

MarketWeek: To trade or not to trade

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The public markets have taken a very public beating over the last two years.

REITs have suffered even more than the broader markets. From the peak in February 2007 through March 5, the MSCI US REIT Index (RMZ) is down approximately 75%. Over that same period, the S&P 500 is down about 53%.

Given the volatility on the public side of the house, more and more attention is being paid to the public but nontraded REIT sector. Money continues to flow into nontraded public REITs from retail investors. Brian Jones, a director with Robert W. Baird & Co., said at a recent conference that the sector raised \$12 billion in 2007, and it is expected that it raised about \$10 billion in 2008.

Real estate investor Nicholas Schorsch is one industry participant who has decided that the grass really is greener on the nontraded side.

Schorsch got into the real estate game in the late 1990s buying office buildings and bank branches. Things really took off for him after he acquired 106 bank branches from First Union National Bank following the merger of First Union and CoreStates Financial Corp in 1998. Schorsch realized that it had taken CoreStates decades to amass the prime locations in towns throughout New Jersey, Pennsylvania and Delaware and that there was a real opportunity waiting for him in those properties.

"That was the beginning of American Financial Realty Trust," he told SNL in a recent interview. Schorsch served as CEO, president and vice chairman of American Financial Realty until 2006, taking it public in 2003 in the second-largest REIT IPO in U.S. history. The company eventually sold to Gramercy Capital Corp. in a deal that closed in April 2008, having dramatically underperformed the broader REIT indexes throughout its tenure as a public company.

Schorsch explained that the structure of American Financial caused confusion in the investor community, despite the fact that the REIT was exactly what it was billed to be. "We were a different breed in the industry," he noted. One-third of its portfolio was in net leases, one-third was in multitenant office "primarily leased to the core credit" such as Bank of America or Citizens Banks, and one-third was an opportunistic portfolio, comprising vacant and partially occupied properties. One gave growth, one gave stability and one gave both, he said.

"That was great in '05 and '04 and '03. After 2001, when the World Trade Center happened, the world was like it is today, very uncertain, very concerned. People wanted income," he said. American Financial Realty was paying 9.5% when it went public, and the dividend grew 18% over Schorsch's tenure as CEO.

"The fact is, that wasn't good enough for the public markets, because that was considered to be underperforming," he continued. "The public markets wanted you to be giving them 20%, 25%. ... A lot of companies gave 20%." Schorsch pointed out that over a five-year period ending in 2009, virtually every REIT has a negative yield including dividends.

Today, Schorsch is in the nontraded REIT space, having recently started American Realty Capital Trust Inc., which acquires and operates a portfolio of commercial real estate primarily consisting of single-tenant properties net leased to high credit quality tenants throughout the United States.

The nontraded REIT space, he said, is a truly retail business. "It's an illusion" that the public REIT space is a retail business, he said, because the same 15 or 18 funds own the majority of those REITs.

"Our business today at American Realty Capital and our REIT, which is a public nontraded REIT, is focused to provide the retail investor with the transparency of public company with predictable income and repeatable income and an investment strategy that is long term in nature," Schorsch said. "In the asset class that we're in, which is net leases, that's all you can do."

"You're not buying net leases to generate 25% annual IRRs," he continued. "This isn't the business for that, and it may not be appropriate in the public sector."

With American Realty Capital Trust, Schorsch is back to the bank branch and freestanding retail real estate business. "Basically we do anything that's on a corner," he said, explaining that the corner is his version of beachfront property, that irreplaceable site that everybody strives to get because it has traffic on both sides.

Most recently, the REIT announced in November 2008 that it acquired 50 bank branches triple-net leased to PNC Financial Services Group Inc. unit PNC Bank NA for \$42.3 million. Schorsch said retail banking is probably "the most profitable business in America right now, better than any other business including Microsoft." The Federal Reserve is charging a quarter of a point, and banks are lending out money for 6% to 7.5%. Banks, he said, are the grease that makes the country work.

"What I learned [back in '99] is what I'm learning again now, which is that model, it ain't broke. It's working fine," he said. "The retail bank businesses weren't put out by the Internet. They weren't put out by the excesses of Wall Street. They weren't put out of business by the investment banks. When it's all done, Goldman Sachs is going to have branches, and Morgan Stanley is going to have branches. Everybody's going to have branches."

And the nontraded space allows Schorsch to run his business as the public markets would not. Whereas the public sector wants businesses to be managed quarter over quarter, Schorsch explained that the nontraded REIT space, on the other hand, allows people to take a real view of business. A business cycle, he said, does not look like quarter over quarter.

Schorsch said that starting in 2004, REITs were traded for their capital appreciation rather than their income. Hedge funds and other funds were getting involved more and more in the space. "That's completely contradictory to the whole principle behind real estate investing. You've now got people making short-term bets on long-term assets. You've misaligned your investors," he said. People bought real estate securities as an asset allocation for diversity in their portfolios, and now their real estate investment is down more than their stock because it is trading like equities.

"I like the nontraded space because it's slightly different. You're investing in a company based on original asset value," Schorsch said. Yes, there are fees involved, but he pointed out that there are fees involved with public company investing, too.

Schorsch said his is the first public team to move to the private side but that he sees more companies considering the nontraded option. Pacific Office Properties Trust Inc., for example, has filed to do a nontraded offering.

And Schorsch is looking to help other companies make the transition. American Realty Capital's broker/dealer, Realty Capital Securities, is purpose-built, he said, to take other companies — best-in-class sponsors — out. "There are dozens of classes of assets we'd be willing to help through our broker/dealer," he said.

"We look at it that we're kind of the first of more to come," he said. "I think there will be many more." *i*