Coming off a disastrous 2016, sales of nontraded REITs could bounce back in 2017

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After a disastrous 2016, industry analysts and executives are cautiously optimistic that sales of nontraded real estate investment trusts will bounce back next year.

There are a number of reasons why sales of nontraded REITs, declined from nearly $10 billion in 2015 to $4.5 billion in 2016.

One was a new industry rule, known as 15-02 by the Financial Industry Regulatory Authority Inc., that increased pricing transparency for investors. But now financial advisers are growing more comfortable with REITs designed to counteract that rule. These REITs have different share classes and commission structures that pay the adviser over time rather than in one, large, upfront 7% commission that the standard A share pays.

Kevin Gannon, president and managing director of Robert A. Stanger & Co. Inc., said he expected a bump in REIT sales next year as advisers grow more familiar with REITs that have daily or monthly net asset values — NAVs — or lower upfront commission, as the new T shares do.

"It's an education process for advisers to go from selling an A share with a 7% commission to a T share, with 2%," he said.

Another factor that dampened nontraded REIT sales in 2016 was the Department of Labor's new fiduciary rule, which requires brokers and advisers to act in their clients best interest when giving retirement advice. One major independent broker-dealer, Commonwealth Financial Network, went so far as to eliminate paying advisers commissions for working with clients' retirement accounts. Nnontraded REITs are typically sold to retirees as a way to generate income.

With Donald Trump's election, speculation is mounting that the DOL rule could be repealed or at least postponed beyond its scheduled implementation in April.

Another reason for industry optimism is the entrance of Wall Street powerhouse Blackstone Group, which is marketing a $5 billion nontraded REIT. Blackstone's presence could bring greater legitimacy to a product that has been widely criticized for steep commissions and hard to understand fees that benefit management but cut into returns for investors.

"Next year, excluding the new Blackstone REIT, the industry could see $5.1 billion in equity raised and then $6.6 billion in 2018," said Mr. Gannon. "Adding Blackstone's REIT to the total could probably increase the total by another $2 billion in 2017."

"We're looking at 2017 as a growth year for REITs, both publicly registered nontraded REITs and private placement type offerings," said Mitchell Sabshon, president and CEO of Inland Real Estate Investment Corp. "We are very cautiously optimistic that the industry has rounded a corner. We have improved the structure of products. And there are new participants in the sector who we welcome and lend credibility to the importance of this space."

Mr. Sabshon noted that around half a dozen nontraded REITs have recently eliminated real estate transaction fees, a clear positive for advisers and their clients. "That's driven by sponsors competing with other products with lower fees in the short run and the enhanced likelihood of delivering performance in the long run."

Other industry players tempered their optimism for nontraded REIT sales in 2017, with the potential fallout for real estate investing in general caused by an overhaul in the tax code that is sure to be a priority for a Republican-controlled Congress and the new administration of Mr. Trump. Rising interest rates also make borrowing more expensive, potentially crimping REITs.

Will a new tax code eliminate the current deduction for depreciation of real estate assets over time? Will the 1031 exchange, which allows investors in real estate to defer capital gains taxes, be eliminated?

“By far the biggest story to follow and the potential game change in 2017 is what's going to happen with the tax code,” said Cedrik Lachance, director of U.S. REIT research at Green Street Advisors. “Congress is going to try to reinvent the tax code and that has implications for real estate, although the legislators won't be thinking about real estate.”

“I think you're going to see some modest increase in nontraded REIT sales, but it won't be to 2015 and $10 billion,” said Allan Swaringen, president and CEO of Jones Lang LaSalle Income Property Trust. “There could be a slowdown in the first part of year, with interest rates rising and the new administration.”

“Most of us are leveraged investors and the cost of that leverage has gone up recently 100 basis points. In the first quarter of 2017 it could be 150 basis points higher,” he said. “And the big story could be the Trump administration and tax reform. What will the impact be on commercial real estate?”

(More: Nontraded BDC sales sink like a stone in 2016)