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RETURN OF THE REITS

By Harold D. Hunt

As the heady days of NASDAQ 5,000 and the technology stock boom fade into the past, many are diversifying their investments hoping for better returns. Real estate investment trust (REIT) stocks are an increasingly popular investment alternative.

REIT ownership in Texas is substantial, with about 120 REITs controlling more than 3,000 properties in the state, according to SNL Financial's March 2002 Property Register.

REIT Evolution

A REIT is basically a company established to own, and in most cases operate, income-producing real estate. REITs also can own mortgages or real estate-related securities, develop new properties and purchase older buildings for renovation and modernization.

Congress created REITs in 1960 so that small investors could invest in large-scale, income-producing real estate properties by purchasing shares. Today, a large percentage of REIT shares are owned by institutional investors.

Before the passage of the Tax Reform Act of 1986, managers of REIT funds were not allowed to operate or manage the funds' real property. The act improved the competitiveness of REITS as an alternative investment, transforming management from passive owners to active operators. The savings and loan crisis, however, combined with overbuilding in many U.S. cities, and the popularity of real estate limited partnerships, prevented REITs from gaining widespread acceptance during the 1980s.

The REIT industry has grown rapidly in recent years. Total market capitalization for all publicly traded REIT stocks increased from $16 billion in 1990 to more than $160 billion as of mid-2002. Although this growth rate is impressive, REITs still own less than 10 percent of the U.S. real estate market.

On Jan. 1, 2001, the REIT Modernization Act went into effect, allowing REITs to own up to 100 percent of the stock of a taxable REIT subsidiary (TRS). These subsidiaries provide any type of supplemental service, such as telecommunications access or copy service, to REIT tenants or tenants of other properties. Although some of these ventures have turned out badly, REIT managers may be able to use their real estate expertise to form practical, related TRS services in the future.

REITs are required to pay at least 90 percent of their taxable income to shareholders in the form of annual dividends. Qualifying REITs are permitted to deduct dividends paid to shareholders from their taxable income. As a result, most REITs pay as much of their taxable income as possible to their shareholders and typically owe no corporate tax. Shareholders pay taxes on dividends received plus any capital gains from the sale of REIT shares.

At least 75 percent of a REIT's total assets must be invested in real estate. Furthermore, at least 75 percent of a REIT's gross income must come from rents or mortgage interest. Taxable REIT subsidiaries may not exceed 20 percent of a REIT's assets. REITS may receive no more than 30 percent of their gross income from the sale of real property held for less than four years or securities held for less than one year.

A REIT must have at least 100 shareholders, and five or fewer shareholders cannot own more than 50 percent of the outstanding shares.

Types of REITs

Equity REITs own and operate income-producing real estate, engaging in a wide range of real estate activities such as leasing, development and tenant services. However, REITs must acquire and develop properties primarily to operate them as part of their own portfolio as opposed to reselling them once they have been developed. REITs get around this "build and hold" requirement by using a TRS to develop and sell new construction, but they must pay income taxes on the TRS. Equity REITs make up the bulk of publicly traded REITs, representing about $150 billion of the $160 billion publicly traded REIT market.

Mortgage REITs lend money directly to real estate owners and operators or extend credit indirectly through the acquisition of loans or mortgage-backed securities. Mortgage REITs primarily extend mortgage credit on existing properties.

Hybrid REITs, which are a combination of equity and mortgage REITs, both own properties and make loans to real estate owners and operators.

Today, about 180 different REIT stocks are publicly traded on the major U.S. stock exchanges, of which about 150 are equity REITs. A large number of private REITs not traded on any exchange exist as well, bringing the total number of U.S. REITs to about 300, with assets totaling more than $300 billion. According to SNL Financial's March 2002 Property Register, 111 equity REITs, 11 mortgage REITs and one hybrid REIT own properties in Texas.

Annual Total Return for Publicly Traded Equity REITS by Sector (in percent)

Sector	2000	2001
Industrial/Office	33.4	7.1
Retail	18.0	30.4
Residential	34.3	9.0
Diversified	24.1	12.5
Lodging	45.8	(8.6)
Health Care	25.8	51.9
Specialty	(31.6)	7.6
Self-Storage	14.7	43.2
All Equity REITs	**26.4**	**13.9**

Source: National Association of Real Estate Investment Trusts. For a detailed breakdown, see the web version of this Tierra Grande at http://recenter.tamu.edu.

Advantages, Risks of REIT Ownership

According to Jeff Caira, vice president of Pioneer Investment Management, the renewed investor interest in REITs since the tech stock downturn stems from their relatively stable and predictable cash flows, the diversification they provide in an investor's portfolio and the dividend yield they offer. From 1982 to 2002, about two-thirds of the total return from REITs has come from dividend yields; the remainder is a result of stock price appreciation.

Other advantages of owning REITs include professional management of real estate assets, transparency of REIT firms because of securities laws disclosure requirements and liquidity of REIT shares compared to personally owned real property.

REIT stocks offer diversification through investment in a portfolio of properties rather than a single asset. The property portfolios may be geographically diverse, with properties in a variety of cities or regions. Although most REITs invest in a specific type of property, such as retail or industrial real estate only, a number of REITs own a mixture of property types. REITs also are diverse in management styles, which range from aggressive risk-taking approaches focused on rapid growth to risk-averse, low-key management.

As is true of most investments, there are risks associated with owning REIT stocks. Many are market-driven, including the risk of markets becoming overbuilt, insufficient demand for real estate, risk of tenant default and falling rents. Investors also should be aware that REIT share prices and real estate cycles may not coincide. Real property can perform well as REIT stocks are performing poorly and vice versa.

Texas REIT Activity

Not surprisingly, REIT ownership is highest in the state's five largest metropolitan areas: Austin, Houston, Dallas, Fort Worth-Arlington and San Antonio.

Of the 73 million square feet of Texas industrial space under REIT ownership, almost 80 percent is in either the Dallas-Fort Worth Metroplex or Houston. Fifteen public REITs own industrial properties in Texas.

The apartment market has the highest concentration of REIT-owned properties in the state's major metro areas. More than 90 percent of all REIT-owned apartment units are in Austin, the Dallas-Fort Worth Metroplex, Houston and San Antonio. Twenty-one publicly traded REITs own more than 172,000 Texas apartment units.

More than 80 percent of all REIT-owned office space is in the Dallas and Houston metropolitan areas. Twenty-one publicly traded REITs and five private REITs own more than 71 million square feet of office space in Texas.

Retail space owned by REITs is concentrated in the major metro areas as well. More than 80 percent of enclosed regional mall space, 70 percent of single-tenant space and 80 percent of shopping center space is in Austin, the Dallas-Fort Worth Metroplex, Houston and San Antonio. Thirty-five publicly traded REITs and six private REITs own Texas retail properties.

Number of REIT Properties by MSA
Estimates as of March 2002

MSA	Total Properties	MSA	Total Properties
Outside the MSAs	144	Laredo	4
Abilene	6	Longview-Marshall	14
Amarillo	24	Lubbock	14
Austin	280	McAllen-Edinburg-Mission	10
Beaumont-Port Arthur	50	Odessa-Midland	39
Brazoria	2	San Angelo	6
Brownsville-Harlingen	15	San Antonio	244
Bryan-College Station	16	Sherman-Denison	4
Corpus Christi	24	Texarkana	9
Dallas	939	Tyler	15
El Paso	51	Victoria	6
Fort Worth-Arlington	255	Waco	13
Galveston	18	Wichita Falls	5
Houston	870	Location Not Disclosed	42
Killeen-Temple	16	**Total**	**3,135**

Source: National Association of Real Estate Investment Trusts. For a detailed breakdown, see the web version of this Tierra Grande at http://recenter.tamu.edu.

Ten publicly traded REITs own elder care properties; seven own other medical-related properties in Texas.

Twenty-six public REITs and one private REIT own lodging properties in the state. Five public REITs own self-storage properties.

Since 1994, total returns from REITs have varied widely by property type. Most recently, retail, self-storage and health care related REITs have performed best while lodging REITs have performed worst.

The average annual total return for all equity REITs during the ten years ending March 31, 2002, was 12.5 percent. By comparison, the S&P 500 recorded a 13.3 percent average annual return during this time.

For 2001, equity REITs posted a 13.8 percent annual total return versus an

11.9 percent loss for the S&P 500 and a 14.9 percent loss for the NASDAQ. Historically, REIT stock performance has not correlated strongly with other equity securities. It is not surprising that REITS continue to draw attention from investors interested in diversifying their portfolios.

Consultation with a competent investment professional is recommended.

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