DIRECT INVESTMENTS SPECTRUM

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"NON-LISTED REITs BUOY SECONDARY MARKET"

The limited partnership secondary market, which also involves trading in limited liability companies and non-listed real estate investment trusts (REITs), is like a Timex watch: *It takes a licking and keeps on ticking.*

When publicly-registered limited partnerships began liquidating in droves in the second half of the 1990's, prospects for the secondary market, where interests in non-listed investments have been bought and sold since the 1980's, looked awfully bleak. Indeed, trading volume in this market began to nosedive after this market peaked in 1996. By the time 2001 rolled around, it seemed that this market was headed towards a place called oblivion.

But then along came the non-listed REIT phenomenon that has raked in approximately $42 billion of investor capital since these investments burst onto the scene in 2002. Though non-listed REITs are still relatively few in number compared to the number of partnerships that change hands in the secondary market, they have made a big impact on trading volume, much to the delight of the independent firms that comprise this informal market.

For the two-month period covered in the "Secondary Spectrum" section of this issue of *Direct Investments Spectrum*, transactions involving shares of non-listed REITs accounted for almost 25% of the total trading volume for this period of $8.7 million. This is particularly noteworthy in that shares of only 15 non-listed REITs changed hands during this period compared to 129 limited partnerships and limited liability companies.

For the two-month period of October and November 2007, secondary market trading in non-listed REITs was even more predominant. During this period, transactions involving shares of 11 of these companies accounted for 52% of total trading volume. This is music to the ears of secondary market players.

Non-listed REITs are routinely among the most actively traded investments in the secondary market in terms of dollar volume. With respect to the transaction data reported in this issue, three of the top eight investment programs in trading volume are REITs, and six of the top fourteen. Likewise, for the prior two-month trading period, four of the top six investment programs in trading volume were REITs.

The most actively traded non-listed REIT in terms of both number of transactions and trading volume is far and away Inland Western Retail Real Estate Trust which completed its last public offering in September 2005, having raised some $4.2 billion in two offerings. Trading volume in these shares for the two-month period reported in this newsletter was just over $1 million which accounts for more than 10% of total secondary market volume for this period and about half of total trading volume for REITs. It's worth noting that these shares consistently trade at a premium to their original offering price. Although this REIT has a share repurchase plan for investors desiring liquidity, these shares typically fetch higher prices in the secondary market.

Inland Retail Real Estate Trust had been the most actively traded REIT in the secondary market until it was purchased by Developers Diversified (NYSE:DDR) in February 2007. This liquidation was a major blow to this market as trading volume in these shares was very high. For instance, during the two-month period of August and September 2006, transactions in these shares exceeded $4 million. For the prior two-month period, this figure was over $3 million.

Piedmont Office Realty Trust, formerly known as Wells Real Estate Investment Trust, is the second most actively traded non-listed REIT in the secondary market. This company completed its last public offering in July 2004 after raising a total of $4.7 billion in four offerings. Trading volume in these shares was about $267,000 during the two-month trading period covered by this issue, down from just over $1 million in the previous two-month trading period.

Secondary market trading in the shares of Piedmont jumped in 2007 after the company suspended its share repurchase program while the board considered listing these shares on the NYSE, raising capital in a firm commitment offering and making the company self-advised. The company did become self-advised in 2007, but abandoned listing its shares and raising more capital due to market conditions. After shareholders approved a proposal to extend the company's list-or-liquidate deadline to January 30, 2011, the board announced that share repurchases would resume at the end of December. Unless the company reaches the maximum for such repurchases, secondary market trading volume in these shares will likely decline in 2008 relative to 2007 as liquidity-minded shareholders tap the REIT's share redemption program.

The "Corporate Property Associates" series of non-listed REITs sponsored by W.P. Carey & Co. are also consistently among the most frequently traded programs in the secondary market in terms of dollar volume. Buyers like the "CPA" REITs because of their consistent dividend yields and W.P. Carey's enviable track record of taking its
non-listed REITs and limited partnerships "full cycle." The fact that these shares are priced at lower yields than most non-listed REITs says a lot about how secondary market buyers regard these companies.

PREMIUM PRICES

It's no coincidence that four of the most actively traded REITs in the secondary market are routinely priced at premiums relative to their original unit sizes. These include Corporate Property Associates 14 and 15, Inland Western Retail Real Estate Trust and Piedmont Office Realty Trust. (In the case of Corporate Property Associates 14 and Piedmont Office Realty Trust, each company's original share price of $10 has been adjusted down to $9.55 and $8.38, respectively, due to special liquidating dividends paid to these shareholders).

The higher the prices at which shares of non-listed REITs trade, the better this is for the secondary market. To be sure, this market stands to gain when shares of these companies change hands at prices that exceed their stated redemption values. When this happens, shareholders wanting liquidity are more likely to sell their shares in the secondary market rather than back to their REIT. This assumes, of course, that the secondary market price is sufficiently higher than the redemption price so as to cover transaction costs such as commissions and transfer fees related to selling in this market.

During the two-month trading period covered by this newsletter, shares of six non-listed REITs changed hands in the secondary market at average prices that exceeded their respective redemption prices. They include Corporate Property Associates 14, 15 and 16, Inland American Real Estate Trust, Inland Western Retail Real Estate Trust and Piedmont Office Realty Trust. The company with the largest "spread" between its average trading price and redemption value is Corporate Property Associates 14. While this "spread" is relatively small for most of these companies - especially when secondary market transaction costs are factored in - at least this gives shareholders another option for obtaining the highest possible price for their shares.

When secondary market prices for a REIT's shares are competitive with the price offered under its repurchase plan, this alleviates some of the pressure under these plans which are typically limited to only 2% to 5% of a REIT's outstanding shares being redeemed in a twelve-month period. At these buy-back levels, it doesn't take many redemption requests to max out a REIT's share repurchase plan. When this happens, as it has for some of these companies, liquidity-minded investors have only two options: selling in the secondary market or waiting until their REIT resumes redeeming shares. The longer a REIT suspends the repurchase of shares, the greater the backlog of redemption requests becomes. This scenario inevitably results in higher secondary market trading volume in these shares.

To be sure, any time a non-listed REIT either maxes out or suspends its share redemption plan, the secondary market benefits. A share repurchase plan can quickly max out when a REIT reports some sort of negative news such as a dividend reduction which can spur redemption requests by nervous investors. Fortunately, non-listed REITs have reported very little "bad" news thus far. This could change, of course, if the economy slumps to the point commercial real estate is adversely impacted.

An outright suspension of a share redemption plan - especially if it's because a REIT is experiencing problems - can also spur secondary market trading in the company's shares. In this regard, Desert Capital REIT, a mortgage REIT that has recently experienced a high number of loan defaults, has announced that it will stop repurchasing shares. It will be interesting to see how many of these shareholders make their way to the secondary market to sell their shares.

A FAIR SHAKE

The drop in share prices of listed REITs over the past year has been well documented. According to NAREIT, the national trade association for REITs, share prices for publicly-traded, equity-based REITs fell 19% in 2007. This was followed by an additional 5% decline in the first two months of this year as investors dumped financial stocks. Even equity REITs reporting markedly higher Funds From Operations (FFO) - the primary benchmark upon which analysts value these companies - were thrown under the bus by investors. All in all, equity REIT share prices dropped 27% in the twelve months ending February 29, 2008.

At the same time, secondary market prices for non-listed REITs have not experienced anything like what has happened to listed REITs in terms of pricing volatility. This is noteworthy since one of the key selling points used by sponsors of non-listed REITs is that investors in these companies are not subjected to the volatility of the stock market which has driven investors nuts over the past year. Not only is there zero volatility in the share prices of non-listed REITs because they are not publicly-traded, neither is there any volatility to speak of in the secondary market where these shares change hands.

In fact, one could argue that secondary market buyers of non-listed REITs are giving sellers a very fair shake relative to today's pricing of listed REITs. Consider, for instance, that Inland Western Retail Real Estate Trust is being priced in the secondary market at a dividend yield of 6.1%. At the same time, Inland Real Estate Corporation, a listed REIT trading on the NYSE under the symbol "IRC", was trading

at a dividend yield of 6.5% as this newsletter went to press. And not only is Inland Western being priced at a lower distribution yield compared to Inland Real Estate Corp., it is being priced at a much higher FFO multiple. So much for disparaging the secondary market for taking advantage of investors wanting liquidity.

In terms of the dividend yields at which shares of non-listed REITs changed hands in the secondary market during the two-month period covered by this issue, the average was 7.0%, with a range of 6.1% to 8.8%. This compares to the current average dividend yield for publicly-traded, equity-based REITs of about 5.0%.

Dividend yields for non-listed REITs are generally higher than for listed REITs since non-listed REITs pay out a much higher portion of their FFO than do listed REITs. Indeed, most non-listed REITs trading in the secondary market pay dividends that equal most or all of their FFO, and sometimes more. At the same time, the average dividends-to-FFO ratio for publicly-traded, equity-based REITs is about 70%.

With this in mind, here's a look at the pricing of non-listed REITs in the secondary market compared to their publicly-traded counterparts owning generally the same types of real estate (Note: Dividend yields for listed REITs are based on closing prices as of March 14, 2008):

OFFICE REITs	Dividend Yield
Behringer Harvard REIT I	7.4%
Hines Real Estate Investment Trust	7.2%
Piedmont Office Realty Trust	6.9%
Wells Real Estate Investment Trust II	6.6%
Average	7.0%
15 Listed Office REITs	6.0%

INDUSTRIAL REITs	Dividend Yield
Dividend Capital Total Realty Trust	7.4%
Average	7.4%
7 Listed Industrial REITs	6.6%

HEALTHCARE REITs	Dividend Yield
Grubb & Ellis Healthcare REIT	8.0%
Average	8.0%
10 Listed Healthcare REITs	6.8%

SHOPPING CENTER REITs	Dividend Yield
Inland American Real Estate Trust	6.6%
Inland Western Retail Real Estate	6.1%
Average	6.35%
15 Listed Shopping Center REITs	5.8%

DIVERSIFIED REITs	Dividend Yield
CNL Income Properties	6.7%
Corporate Property Associates 14	6.3%
Corporate Property Associates 15	6.1%
Corporate Property Associates 16	6.5%
Average	6.4%
8 Listed Diversified REITs	6.7%

FREESTANDING RETAIL REITs	Dividend Yield

Cole Credit Property Trust II	8.8%
Average	8.8%
4 Listed Freestanding Retail REITs	7.1%

The bottom line is that non-listed REITs are being priced very fairly by secondary market buyers relative to the pricing of listed REITs. One could even argue that non-listed REITs are being overpriced in the secondary market compared to current pricing of listed REITs. Regardless, this is good news for investors in non-listed REITs, especially if the secondary market is their only liquidity option. While share repurchase programs have functioned well enough to meet most of the liquidity needs of shareholders in non-listed REITs so far, it's important to realize that these programs can max out or be terminated altogether at a moment's notice.

Another observation is that, while listed REITs are priced primarily based on FFO multiples, non-listed REITs trading in the secondary market seem to be priced based upon dividend yields more than anything else. This means that, as dividends go, so goes the secondary market pricing of non-listed REITs. It also means that secondary market buyers of shares in non-listed REITs that are paying dividends exceeding FFO may get burned if this doesn't change over time.

The non-listed REIT phenomenon arrived just in time for the secondary market which was drying up due to limited partnership liquidations. As these companies "age", this will likely result in a growing number of these investors finding their way to the secondary market to get liquid. When they do, this market will be ready and able to accommodate their desire for liquidity. And every indication thus far is that these sellers will receive a fair price for their shares. ■