
THE STANGER REPORT™

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EDITORIAL OPINION

Silence of the Lambs

- Hannibal Lechter: Something woke you, didn't it? What was it?*
- Clarice Starling: I heard a strange noise...it was....screaming. Some kind of screaming like a child's voice.*
- Hannibal Lechter: What did you do?*
- Clarice Starling: I went downstairs, outside. I crept into the barn. I was so scared to look inside, but I had to.*
- Hannibal Lechter: And what did you see, Clarice?*
- Clarice Starling: Lambs. The lambs were screaming.*
- Hannibal Lechter: They were slaughtering the spring lambs... And what became of your lamb, Clarice?*
- Clarice Starling: They killed it.*
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If you listen closely in the coming weeks you may hear a similar sound as investors in Moody National REIT I and Moody National REIT II read the preliminary proxy statement/prospectus relating to a proposed merger of these two non-listed REITs sponsored by Moody National. The question which will be played out over the coming months is whether the lambs (passive REIT investors -- no insult intended) will vote "yes" to the merger and succumb to this spring slaughter, or instead be "shepherded" by their financial advisors to reject the merger on its present terms.

Gathering In The Sheep

Moody National REIT I (Moody I) is a small non-listed REIT that raised about \$133 million and closed in the first quarter of 2015. According to the recent preliminary proxy statement/prospectus filed on February 2, 2017 relating to the transaction, Moody I's portfolio includes over \$300 million of hotel properties with an implied net equity value (before liquidation transaction expenses) of approximately \$158 million, or almost \$11.90 per share. The original offering price per share was

\$10.00. So, after deduction of front-end distribution and offering costs, a net investment of \$8.80 has ostensibly increased 35% to \$11.90 within ten months of the REIT's final property purchase.

Moody National REIT II ("Moody II"), on the other hand, is a smaller sister non-listed REIT that also invests in hotel properties and holds a portfolio of approximately \$113 million. Moody II has raised approximately \$92 million through February 2017 in a currently effective offering. The offering was declared effective by the SEC on January 2, 2015 and broke escrow on July 2, 2015. After raising just \$7 million, the company performed its first valuation based on a portfolio comprised of one property which was purchased two weeks before the valuation date. Although the original offering was priced at \$25.00 per share and carried total front-end distribution and offering costs of 12% (along with an acquisition fee of 1.5% and a financing fee of 1%), this first valuation came in at an estimated Per Share Net Asset Value ("NAV") of \$25.03 – a substantial gain on estimated net offering proceeds, less acquisition and financing fees.

With this valuation in hand, Moody II elected to issue this estimated Per Share NAV, presumably for account statement reporting (instead of Net Investment). More importantly, the REIT continued to sell shares at a price of \$25.00 – i.e. without grossing up the offer price to reflect the 12% securities load, as other non-listed REITs which provide a valuation during an offering period have done. The result: New purchases not only diluted the value of existing investors but they also apparently went on account statements at either this higher "appraised" Net Asset Value or the gross offering price. So while other public non-listed REITs faced the music of the FINRA 15-02 account statement changes and reported new sales on account statements at Net Investment (which for Moody II would have been approximately \$22.00 per share), Moody II appears to have avoided the intent of FINRA 15-02.

Cannibalizing Investor Returns

So now comes Moody II with an offer to merge with Moody I by issuing shares of Moody II or, subject to an aggregate limit of 50%, cash for each Moody I share. The stated range of nominal consideration to the Moody I shareholders is \$10.25 to \$11.00 per share, depending upon the level of transaction costs incurred in the deal. While the structure is unusual to say the least, the transaction cannibalizes the inherent value of Moody I investors' shares by burdening that value with up to \$21.8 million of transaction costs. We estimate these transaction costs represent 13.8% of the aggregate Moody I equity value.

To take another bite out of the Moody I investors, Moody II will be denominating the value of the shares of Moody II at \$25.00 per share rather than the pro forma Combined Net Investment Amount of approximately \$23.00. By our calculation, the aggregate cost and discount related to the fees and possibly overstated stock price ascribed to Moody II in the merger totals about \$29.3 million, or about 19% of the pre-transaction equity value of Moody I.

Looked at from a different perspective, the investors in Moody I are incurring up to \$21.8 million of transaction costs to merge with a portfolio comprised of two hotel properties and one note purchased at an aggregate cost of \$113 million – a merger which at best will provide liquidity to half of the Moody I investors.

Hannibal Lechter: Well, Clarice – have the lambs stopped screaming?

Hiding the Bodies

Clarice Starling likely had an easier task finding the serial killer, Buffalo Bill, in the movie *Silence of the Lambs* than Moody National investors will have in finding the totality of these trans-

action costs and other pertinent valuation information in the Proxy Statement/Prospectus. Nowhere in the Q&A Section is the question asked: “What are the total transaction costs associated with the merger?” Nowhere in the Q&A Section is the question asked: “What is the most recent value of my shares in Moody I / Moody II?” Nowhere in the Summary Section is there a straightforward and complete listing of the various transaction costs relative to the per share estimated value of Moody I and Moody II.

In addition, this acquisition via merger represents a significantly larger property portfolio than Moody II now owns, and it stands to have a significant economic impact on Moody II investors. Yet, nowhere in the Prospectus is there a complete description of the analysis of the merger performed by the investment banker engaged by Moody II to evaluate the transaction – an analysis that would be especially relevant and material to new investors who are now acquiring or will acquire Moody II shares while the offering is still ongoing.

CSI (Crime Scene Investigation)

Jame “Buffalo Bill” Gumb: You don’t know what pain is!!

A forensic dissection of the opaque disclosure of the Proxy Solicitation turns up the following clues as to the composition of those transaction costs. First, Moody I will pay its advisor approximately \$5.6 million to terminate its advisory contract. Never mind that the advisory contract is cancellable without penalty on 60 day notice and that an affiliate of the advisor will continue to earn asset management fees managing the very same assets for Moody II post transaction – a Moody II which potentially will have more Moody I shareholders than its own. It is also noteworthy that this affiliated advisor will be paid an acquisition fee equal to 1.5% of all the cash merger consideration paid to the Moody I investors – an amount that could reach

about \$1 million. The Moody I advisor also will be paid an incentive fee of over \$600,000 despite the fact that its affiliate will continue to manage the same assets and at least half of the investors will not have achieved a true liquidity event. All told, the affiliated advisors of Moody I and Moody II will stand to pocket up to approximately \$7.3 million.

Second, and perhaps the most blood curdling feature of the proposed merger, is that Moody I will pay financial advisors a “servicing fee” if their clients choose to receive shares of Moody II instead of cash in the merger. **This fee is equal to 8.5% of the equity value ascribed to the Moody II common shares issued to Moody I shareholders – or \$2.125 per share issued.** The fee paid to those same advisors for any investor that elects to take cash - ZERO. Although described as a “shareholder servicing fee,” this arguably looks a lot like paying for “Yes” votes. So, financial advisors recommending that their clients vote “Yes” and take shares in the merger stand to be paid a total of between approximately \$5.8 million and \$11.6 million. Although these arrangements appear to fly in the face of the roll-up rules and the Moody I charter, they are enabled by asking the Moody I Investors to concurrently approve charter amendments which wipe out the investor protections of the roll-up rules while at the same time failing to provide what we would consider to be a compelling investment rationale for the merger. We do, however, believe that revising a REIT’s charter can be defensible in situations where the potential benefits to investors and the likelihood of their achievement are demonstrable and outweigh the adverse impacts of amending certain investor protections.

In more than thirty-five years of experience looking at public, non-listed real estate merger transactions, we have never seen a transaction with such transparent and lucrative incentives for both the sponsor/advisor and the shareholders’ financial advisors.

Hannibal Lechter: First principles, Clarice. Read Marcus Aurelius. Of each particular thing ask: What is its nature..... what needs does he serve...?

Clarice Starling: Anger, um, social acceptance, and, uh.....

Hannibal Lechter: No! He covets.

Unfortunately, They Didn't Call A Forensic Accountant

The Special Committee of the Board of Directors of Moody I engaged FBR, an investment banking firm, to provide financial advice and a fairness opinion in connection with the merger. We cannot tell from the disclosure in the Proxy Statement/Prospectus if pursuit of the merger was preceded by a sufficiently rigorous evaluation of strategic alternatives for Moody I and a quantification of those alternatives. Further, while FBR's fairness opinion purports to address the fairness of the "Proposed Consideration" to be received by the Moody I investors, it does not disclose any estimated range of value of the shares of the consolidated, post-merger entity which Moody I investors opting for shares would receive. FBR will receive a total fee of \$1.9 million for its fairness opinion and financial advisory services.

What the Special Committee should have done is not just call FBR, because this proposed transaction needed a forensic accountant to piece the proposal together, search for alternative (i.e.

less expensive) transaction structures, and evaluate alternative strategies for the REIT, such as an outright sale of Moody I's assets.

Hannibal Lechter: You still wake up some times, don't you? You wake up in the dark and hear the screaming of the lambs.

Clarice Starling: Yes....

Hannibal Lechter: Brave Clarice. You will let me know when those lambs stop screaming, won't you.

Preventing the Bite

We have seen transactions where a bite was taken out of investors, but never this close to the bone. Unless confronted with regulatory challenges, it is unlikely that the special committees or boards of each REIT will initiate any restructuring of the transaction prior to submitting the merger to an investor vote. Given that likely reality, the fate of this transaction lies in the hands of the lambs and their financial advisors. If history is any indication, this transaction has a good chance of being approved despite what in our opinion are very serious flaws. If that comes to pass, we suggest the special committees, boards and bankers take a cue from Hannibal when it comes to selecting an appropriate menu for the traditional dinner celebrating the closing of the transaction:

"...liver, fava beans and a nice Chianti." ■