More than 15 years ago, on behalf of an internationally recognized financial services firm, Goodwin created the first open-ended non-traded REIT structure that allowed for regular sales and redemptions at net asset value ("NAV REIT"). That NAV REIT offering was cleared with federal and state regulators but was unfortunately shelved on the eve of the Great Recession, and it has taken well over a decade for this structure to become well established. Today, with Blackstone Real Estate Income Trust raising staggering amounts of capital, NAV REITs are dominating the non-traded REIT space. While the basic NAV REIT structure has not changed significantly since it was first developed, there is currently some variation in product design in the space, and there is room for more variation and improvement. This alert looks briefly at the history of NAV REITs, some of the features of NAV REITs currently in the market, and potential new features to improve upon the structure that may be implemented in the future, particularly with respect to the liquidity feature that is central to its appeal to a wide range of investors.

**NAV REIT HISTORY**

**Non-Traded REITs Before NAV REITs**

When non-traded REITs were first introduced in the 1990s, they typically shared the following characteristics:

- their shares were offered at a fixed price for the duration of a continuous offering (usually 2-3 years), often an arbitrary $10 or $20 per share, whether an investor bought on the first day or the last day of the continuous offering period;
- their shares were generally sold with upfront selling commissions of 7% and dealer manager fees of 2%-3%;
- redemptions were limited to up to 5% of the weighted average number of shares outstanding during the prior 12 months and often reflected either arbitrary or penalizing valuations to discourage redemption requests save for hardship situations; and
- they were designed as finite-life vehicles with a life of 5 to 9 years at which time they would seek a liquidity event.

Due to high upfront loads, illiquidity, cycle-dependent life with arbitrary deadlines for exiting, and other features that hampered growth in net asset value ("NAV") absent dramatic cap rate compression, traditional non-traded REITs were not appealing to large swaths of investors. Rather, it is often said that they were “sold not bought” in reliance on a capillary network of brokers and financial advisors for distribution to largely retail investors as a tool for adding “core” real estate exposure to their investment portfolio. Although a number of REITs continue to sell shares with this basic structure, the sales of traditional non-traded REITs now represent a fraction of the total sales in the non-traded REIT space.

**Creation of the First NAV REIT**

As noted above, early in the 2000s, Goodwin worked with a client to pioneer a fundamental evolution in the structure and operation of non-traded REITs designing the NAV REIT to introduce more investor-friendly and institutional-quality features, including:
• frequent and systematic valuations to establish and disclose NAV on a regular basis, but with less volatility than had come to characterize exchange-listed equity REITs;
• enhanced opportunity for liquidity via regular redemptions at NAV per share at a time chosen by investors;
• open-end (indefinite-life) structure; and
• lower and simpler selling fees, including no-load shares, and a streamlined management fee structure.

The initial focus on enhancing the features of this new product class has continued uninterrupted since – from a bold idea on a whiteboard back then to a robust architecture embraced by the market today. See the Goodwin alert “Evolution of the Non-Traded REIT Industry and the Benefits of Perseverance,” dated February 28, 2012, for more information on the history of NAV REITs.

CURRENT NAV REIT FEATURES

Today NAV REITs are sponsored by a mix of traditional non-traded REIT sponsors, relatively new entrants to the space such as Blackstone, and other large investment managers and real estate investment firms. Although all NAV REITs currently being offered have the core features that were part of the original NAV REIT structure -- (i) frequent and systematic valuations to establish NAV on a regular basis, (ii) enhanced opportunity for stockholder liquidity via regular redemptions at NAV per share, (iii) lower and simpler all-in fees, including no-load shares, and (iv) indefinite life -- there is some variation in product design.

NAV

NAV is typically determined and published on a daily or monthly basis based in part on valuations provided by independent third parties, often on a rolling basis where every asset is appraised on a rotating cycle. For those NAV REITs that use a daily NAV, shares are available for purchase on each business day. For purchase orders that are received prior to the close of business on any business day, the purchase price per share of each class is the NAV per share for such share class for that day, plus applicable upfront selling fees (which typically vary by share class to suit different segments of the investor population), as calculated after the close of business on that day. As a result, at the time an investor submits a purchase order, they will not know the exact price at which the order will be executed. This is similar to the way mutual fund shares are priced. For NAV REITs that use a monthly NAV, shares are available for purchase on a monthly basis. The purchase price per share of each class will typically be the prior month’s NAV per share for such class as of the last calendar day of such month, plus applicable upfront selling fees.

Redemptions/Liquidity

Subject to the aggregate redemption limits discussed below, for those NAV REITs that use a daily NAV, redemptions typically can take place on each business day and the per share redemption price is determined in a manner consistent with share purchases. Similarly, for those NAV REITs that use a monthly NAV, redemptions typically can take place on a monthly basis and the per share redemption price is determined consistent with sales. Most NAV REITs also subject redemptions to short-term trading discounts (e.g., if the shares are held for less than a year, they will be redeemed at 95% of NAV per share).

Aggregate redemptions by stockholders are typically allowed up to 5% of NAV per calendar quarter. For some NAV REITs, if redemptions, net of proceeds from sales of new shares, for a calendar quarter do not reach the 5% limit, the unused portion will be carried over to the next quarter subject to certain limits. The redemption feature is not required by law and can be completely suspended at the discretion of the NAV REIT if it is deemed to be in the best interest of the NAV REIT and its stockholders.

There are differences in how redemptions are handled if the redemption limit is reached in a period. For some NAV REITs, in the event that the redemption limit is reached during a period or the NAV REIT determines to
repurchase some but not all of the shares submitted for repurchase during any period, shares submitted for repurchase during such period will be repurchased on a pro rata basis. All unsatisfied repurchase requests must then be resubmitted after the start of the next period. For other NAV REITs, if net redemptions in a quarter reach the 5% limit, then proration is applied to open redemption requests on the day the limit is reached, but no other redemption requests for the rest of the calendar quarter are accepted and all stockholders have equal access to the following quarter’s redemption pool. In this structure, NAV REITs begin accepting redemption requests again on the first business day of the next quarter, but will apply the 5% quarterly limitation on redemptions on a per-stockholder basis, instead of a “first-come, first-served” basis so as to dampen the risk of a “run-on-the-bank” scenario -- particularly where larger stockholders or stockholders acting on a group basis under the advice of investment advisors might cause pressure to build very quickly in the new cycle. In this “flow-regulated” system each stockholder will be ensured the ability to redeem an equal portion of its investment as of the last business day of the preceding quarter at any time during the in-process quarter. The per-stockholder limit remains in effect for the following quarter if total net redemptions reach a certain threshold during the quarter, thus, in effect, continuing the “dampening” effect for so long as available liquidity remains constrained relative to demand for liquidity.

Share Classes

Following changes in REIT qualification requirements, today most NAV REITs offer multiple classes of common stock which are usually distinguished from each other by the amount and timing of the payment of upfront selling fees and ongoing “distribution fees” that are charged on a trailing basis on each class. This structure is designed to replicate the “a-la-carte” offering by many actively managed pooled investment vehicles where investors are able to select the blend most suited to their strategy of front-end loaded versus back-end loaded fees. The bespoke fee structure results in a different NAV per share even though proceeds from the sale of shares of all classes are invested in a single portfolio of assets with no differentiation as to access to liquidity. Although different names for the classes are used by some NAV REITs, the most common naming convention is Class S Shares, Class T Shares, Class I Shares and Class D Shares.

Class S Shares and Class T Shares are typically available through brokerage and transaction-based accounts with Class S Shares having higher upfront selling commissions than Class T Shares and similar ongoing stockholder servicing commissions as Class T Shares but no dealer manager fees. Class T shares will have lower upfront selling commissions than Class S Shares but unlike Class S Shares have an upfront dealer-manager fee. Class D Shares are generally available for purchase only through fee-based programs, also known as wrap accounts. Class D Shares have lower upfront selling and stockholder servicing fees than Class T Shares and Class S Shares and do not pay dealer manager fees. Class I Shares are typically available to institutional investors and wrap accounts that meet certain higher minimum investment requirements and have no class specific fees.

Most NAV REITs will also cap their total upfront selling commissions, dealer manager fees and stockholder servicing fees on shares at 8.75% and in connection with reaching that limit those shares will automatically convert to into a number of Class I Shares with an equivalent NAV as such share. Additionally, shares of other classes will automatically convert into a number of Class I Shares with an equivalent NAV as such share on the earliest of certain events such as a listing or merger.

Open-Ended

NAV REITs are all open-ended/indefinite-life vehicles. Some NAV REITs have provided a time frame (e.g., seven years after launch of the program) at which time they may consider a liquidity event, but they are under no obligation to do so under their charter or otherwise. Therefore, redemption at a time chosen by each investor is the mechanism on which investors can count on to achieve liquidity.
THE NEXT FRONTIER: A BETTER LIQUIDITY FEATURE

With a variety of institutions contemplating entering the non-traded REIT space and sponsoring NAV REITs, we expect to see more variation in the NAV REIT structure going forward. This is especially true around liquidity, meaning differentiation in the redemption feature among different classes to better match availability of liquid assets to fund redemptions with the expected timing of redemption requests. This matching would be done without the disruption of suspensions, queuing or gating.

Redeemable shares represent an interest in an illiquid portfolio of real estate assets, so liquidity cannot be a guarantee, but it surely must be more than an aspiration. Access to liquidity at a time of each investor's choosing must rest on a robust foundation that minimizes the risk of a liquidity crisis given the unpredictability of inflows and outflows. That foundation must include: (i) a layer of liquid assets to bridge a temporary mismatch between inflows and outflows, (ii) access to committed liquidity lines of credit if the imbalance persists in the short term, (iii) if pressure from foreseeable redemption requests builds up in the medium term, sufficient runway to evaluate liquidating real estate assets in an orderly manner, and (iv) enough visibility to pursue a strategic exit in the long term via a merger or liquidation.

Each one of these features can be measured using two parameters: cost and time. In a perfect structure the two would be blended in a continuous, seamless curve to reduce volatility, minimize impact on total return to stockholders, and ensure maximum reliability of the redemption feature. Unfortunately, not unlike the moon, when it comes to liquidity NAV REITs have two sides: one is lit up (daily or monthly access to redemptions at NAV), the other one is dark (shut downs of redemptions). NAV REITs have never had to deal with the dark side because liquidity has been plentiful since the first NAV REIT launched its offering. So far the cost of liquidity has been amortized over the entire equity capital structure, blended into operating expenses without significantly depressing NAV. That being said, NAV REITs cannot pretend that they can enjoy the bright side of liquidity without preparing for the dark side. Short-term liquidity has a cost, either the opportunity cost of keeping extra cash-on-hand or charges for other liquidity buffers, both of which negatively affect total return and interfere with optimal portfolio construction. In the medium term, as more investors seek to access liquidity, possibly at an accelerating pace during times of stress, available liquidity is depleted, leaving a choice between increasing leverage to the extent unsecured or secured financing is available or forcing unanticipated sales of assets. In the longer term a shut-down of redemptions may be the only way to protect the balance sheet. Each of these phases of a liquidity squeeze pose difficult challenges for sponsors and directors, who are charged with protecting the interests of all investors, rather than allowing those investors who run for the exits first to harm those who are patient or unaware of building pressure.

One does not have to look far to be reminded of how dangerous the dark side of liquidity can be: the open-ended property fund sector in the United Kingdom has been under severe pressure for a number of years because liquidity is mandated by law for all investors and waves of excessive redemption requests (most notably following the Brexit referendum) have forced shut-downs of redemptions. The Bank of England recently published its Financial Stability Report and the key item of focus in that report was the risk posed by the liquidity mismatch between the redemption features offered by open-ended property funds and their often illiquid assets. A lot of applied and theoretical analysis has been done to come up with a “better way” to handle liquidity stress, using many different combinations of pricing (NAV discount, bid-ask spreading) and gating. The UK policy debate continues, with low likelihood of a solution, let alone a perfect one, being implemented soon. In the meantime, UK open-ended property funds are raising little new capital and are forced to keep astonishingly high percentages of their assets in cash to safeguard access to redemptions. The dark side is very dark indeed…
Over its relatively short life, most of it lived on the light side of liquidity, the United States NAV REIT structure has experimented with a few devices to make liquidity stress bearable. As noted above, for some NAV REITs if net redemptions in a calendar quarter reach the redemption limit then those NAV REITs will begin accepting redemption requests again on the first business day of the next calendar quarter, but will apply the redemption limitation on a per-stockholder basis, instead of a first-come, first-served basis. Therefore, at any time during that quarter each stockholder will be able to redeem a portion of the stockholder's investment on the last business day of the preceding quarter. The per-stockholder limit will then remain in effect for the following quarter if total net redemptions reach a certain threshold during the quarter.

However, other NAV REITs are silent on (or choose not to acknowledge) the dark side and have less robust redemption programs in place and could potentially reward investors for being the first to seek redemptions before other investors are aware that there is a liquidity squeeze developing. Those redemption programs may also incentivize investors to seek a redemption during a liquidity squeeze so they at least get their pro rata share and that pro rata share would continue to shrink the more that investors line up to seek redemptions. All NAV REITs have the option of completely suspending redemptions, but they would most likely do so at a great reputational cost to the NAV REIT and its sponsor. As the UK open-ended property fund experience has shown, once pressure builds there are no safe choices: (i) shutting-down is a blunt instrument that shocks investors no matter how clear the disclosure of illiquidity risk was in offering documents; (ii) gating tools are never seen as treating all investors fairly and equitably; and (iii) pricing tools can be arbitrary and are fraught with unintended consequences. Surely the inevitable fact of life is that REIT shares represent an interest in an illiquid pool of real estate and some NAV REITs will be better equipped to address liquidity pressure in any given market cycle than others.

We have come to believe that there is a better way. The space program has shown that manned crafts can survive a trip to the far side of the moon if the engineering is right and the science rigorous. The non-traded REIT structure was created for a simple mission: to appeal to a single, relatively flat universe of investors served by networks of commissioned retail brokers paid within a “wash & repeat” closed-end fund structure. The NAV REIT structure has evolved to appeal to an increasingly diverse range of investors represented by a growing set of advisors executing different investment strategies. What if the NAV REIT classified share structure could be enhanced to offer investors not only a menu of selling load choices, but also a menu of liquidity options to produce a seamless liquidity curve that blends the cost and time parameters, rather than the current two-sided liquidity moon?

Many of the investors in NAV REITs do not want or need the ability to redeem their shares on demand – their time horizons are part of their capital allocation model. However, these investors are bearing a share of the cost of daily/monthly liquidity on demand, which inevitably means lower total returns as the NAV REIT either holds more liquid assets at a low yield to meet unexpected redemption request or subsidizes redemptions for investors with near term expectation of liquidity by making sub-optimal portfolio management choices.

What if each share class were divided into subclasses allowing for progressively longer notice requirements for liquidity via redemption and higher dividend rates for those less liquid share classes? For example, subclass X could allow for daily/monthly redemptions subject to current flow-regulation mechanisms (the “Liquid Shares”), subclass Y could allow for redemptions only to the extent that inflows or flow-regulation mechanisms allow (the “Tier Two Liquidity Shares”), and subclass Z could allow for redemptions only with a long notice period on an annual or bi-annual basis (the “Redemption Notice Shares”). Liquid Shares would offer the lowest dividend rate to account for the cost of on-demand liquidity as measured by the drag on returns of keeping cash available or the financing costs of liquidity lines. Tier Two Liquidity Shares would pay a higher dividend than Liquid Shares and that dividend rate would account for the foreseeable impact of rebuilding the liquidity buffer, including the cost of unplanned sales of assets to relieve pressure on the “ordinary” redemption queue if imbalance persists.
The dividend rate on the Redemption Notice Shares would be the highest because they provide the least drag on returns and the sponsor could manage the portfolio to provide liquidity if their request for access to liquidity comes with sufficient advanced warning. Each subclass could be exchanged for a higher or lower liquidity subclass on a forward basis, possibly with the same notice requirement of Redemption Notice Shares to prevent arbitraging. The same mechanisms in place for many NAV REITs to discourage frequent trading could be extended to prevent frequent exercise of the exchange feature to game the “staggered liquidity” structure. These structuring devices would allow NAV REITs to better anticipate the foreseeable volume of redemption requests, plan their liquidity buffers accordingly, and ultimately optimize asset management. Traditional non-traded REITs grew obsessed with quick exits to prevent being stuck as their “end-of-life” date approached. UK open-ended property funds are obsessed with sudden death from market trauma. NAV REITs are either uncomfortably planning for uncertain life expectancy or ignoring mortality altogether. Instead, like the Apollo astronauts, they should be confident that they will safely see the light side of the moon again.

The NAV REIT’s investor-friendly features have helped widen the appeal of non-traded REITs to new segments of the investing public and to new categories of financial intermediaries. Goodwin understands that developing innovative product design in the NAV REIT space is complicated — our first approach to the SEC many years ago was met with great enthusiasm (“this is a great structure to protect investors”) as well as stiff resistance (“how is the NAV REIT structure legal under the federal securities laws?”). We persevered, and ultimately succeeded in convincing the SEC of the legal viability of the NAV REIT structure. REITs in general and NAV REITs in particular sit at the intersection of federal and state securities regulation, the regulation of investment vehicles and their managers/advisors, and tax requirements. NAV REITs are complicated structures that require disciplined business and legal thinking, but with further improvements to the structure they can surely work better for investors in all market conditions to further widen their appeal.

Goodwin has also been at the forefront of working with clients that have utilized the NAV REIT structure to access the crowdfunding market through direct-to-investor sales using internet platforms. These platforms disintermediate the typical offering process and instead offer no-load investment opportunities generally combined with a reduced management fee structure that are publicly offered to both accredited and unaccredited investors utilizing the updated Regulation A rules (Regulation A+) or Section 506(c) of Regulation D (which allows general solicitation in private placements but only to accredited investors).
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