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REITs

Red Hot or Just Overheated?

Current Successes Spawn Fears of Another Real Estate Collapse

By Wayne E. Etter

After more than a decade of relative obscurity, real estate investment trusts (REITs) began their climb to renewed national financial prominence in 1992. REITs have raised—and continue to raise—substantial amounts of capital to acquire existing properties and to finance the development of new properties. Some in the real estate industry are wondering whether this activity will lead to overbuilding and another real estate collapse. Such concern is reasonable for those who recall the REIT problems of the 1970s and the general overbuilding in many real estate markets in the 1980s.

What are REITs?

REITs are corporations or business trusts that are managed by boards of directors or trustees. Their shares are fully transferable, and they must have a minimum of 100 shareholders; no more than 50 percent of a REIT's shares can be held by five or fewer individuals during the last half of each taxable year. When institutions own REIT shares, the institutions' beneficiaries are considered the owners of those shares rather than the institution.

REITs must invest at least 75 percent of their total assets in real estate, and they must derive 75 percent of their gross income from real property rent or interest from real estate mortgages. No more than 30 percent of their gross income can be derived from the sale of real property held for less than four years. REITs do not pay corporate taxes if 95 percent of their portfolio income is passed through to shareholders.

REITs are usually described as equity REITs, mortgage REITs and hybrid REITs. Equity REITs own real estate and, therefore, rent is their primary source of revenue. Because equity REITs usually limit their investments to properties in a particular industry or to a particular property type, they are further classified by their investment specialization. Mortgage REITs make real estate loans and earn interest. Hybrid REITs combine the activities of equity and mortgage REITs.

REITs are similar to stock mutual funds; individuals and institutional investors purchase shares that represent an undivided interest in the properties owned by the REIT. Because REIT shares can be traded, they are highly liquid, particularly when compared to direct ownership of real estate or to the partnership interests owned by many real estate investors during the 1980s.

According to the National Association of Real Estate Investment Trusts (NAREIT), there are more than 300 REITs in the United States. Currently, 147 REITs are traded on the New York Stock Exchange, 42 are traded on the American Stock Exchange and 12 are traded by members of the NASDAQ National Market System. Some REITs, however, are privately owned by institutional investors and are not publicly registered or traded.

A Recent History

An explosion of REIT activity has occurred in the last several years. They have become a major source of funding for the real estate industry as shown by the rapid increase in security offerings (see table). Initial equity offerings are shares sold by new REITs; secondary offerings are additional shares sold by existing REITs.

According to NAREIT, the total dollar value of 318 REIT equity offerings during 1997 was approximately $32.6 billion. The table shows annual total equity offerings by REITs were more than $4 billion in only two years between 1982 and 1992. From 1993 to 1996, there was a substantial increase in REITs' total equity offerings, averaging more than $11 billion per year. Nevertheless, the 1997 equity offerings were nearly triple the average amount for the preceding four years and about double the amount of total equity offerings for the entire 1982-92 period.

The number of equity security offerings by REITs for the period is also reported in the table. As was noted for the dollar amount, 1993 to the present is significantly different from 1982-92. The average annual number of equity security offerings for the former period was 25.5; for the latter period, the average was 110.8. But in 1997, there were 318 offerings. Of particular interest is the large number of initial equity offerings in 1993 and 1994. Each initial equity offering represents the formation of a new REIT. Thus, there were 259 REITs formed during the entire period between 1982 and 1997, and 95 of them were formed in 1993 and 1994.

Reasons for Rapid Growth

Several explanations exist for the dramatic growth of REITs in recent years. Initially, they became popular with individual investors because their cash yield was attractive. Declining interest rates made REIT shares attractive, compared to certificates of deposits issued by financial institutions. Rather than replace maturing higher yield CDs with lower yield CDs, some investors bought REIT shares, without regard for the possible risk differences between CDs and REIT shares.

These investors saw opportunity in the depressed commercial real estate markets of the early 1990s. For example, a number of lending institutions were selling distressed properties from their portfolios at prices reported to be as much as 50 percent less than their original valuation. Some REITs, the so-called "bottom fishers," were organized to buy distressed properties. This made it possible for small investors to participate in a market from which they would have been excluded otherwise.

The increasing popularity of REITs caused the creation of new REITs and the expansion of existing ones. The combination of increased demand for REIT shares and the extended economic expansion of the 1990s has resulted in increasing prices for commercial property in the cities where REITs are active.

Developers who needed cash in the early 1990s to pay debts on already-developed properties and to undertake new developments took advantage of the demand for REIT shares by organizing REITs or by trading their properties to existing REITs. This provided developers with the capital for new development at a time when there were few other available sources.

These activities were particularly profitable for the REIT sponsors in the early stages of the economic recovery, as investors were willing to accept yields on their REIT shares that were considerably lower than the yield on the property. Consequently, a property yielding a 10 percent cash return could be purchased for the portfolio, using funds obtained from the sale of REIT shares equity that were sold with a 6 percent dividend yield.

All of this activity made REITs popular with Wall Street firms because REITs provided profitable business for their underwriting departments as well as saleable product.

Pension funds became REIT investors as a result of the Revenue Reconciliation Act of 1993. Prior to the act, a REIT's income was taxable if, during the last one-half of its tax year, more than 50 percent of the value of the REIT was owned by five or fewer individuals. This requirement made it difficult for pension funds to make large dollar investments in a single REIT. However, this restriction was, for all practical purposes, eliminated by the Revenue Reconciliation Act. Since December 31, 1993, REIT shares have been considered to be owned by the institution's beneficiaries rather than the institution. Pension funds became immediate participants in the REIT market. Many of these investors swapped major properties for REIT shares.

REITs in the 1970s

Initial legislation that made REITs possible was passed in 1960. During their first few years, they primarily raised equity funds and purchased income-producing properties. However, a surge of REIT activity in the early 1970s resulted in a major financial crisis. How did this come about?

The rising development activity of the early 1970s presented what appeared to be an extraordinary opportunity for the industry. Because of increasing demand for construction financing by real estate developers, many REITs became construction lenders. New REITs were created for this purpose; some were created by commercial banks to provide construction financing for projects that could not meet the banks' legal lending requirements.

After issuing their initial shares, many REITs that provided construction financing did not raise additional funds in the equity market. Instead, they borrowed short-term funds from commercial banks and in the commercial paper market. This financial leverage allowed the REITs to maximize their earnings and dividends.

Unfortunately, many REITs that financed construction loans paid little attention to the properties' income-producing potential or to the likelihood of their sale when completed. Often, developers' loan requests for the speculative properties were supported by appraisals that justified the loan amount, but the question of assessing the properties' market demand was not considered. Usually, it was assumed that the properties could be rented or sold at the rate or price necessary to make them a success.

Because of the spread between their borrowing and lending rate, REITs were profitable and grew rapidly. The profit potential made it difficult for them to decline developers' proposals, no matter how poorly designed the project was or how much market demand existed for the property. In some cases, the initial construction loan amount was inadequate to complete the property, and additional funds had to be advanced. Some unfinished properties were not worth finishing, and these were a complete loss for the REITs.

As the industry expanded, the supply of unfinished properties and poorly designed and constructed properties increased. Permanent financing could not be arranged for these properties and developers could not repay their construction loans to the REITs. Eventually, the REITs could not meet their payments on their maturing short-term loans and commercial paper. With widespread defaults imminent, the Federal Reserve Bank encouraged commercial banks to provide REITs the funds necessary to avoid a major financial crisis.

REITs: The Present

REITs of the 1990s differ from those of the 1970s, both in terms of their source of funds and in the types of investments that they make. Currently, a major difference is their use of debt. The REITs of the 1970s were fueled almost exclusively by debt as they borrowed short-term funds at rates lower than they charged for longer-term loans. Their principal source of income was the rate spread between short-term rates and their lending rates. When they were unable to collect interest from their borrowers, they faced default. Equity is the primary source of funds for the REITs of the 1990s. If they are unable to collect the amount of rent and interest that they expect, their dividends will fall and stock prices will decline, but they will not default.

The nature of REITs' current investments is another important difference. Because the REITs of the 1970s had to charge high rates to be profitable, they were forced to finance proposed property developments that were rejected by lenders with lower costs of funds. Accordingly, their portfolios contained many risky properties. In contrast, 1990s REITs have, for the most part, purchased completed properties, many of them at prices below their replacement cost. As the tenant

Offerings of Securities by Real Estate Investment Trusts 1982-97

Year	All Offerings Number	All Offerings Total ($ Mil)	Total Equity Number	Total Equity Total ($ Mil)	Initial Equity Number	Initial Equity Total ($ Mil)	Secondary Equity Number	Secondary Equity Total ($ Mil)	Unsecured Debt Number	Unsecured Debt Total ($ Mil)	Mortgage-Backed Number	Mortgage-Backed Total ($ Mil)
1982	9	435.1	8	430.1	3	315.0	5	115.1	1	5.0	0	0
1983	23	747.0	19	597.0	4	159.0	15	438.0	4	150.0	0	0
1984	18	1,438.4	14	313.4	6	140.4	8	173.0	4	1,125.0	0	0
1985	59	4,270.6	46	3,204.6	29	2,791.9	17	412.7	12	939.0	1	127.0
1986	63	4,668.9	37	1,828.1	20	1,204.4	17	623.7	5	315.9	21	2,524.0
1987	50	2,929.2	27	1,367.4	12	634.4	15	733.0	4	248.0	19	1,313.0
1988	37	3,068.7	26	2,159.2	13	1,374.2	13	785.0	6	335.3	5	574.0
1989	34	2,440.8	26	1,796.6	11	1,074.5	15	722.1	3	150.0	5	494.0
1990	24	1,765.2	18	1,271.2	10	882.0	8	389.2	4	294.0	2	200.0
1991	35	2,288.6	28	1,594.6	8	808.4	20	786.2	3	169.0	4	525.0
1992	57	6,515.1	32	1,973.7	8	919.2	24	1,054.5	9	819.6	16	3,721.0
1993	141	18,326.6	100	13,191.7	50	9,335.4	50	3,856.3	18	1,352.6	23	3,782.0
1994	145	14,721.0	97	11,120.3	45	7,175.8	52	3,944.5	26	2,093.8	22	1,506.0
1995	195	12,493.4	101	8,260.7	8	939.3	93	7,321.4	73	3,444.0	21	788.0
1996	225	17,455.8	145	12,308.7	6	1,107.8	139	11,200.9	76	4,753.9	4	327.0
1997	463	45,270.9	318	32,674.1	26	6,296.5	292	26,377.6	134	10,568.2	11	2,028.0

Source: NAREIT ONLINE, The National Association of Real Estate Investment Trusts

demand for these properties has grown, their rental revenue and value have increased as well.

REITs: The Future

One definite concern for most publicly-traded firms, including REITs, is Wall Street's incessant demand for earnings growth. Almost any failure to meet the expected earnings goal results in Wall Street's downgrading a firm's attractiveness as an investment. Usually when this occurs, the company's stock price falls, and the firm's stockholders lose wealth. Unless the firm's earnings growth is resumed, the firm's managers may lose their jobs. What problems do REIT managers face as they attempt to maintain earnings growth?

Most corporations achieve growth over time by reinvesting their earnings rather than paying them out to shareholders. REITs, however, must pass through 95 percent of their portfolio income to their shareholders to avoid being taxed. For a REIT to grow, it must sell additional shares. Usually, raising new capital is more costly than using retained earnings.

While the principal source of capital for REITs has been and continues to be equity funds, the data in the table indicate an increase in the use of debt by REITs. The proper use of debt can enhance the shareholders' benefits and enables the acquisition of additional properties.

In the past, much of the REIT growth came from purchasing properties at low prices. As the commercial real estate market has improved, values have increased. The supply of quality properties available at low prices has likely been consumed. New acquisitions will have a more limited potential for appreciation. Further, there are a limited number of suitable properties for REITs to buy, and many of these are already in the hands of REITs. As a result, REITs are developing properties for their portfolios in the search for high levels of earnings growth.

Increasing the income from currently-owned properties is an ongoing goal of REITS. This can be accomplished by increasing rents and reducing operating expenses, as the market allows. They also can achieve some economies of scale in the management of their properties' operating expenses. While a poorly managed property's profitability can be improved when placed under good management, income growth potential has obvious limits. Once an acquired property has been fully leased at the current market rent, further increases will be determined by normal supply and demand interactions.

There is concern about the high prices that REITs are paying for properties. In some cases, they have driven other buyers from the market. If these properties perform as the REITs expect, the higher prices should not pose a problem. However, if the properties perform poorly because of supply and demand conditions within a particular market, the expected return will not be achieved, the shareholders will be disappointed and the REITs' share prices will decline.

In evaluating this concern, two points need to be considered. First, REITs are closely monitored by financial analysts. These specialists, employed by mutual funds and pension funds that invest in REIT shares and by investment brokerage firms, are concerned with the quality of REIT portfolios. A negative report by these "watchdogs" will have an adverse effect on a REIT's share price, a consequence that REITs will want to avoid by making sound portfolio acquisitions. Second, REITs have a lower cost of capital than many other real estate investors. This characteristic, which enables them to pay a higher price for real estate than other investors can, will be examined in a future issue.

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