A Texas-Sized Scheme
Exposing the Darkest Corner of the REIT Business
United Development Funding (UDF)

"Only when the tide goes out do you discover who's been swimming naked." Six years ago, the Federal Reserve set in motion one of the greatest financial experiments on record: setting interest rates at zero and seeing what happens. To this point, the result has been massive asset reflation. While what happens next is still the great unknown, low interest rates and rising asset values have provided great cover for many mistakes made over the past six years across all asset classes. The Fed has truly been the rising tide that has lifted almost all boats. Amid this rising tide, an asset class best known as public non-traded REITs emerged as a prominent retirement product sold almost exclusively to retail investors. When the tide goes out, public non-traded REITs will be exposed for the terribly flawed economics on which the $100 billion dollar business was built.

A public non-traded REIT is public because it has the minimum number of shareholders required to be public; it is non-traded because it is not listed or traded on a major stock exchange. This product is sold to retirees as a low-risk, long-term income-producing asset that is not subject to stock market volatility – pedaled as a fixed-income product without exposure to interest rates. In reality, an investment in a public non-traded REIT is typically an investment in an illiquid "start-up" real estate company that must accumulate assets quickly and is subject to the same market risks (or greater market risks) as its publicly traded, more liquid peers which benefit from lower costs of capital.

When boiled down to the least common denominator, public non-traded REITs exist because of high upfront commissions that provide the incentive for financial advisers to sacrifice their client's best interest for their own personal greed. Prior to a non-traded REIT ever purchasing an asset which may or may not generate future positive returns, ten to fifteen percent of an investor's capital is consumed by upfront offering fees, broker commissions and asset origination fees. While the high upfront fee load incents "investment advisers" to push the product and is a primary reason why public non-traded REITs exist, it is also why so many are set to fail from the beginning.

The low interest rate environment has also contributed to the growth of the non-traded REIT asset class. Yield-starved retail investors are promised above market returns and the non-traded REITs deliver, at least initially. How can a non-traded REIT with no assets to start, subject to exorbitant fees and commissions, deliver above market returns almost immediately? First, brokers mark the investment on the investor's statements at the offering price and not the 'net' price after fees that frequently exceed 10%. Second, by raising new capital subject to astronomically high (some might even say criminal) fees and commissions and partially using the new capital to fund distributions to shareholders. The practice of paying distributions to common shareholders by raising more high friction capital from new shareholders (rather than income generated from assets) is irrational, but unfortunately, has been a staple of the non-traded REIT universe over the past several years.

The Securities and Exchange Commission (SEC) describes a Ponzi scheme as "an investment fraud that involves the payment of purported returns to existing investors from funds contributed by new investors." Not all non-traded REITs are Ponzi schemes, but almost all non-traded REITs share one of the hallmarks of a Ponzi scheme – funding distributions to shareholders with funds contributed by new investors. The difference is that non-traded REITs plainly disclose this practice. The issue is systemic, and the SEC is fully aware of the problem, highlighting non-traded REITs as one of the five most serious problems affecting retail investors going into 2015.

The Federal Reserve, by keeping interest rates near zero, has masked the true extent of the problem as rising asset values have partially offset the carnage created by massive fees and irrational distribution practices. In the rare, most favorable scenarios, non-traded REIT managers manage to return principal at par. Retail investors consider this a win and are none the wiser; not appreciating that their illiquid investment significantly underperformed publicly listed peers. The MSCI REIT index has almost doubled in the past six years while non-traded REITs struggle to return par; usually a premium is paid for liquidity, not the other way around.

In the less favorable, more typical scenarios, net asset values actually decline as these companies mortgaged the future to pay outsized current returns, despite significant appreciation in real estate values. In the most egregious circumstances, a business model that was flawed to start (and made worse by bad stewardship) evolves into something that looks more like a Ponzi scheme than a real estate business as poor investments are masked by additional capital raises. Bad business decisions beget more bad business decisions and ultimately devolve to the point where maintaining the scheme overcomes efforts to generate legitimate returns.

The following will detail one of the most egregious cases. RCS Capital (RCAP) has been the funding mechanism by which retail capital has unassumingly and consistently made its way to United Development Funding (UDF).

The largest vintage to date, United Development Funding IV ("UDF IV", Nasdaq ticker: UDF), markets itself to retail investors as an opportunity to diversify portfolios with "unique and fundamentally sound investments in affordable residential real estate". In reality, UDF IV is a mortgage REIT with a high concentration of risk to a single borrower and is part of a larger family of REITs under the United Development Funding umbrella, which operates publicly listed and public non-traded REITs.

The UDF umbrella exhibits characteristics emblematic of a Ponzi scheme: (1) new capital, both equity and debt, is used to fund distributions to existing investors; (2) subsequent UDF companies provide significant liquidity to earlier vintage UDF companies, allowing them to pay earlier investors; and (3) if the funding mechanism funneling retail capital to the latest UDF company is halted, the earlier UDF companies do not appear to be capable of standing alone and the entire structure will likely unravel, with investors left holding the bag.

UDF I, the first iteration, appears to have begun as a private entity owned by limited partners, pre-financial crisis, investing as a real estate developer and as a lender to real estate developers and homebuilders. UDF I was long real estate, in a levered way, at the worst time to be levered and long real estate. As UDF I began to falter during the financial crisis, it appears that capital from a public non-traded entity, United Mortgage Trust (UMT), was used to help bail out UDF I. UDF I and UMT are affiliates, sharing common management, and management decided to issue loans from UMT to UDF I, allowing UDF I and its subsidiaries to repay various 3rd party debt.

Unfortunately, UMT was in the core business of issuing sub-prime residential mortgages, and this core business deteriorated rapidly. Enter United Development Funding III (UDF III), a separate public non-traded affiliate, also under common management control, which was used to purchase a significant "economic participation interest" in UMT's loan to UDF I, which happened to grow exponentially throughout the financial crisis, even as UDF I defaulted on 3rd party loans. Through this mechanism, UDF III retail capital appears to have been used to repay UMT retail capital which was used to bail out UDF I. And the Ponzi-like real estate scheme was set in motion.

As the problem grew, UDF partnered with RCAP to raise a larger pool of funds via UDF IV. UDF IV has since provided liquidity to UDF I, UMT and UDF III, among other affiliates, further exacerbating the problem and perpetuating the scheme. After raising capital as a non-traded REIT, UDF IV closed its offering and listed on the Nasdaq in June 2014. As prior vintages continually needed a source of liquidity, RCAP was once again called upon to raise the equity, this time through the latest vintage, UDF V, with a maximum offering size of $1 billion.

Each subsequent UDF entity appears to operate the same business, in the same markets, lending to the same borrowers, often on the exact same developments. The same three borrowers collectively account for 90% of both UDF III and UDF IV, with the largest borrower accounting for approximately 43% and 67%, respectively. What legitimate lender would expose itself to this level of concentrated credit risk, and why do multiple entities exist to do the same exact thing?

Management at UDF will argue that it has been a principal beneficiary of low interest rates, the strength of the housing recovery, the strength of the Texas economy specifically and, ultimately, rising asset values that have followed; it will also maintain that its loans are fully covered by appreciating collateral values. The macroeconomic arguments make perfect sense. How could a real estate lender in Dallas, Texas, be underwater six years into a steady recovery? On the surface, the explanation involves inheriting past sins of former funds that pre-date the financial crisis, poor stewardship, unregulated lending, and a flawed business model. Below the surface, the explanation is likely a lot more sinister.

Visits to actual development sites, which serve as collateral to UDF development loans, show that, in numerous instances, there is no development and the collateral is still non-income producing, raw land 2, 3, 5 (as much as 10) years after loans were issued. Where did all the money go if not to developments?

There is also evidence that UDF V has indirectly used new retail capital to provide liquidity to affiliates, despite specifically stating in its prospectus that it would not engage in these practices. It also appears that seventy-five percent of UDF V's loans to date have been issued to the single largest borrower of both UDF III and UDF IV, and these new loans have been used, in the majority of cases, to repay old loans issued by UDF III and UDF IV. In short, UDF V appears to be the new mechanism to provide liquidity to UDF III and UDF IV. Similar to a Ponzi scheme, it appears that UDF V investor capital is being used to return capital to UDF III and UDF IV investors. Each day that it persists, new victims are created with the most gullible money of all - retail investors and retirees - ultimately paying the price.

The cracks in UDF's facade are starting to appear. On or about October 30, 2015, a lawsuit was filed in Travis County, Texas naming UDF IV as a co-defendant in a case involving allegations of fraud, breach of contract, tortious interference and fraudulent transfer. On November 24, 2015, UMT, UDF III, UDF IV and UDF V each filed Forms 8-K revealing that their independent registered public accounting firm, Whitley Penn LLP, declined on November 19, 2015, to stand for reappointment as the auditor for each company. On the same day that it was announced to public shareholders that Whitley Penn had declined to stand for reappointment, William Kahane (who appears to be affiliated with RCS Capital, AR Capital and Nicholas Schorsch) resigned from UDF V's board. On November 30, 2015, UDF III filed an involuntary bankruptcy petition in the United States Bankruptcy Court for the Western District of Texas against UDF III and UDF IV's second largest non-affiliated borrower. On December 4, 2015, the letter attached was sent to Whitley Penn concerning its audit work and the Forms 8-K filed on November 24, 2015.