shares to unaccredited investors.

For sponsors who can support the NAV REIT in its early stages or rapidly raise capital, a public offering launch may make sense. It is typical in the current market for new public NAV REITs to have large minimum offering requirements, such as $150 million, before they will break escrow to ensure the company will have at least that much capital to make its first investments. Sponsors will typically offer financial support as well, which may include one or more of the following:

- Advancing all organization and offering expenses (other than sales commissions) through the first year of the offering, with reimbursement occurring afterwards over a period of 60 months;
- Waiving management fees for the first six months or more;

- Making a significant investment in the company;
- Warehousing assets for the company;
- Making credit available on attractive terms; and/or
- Paying wholesaling costs incurred by the dealer manager (this is discussed more below).

These support measures are important because without them, the expenses of conducting a public offering, being a public company and acquiring a portfolio would dilute the NAV per share for early investors. To help with this issue, NAV REITs may also state in their NAV policies that acquisition and/or offering expenses will be reflected ratably over a few years for purposes of calculating the NAV, rather than all at once as may be required under generally accepted accounting principles ("GAAP").

CAN AN EXISTING NON-TRADED REIT BE CONVERTED INTO AN NAV REIT?

A number of private and public non-traded REITs exist that are not currently NAV REITs. Typically, these non-traded REITs raised capital in offerings with a fixed price per share (such as $10 or $25) that did not change throughout the offering, have not yet calculated an NAV per share or are calculating it only once per year, and planned on offering stockholders liquidity at some point in the future through a sale, listing or liquidation, rather than offering significant liquidity through a robust share repurchase program. These companies may determine that it is appropriate to convert into an NAV REIT, and a few have successfully done so. Sometimes, the board of directors may make this decision on behalf of the company without stockholder approval. However, if the company's charter has a liquidation date or other provision that would prohibit conversion to an NAV REIT, or if the company wants to pursue a public NAV REIT offering but its charter does not have the charter provisions that will be required by states in connection with a public NAV REIT offering (discussed in the penultimate FAQ below), stockholder approval may be required.

One major advantage of converting an existing non-traded REIT to an NAV REIT, as opposed to launching a new NAV REIT from scratch, is that the company may already have sufficient size and scale to support the costs of being a public NAV REIT. However, a potential disadvantage is that many legacy stockholders may wish to exit the company though the share repurchase program. If the demand for liquidity is greater than the expected capital raise, then the company may struggle to meet share repurchase demand without shrinking.

HOW ARE NAV REITS MARKETED AND SOLD?

NAV REITs are marketed and sold through a dealer manager, which in turn enters into agreements with participating broker-dealers, registered investment advisers, and other partners with direct access to clients. In a public offering, the dealer manager will be responsible for seeking and obtaining a "no objections" letter from the Financial Industry Regulatory Authority ("FINRA"), which is necessary for brokers to participate in a public offering. The dealer manager will also employ wholesalers, who are critically important to promote the offering with financial advisors at

participating broker-dealers. As discussed above, many sponsors of NAV REITs today pay for these wholesaling costs without reimbursement from the REIT.

Some sponsors may not have their own affiliated broker-dealer and may hire a third party to act as the dealer manager for an offering. However, there are many advantages to a sponsor having their own captive broker-dealer and most successful sponsors have formed their own. One of the main advantages of having a captive broker-dealer is having a dealer manager that is 100 percent aligned with the interests and goals of the sponsor, which can be critically important in promoting the offering. Furthermore, using a third-party broker-dealer adds another entity that needs to be compensated, hurting the economics of the offering. Captive broker-dealers typically are not revenue generators for the sponsor; their purpose is simply to facilitate the distribution of the sponsor's offerings, which indirectly leads to higher advisory fees for the sponsor.

WHY DO NAV REITS HAVE MULTIPLE SHARE CLASSES?

NAV REITs offer multiple share classes for the benefit of distribution partners (e.g., participating broker-dealers, registered investment advisers, and other offering participants). Different share classes can be structured with different types and amounts of upfront and/or ongoing (trailing) compensation. Those differences may then be allocated among the applicable classes by adjusting their dividends and/or NAV relative to other classes. As a simple example, imagine that a REIT pays brokers one percent of NAV per year on Class T shares held by their clients as a trailing commission, whereas it pays no trailing commission on its other share classes.[5] As the REIT pays that expense, it must allocate it specifically to Class T stockholders, as a group, to prevent any of the REIT's other stockholders from bearing that expense. The REIT may lower the Class T dividends and/or Class T NAV per share, relative to the other classes, to allocate the expense.

Historically, such arrangements raised REIT qualification concerns for NAV REITs due to the potential application of the "preferential dividend rule." However, the Protecting Americans from Tax Hikes Act of 2015 (the "PATH Act") repealed the preferential dividend rule for "publicly offered REITs." The term "publicly offered REITs" includes NAV REITs that are required to file annual and periodic reports with the Securities and Exchange Commission ("SEC") under the Exchange Act. Therefore, the multiple share class structure described above no longer raises REIT qualification concerns for public NAV REITs. Private REITs continue to be subject to the preferential dividend rules.

HOW ARE THE PURCHASE AND REPURCHASE PRICES CALCULATED?

Typically, the purchase price for shares in an NAV REIT offering is the most recent NAV per share plus the upfront commission, if any. The repurchase price through the share repurchase program is generally equal to the most recent NAV per share, though there may be a small discount applied if the shares have not been held for at least a year (to deter short-term trading).

WHY DO SOME NAV REIT SHARE CLASSES CONVERT INTO OTHER CLASSES?

The share classes that convert are classes that are subject to ongoing trailing commissions. Most brokers are comfortable with those trailing commissions ending when the total upfront and trailing commissions equals 8.75 percent of the gross proceeds from the sale of shares. The conversion formula typically provides that if an investor has paid a total of 8.75 percent in upfront and trailing commissions on the shares held in the account, the shares will convert to a class with no trailing commissions.

When that happens, the REIT no longer pays the trailing commission, the broker no longer receives the trailing commission, and the investor is no longer subject to the trailing commission expense allocation. Shares with trailing commissions may also convert to a class with no trailing commissions if the company lists its shares of common stock on a securities exchange for trading, if the company is sold, or if the FINRA limits on underwriting compensation with respect to the offering are reached.[6]

HOW IS THE NAV PER SHARE FOR EACH CLASS CALCULATED?

The only rules that govern how an NAV REIT must calculate the NAV of the company's shares are FINRA rules applicable to broker-dealers participating in the offering. Under FINRA Rules 2310 and 2311, for a broker to participate in an NAV REIT public offering and include the NAV per share on customer account statements, the NAV per share must be:

- Based on valuations of the assets and liabilities of the company performed at least annually, by, or with the material assistance or confirmation of, a third-party valuation expert or service; and
- Derived from a methodology that conforms to standard industry practice.

This affords NAV REITs some flexibility in determining the frequency of valuations, the role of third-party valuation expert(s) and the methodology of valuing assets and liabilities. For example, some NAV REITs value shares daily, some monthly and some quarterly. They may also have differing schedules and processes for valuing the company's underlying assets. Some ask their third-party valuation experts to value properties, some ask for confirmation of reasonableness of property values prepared by the REIT's advisor and some merely discuss reasonableness with them. There can be quite a number of variations in approaches.[7] Within the flexibility offered by the FINRA rules, sponsors must consider what NAV methodologies make the most sense for the company and will be most trusted by due diligence reviewers and investors.

After an NAV REIT calculates the NAV of the company as a whole, it must calculate the NAV of each class. Class-specific expenses will cause the NAV per share of some classes to decrease relative to others, unless the dividends of such class are adjusted (i.e., lowered) relative to other classes in order to keep the NAVs of each class the same.

WHAT ARE THE REQUIREMENTS AND LIMITATIONS OF THE SHARE REPURCHASE PROGRAM?

No rule requires an NAV REIT to make any

amount of liquidity available for share repurchases. However, as a practical matter, it is critically important for an NAV REIT to have a robust share repurchase program to give investors confidence that they will be able to exit when they wish to do so. An NAV REIT without a functioning share repurchase program will struggle to raise capital.

There are generally two factors that determine how much liquidity an NAV REIT can provide under a share repurchase program: (i) how much liquidity the NAV REIT can provide before the SEC will consider the share repurchase program subject to issuer tender offer rules, and (ii) how much liquidity the NAV REIT can afford to provide.

With respect to the first factor, when a public company offers to buy its own shares, that activity may amount to an "issuer tender offer" requiring compliance with Rule 13e-4, which is more costly and burdensome than operating a share repurchase program. Under guidance from the SEC in a series of "no action" letters, generally the maximum amount of liquidity an NAV REIT can provide without being subject to Rule 13e-4 is five percent of the company's NAV per quarter.[8]

With respect to the second point, NAV REITs are clearly motivated to keep their share repurchase programs operating at full capacity so that current and future investors have confidence in the ability to exit. Some NAV REITs may provide a "liquidity sleeve" of some sort (this could be an allocation to liquid securities, access to a line of credit, or a combination of the two and other cash resources) to give investors confidence that there will be liquidity for repurchases, but a liquidity sleeve is not required. All NAV REITs disclose that many of their assets are illiquid and that there may be times that the REIT is not able to satisfy all repurchase requests. The board of directors can always refuse to repurchase shares if it is in the best interests of the company to do so. Share repurchase programs do not guarantee liquidity to stockholders.

ARE NAV REITS PERPETUAL LIFE PROGRAMS?

NAV REITs do not have to be perpetual life programs, but generally that is their intention. As discussed above, the initial ramp up for NAV REITs is costly and requires sponsor support because they do not yet have the scale of public companies. Once they get sufficient scale, they are an extremely efficient way for investors to enter and exit a non-traded REIT investment across market cycles. Of course, if another exit opportunity presented itself, the board of directors could pursue to it.

WHAT IS THE PROCESS OF REGISTERING AN NAV REIT OFFERING?

A private NAV REIT offering can be launched quickly, without the need of registering with the SEC and the states (discussed below) or obtaining a "no objections" letter from FINRA.

To register a public NAV REIT offering, a Form S-11 registration statement must prepared and filed with the SEC, audited financials must be obtained and a registration fee must be paid. In addition, all non-traded REITs in a public offering, including NAV REITs, must comply with the SEC's Industry Guide 5, which contains a number of special disclosure requirements for non-traded REITs. While Industry Guide 5, by its terms, applies only to real estate limited partnerships, in 1991 the SEC

stated that "the requirements contained in the Guide should be considered, as appropriate, in the preparation of registration statements for real estate investment trusts and for all other limited partnership offerings."[9]

In 2013, the SEC published specific guidance for non-traded REITs regarding its views on what is required to comply with the disclosure requirements of Industry Guide 5, in "CF Disclosure Guidance: Topic No. 6." Topic No. 6 is essentially a collection of all the SEC's views on Industry Guide 5 requirements that were previously issued to non-traded REIT registrants through comment letters.

Some of the special requirements of Industry Guide 5, as supplemented by Topic No. 6, include:

- Disclosures about upfront expenses of the offering, the estimated use of proceeds, and compensation and expense reimbursements to the sponsor;
- Disclosures about conflicts of interest;
- Disclosures about the prior performance of the sponsor (this can be difficult to prepare);[10]
- Disclosures regarding the share repurchase program;
- Undertakings regarding updating the registration statement and prospectus throughout the continuous offering; and
- Requirements regarding sales literature used to promote the offering.[11]

Once filed (or submitted confidentially), the process of registering an offering on Form S-11 with the SEC can be expected to take a few months before the SEC is prepared to declare the registration statement effective. However, the process with the states will take longer, as described below.

NAV REIT offerings registered on Form S-11 are continuous offerings made pursuant to SEC's Rule 415. Under Rule 415, the offering registered on a Form S-11 registration statement can generally continue for up to three years, or when the amount of registered shares is fully sold, whichever comes first. Thus, NAV REITs must periodically file and transition to new registration statements on Form S-11 to continuously offer shares publicly.

While an NAV REIT is offering shares pursuant to any particular Form S-11 registration statement, a variety of SEC rules require regular updates to the information in the prospectus and registration statement through supplements and amendments, including financial statement requirements for significant acquisitions by the NAV REIT. Complying with these rules requires constant vigilance and work throughout the offering.

With respect to FINRA, for a public offering on Form S-11, the dealer manager must obtain a "no objections" letter. This requires a filing fee and information about the underwriting compensation and selling arrangements to be submitted to and reviewed by FINRA. This process can also be expected to take a few months. If a dealer manager must be formed by the sponsor, then time must be budgeted for that process.

The longest part of the registration process of a public NAV REIT offering is the "blue sky" registration process, or the registration with all the states. Because an NAV REIT is not

traded, it is not exempt from state securities law registration rules.[12] Therefore, a public NAV REIT offering must be registered with all states in which the issuer wishes to offer shares. This process involves many registration applications, filing fees, comment letters and other paperwork. It can be a time-consuming process and requires experienced counsel to guide the company through it most efficiently.

Many states require compliance with the Statement of Policy Regarding Real Estate Investment Trusts, as revised and adopted by the North American Securities Administrators Association membership on May 7, 2007 (the "NASAA REIT Guidelines"). As a practical matter, all NAV REITs must comply with the NASAA REIT Guidelines. The NASAA REIT Guidelines contain numerous requirements and limitations, most of which must be contained in the company's charter, including:

- Suitability standard requirements for investors;
- Requirements regarding independent directors;
- Restrictions regarding leverage, fees and expenses;
- Restrictions regarding certain types of investments, such as investments in joint ventures, equity securities and mortgage loans;
- Special provisions addressing conflicts of interest; and
- Requirements regarding annual reports to stockholders.

Certain states may also impose concentration limits, such as that an investor may not invest more than 10 percent of their net worth in the NAV REIT and other non-traded REITs sponsored by the same sponsor. Generally, states will require renewals of a registration in their jurisdiction every year. Therefore, it requires ongoing work to keep the offering compliant with blue sky requirements, even after initial effectiveness.

WHAT ARE THE PROS AND CONS OF THE CONTINUOUSLY OFFERED, CLOSED-END REGISTERED INVESTMENT COMPANY ALTERNATIVE TO AN NAV REIT?

As discussed at the beginning of this article, a few sponsors have recently launched or have filed to launch offerings that are very much like NAV REIT offerings, except that the issuer is a continuously offered, closed-end registered investment company under the Investment Company Act of 1940 (a "closed-end fund") that has elected to be taxed as a REIT. Unlike an open-end registered investment company, these closed-end funds are not required to buy back their shares. However, they seek to offer liquidity through tender offers for up to 5 percent of the outstanding stock each quarter, which is similar to the liquidity offered by NAV REIT share repurchase plans described above.

The main benefits of this structure are:

- Unlike NAV REITs, registered investment companies may conduct a public offering that is exempt from blue sky registration, which allows them to avoid the requirements of the NASAA REIT Guidelines, state-imposed concentration limits for investors and annual registration with states.

- Unlike NAV REITs, which require purchasers to complete a subscription agreement with representations about minimum net worth, minimum income, concentration limits and other matters, registered investment companies may be purchased much more simply through electronic platforms.

The main drawbacks of this structure are:

- Unlike NAV REITs, closed-end funds may generally not have more 33.33 percent leverage at the entity level. They may achieve greater leverage through property-level debt that is non-recourse to the closed-end fund and may enter into investment management techniques that have similar effects as leverage without being subject to the foregoing limits. NAV REITs have much more flexibility with respect to leverage, as they are allowed up to 75 percent leverage under the NASAA REIT Guidelines or even more if the independent directors believe there is substantial justification for it.

- Unlike NAV REITs, registered investment companies are generally prohibited from engaging in transactions with an affiliated person, sponsor or distributor, such as selling or buying any security or other property or borrowing from or loaning money to the fund. The NASAA REIT Guidelines generally permit such transactions with independent director approval.

- These closed-end funds are prohibited from charging a performance fee on the basis of a share of capital gains upon or capital appreciation of a fund; they may charge a performance fee based on the net income of the fund or may choose not to charge a performance fee. The NASAA REIT Guidelines are more flexible, allowing true performance fees to be charged as long as the total operating expenses of the NAV REIT during any four fiscal quarters do not exceed the greater of (a) 2 percent of its average invested assets (measured at cost) or (b) 25 percent of its net income. This limit may be exceeded if the NAV REIT's independent directors have made a finding that, based on such unusual and non-recurring factors as they deem sufficient, a higher level of expenses is justified.

NOTES:

[1]Press release from Robert A. Stanger, dated January 25, 2022, "2021 Alternative Investment Fundraising Hits $86.1 Billion, More than Triple the 2020 Total; Blackstone Raises $25 Billion for BREIT and $14 Billion for BCRED."

[2]Press release from Robert A. Stanger, dated February 24, 2022, "Investment in Alternative Assets Totals $10.5 Billion in January; Non-Traded REITs Post $3.7 Billion In Fundraising; Non-Traded BDCs Add $3.2 Billion In Fundraising."

[3]Most corporation REITs are formed in Maryland because Maryland law affords REITs relatively broad protection from liability, a fairly easy process by which bylaws can be amended, fairly strong protection against hostile takeovers, and relatively flexible stockholder voting procedures.

[4]A company must register under Section 12(g) of the Exchange Act if a class of its equity securities (other than exempted securities) is held of record by either (i) 2,000 persons, or (ii) 500 persons who are not accredited investors and, on the last day of the issuer's fiscal year, its total assets exceed $10 million.

[5]Note that a trailing commission may be calculated using the NAV of shares sold both through the primary offering and through the dividend reinvestment plan.

[6]FINRA rules limit total underwriting compensation to 10 percent of the gross proceeds of the offering. For purposes of this rule each Form S-11 registered offering by the NAV REIT is a separate "offering" for which the underwriting compensation and gross proceeds must be monitored.

[7]One source (though not an exclusive one) for what

is "standard industry practice" (as stated in the FINRA rule above) is the Practice Guideline 2013-01, Valuations of Publicly Registered Non-Listed REITs, issued by the Institute for Portfolio Alternatives ("IPA") in April 2013. This guideline was primarily developed for non-traded REITs that only value their shares once per year; NAV REIT valuations are largely consistent with it, but NAV REITs tend not to follow every aspect of the guideline.

[8]There are a few no-action letters that allow the five percent to be measured on a "net" basis, meaning only repurchases that exceed new share sales during the period are counted.

[9]Securities Act Release No. 33-6900 (June 25, 1991).

[10]Prior performance information of the sponsor may not be required if the issuer is large enough and has a sufficient operating track record.

[11]The SEC has published specific guidance for the preparation and use of sales literature in non-traded REIT offerings in "CF Disclosure Guidance: Topic No. 3." Many states also have specific rules about sales literature and may require that issuers submit them for review prior to their use. FINRA has also published guidance for broker-dealers on communications with the public concerning non-traded REITs, which is applicable to sales literature, in FINRA Regulatory Notice 13-18. These sales literature requirements will apply continuously while the NAV REIT is offering shares.

[12]Shares that are listed on national securities exchanges (such as the New York Stock Exchange or NASDAQ) are "covered securities" under the Securities Act of 1933, as amended, that are exempt from blue sky registration. Similarly, private placements to accredited investors under Rule 506 of Regulation D are "covered securities" that are exempt from blue sky registration.