THE LONG VIEW—A PERSPECTIVE ON THE REIT MARKET

by John McMahan, CRE

In 1993, the public securities markets raised over $11 billion in new capital for Real Estate Investment Trusts (REITs). This represented more real estate capital than was raised by any other source in 1993 and three times more than was raised by REITs during the prior five years combined. Was 1993 an aberration or is this a major first step on the much heralded road to securitized real estate? What are the implications for institutional investors regarding asset allocation, manager selection and governance, and internal staffing? For investment managers and consultants, does it require a fundamental shift in organizational strategy?

This article attempts to address these and other questions about the rapidly changing world of REITs and their role in real estate securitization. The history of REITs is briefly reviewed, followed by a discussion on the characteristics of modern REITs and why some pension fund investors find them attractive. Finally, we indulge in some crystal ball gazing to anticipate what all this means for institutional investing in the future.[1]

Historical Perspective

REITs didn't start out to be go-go operating companies with high expectations for future growth in earnings. The REIT Act of 1960 envisaged a conservative investment vehicle with "pass through" features which would encourage long term investment in real estate by individual, taxable investors. Less than half of the REITs operating in the sixties were self-advised (internally managed; no external advisor) and, even in these cases, management did not participate extensively in stock ownership. There was little market activity and not much coverage from the financial community.

In the late 1960s, Wall Street began shifting the emphasis of REIT Initial Public Offerings (IPOs) from long term equity investment to short term mortgage investment, largely in the form of construction loans. Mortgage REITs were the largest single source of capital funding for the 1971-1975 real estate boom, largely borrowing short and lending long in order to arbitrage the yield curve. This bubble collapsed in the mid-seventies and REITs became tarred with a negative image they have only recently begun to overcome. Not all of this

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was investor perception—REIT market values had declined almost 75% from their 1972 highs.

Largely as a result of the 1970s debacle, REITs fortunately missed the real estate boom of the 1980s. In the succeeding collapse of the real estate markets at the end of the decade, all forms of capital for real estate had evaporated. Developers and other owners of real estate found themselves with highly leveraged properties, often built with short term financing and no source of refinancing. With interest rates falling and real estate yields rising, Wall Street saw an opportunity to arbitrage between private and public markets.

The Kimco offering in 1991 was the first sign that REITs could play a major role in financing real estate and, more importantly, real estate operating companies. During 1991, eight IPOs involving REITs raised $808 million. A similar number was completed in 1992, raising $919 million. While this was a meaningful capital raising activity, particularly in a capital-starved real estate market, 1993 would prove to be a real turning point. Seventy-five equity IPOs raised $11.1 billion, compared with 62 issues raising $3.7 billion over the prior five years. Excluding placements of less than $50 million, 39 IPOs were completed raising $8.2 billion, approximately 14% of total IPO activity for the year in the entire securities market.

Perhaps more significant, the character of the 1993 IPOs was dramatically different. Virtually all the IPOs represented real estate operating companies, specializing by property type. The new REITs also were significantly larger—ten equity REITs had market capitalization of over $500 million (vs. two at the end of 1991) and 40 had capitalization exceeding $200 million (vs. ten in 1991). Almost two-thirds of new and proposed REITs were structured as UPREITs. Here the REIT owns an interest in one or more existing partnerships, an approach utilized to reduce the tax impact on selling partners.

Most of the 1993 IPOs were self-administered and, in many cases, management had significant equity positions, minimizing conflicts and enhancing congruency with investors. Most of the management groups had spent their careers specializing in the particular property type and had effectively worked together as a team for many years, including at least one full real estate cycle.

At year end 1993, the REIT market reflected many of the changes occurring at the individual firm level. Total market capitalization of all REITs increased to $31.6 billion (equity REITs to $25.6 billion). The 30 largest REITs measured $15.1 billion vs. $8.6 billion at the beginning of the year. REITs, however, still made up less than 2% of all privately held real estate assets.

In 1993, REIT shares continued to outperform the S&P 500 (18.7% vs. 10.1%), and dividend yields were 6.8% at year end, 83 basis points over ten-year treasuries and more than 400 basis points over the dividend yield of the S&P. REITs outperformed the private real estate market by over 2,000 basis points.

Institutional investors, primarily real estate mutual funds, provided almost one-half of the capital raised. As a result of this market activity, liquidity increased dramatically. Salomon Brothers estimated that a $1 million transaction involving 54 out of the 69 REITs they tracked could be consummated in two days or less. One percent of the outstanding shares of half the companies could be traded in the same period.[2]

The Modern REIT

Although regulations have loosened considerably over the years, REITs still must meet several fairly stringent rules if they are to maintain their REIT status.

- Have at least 100 shareholders. Five individuals cannot own more than 50% of the stock (5/50 rule)[3].
- Seventy-five percent of assets must be in real estate equity, mortgages, REIT shares or cash.
- Seventy-five percent of income must come from rents or mortgage interest.
- No more than 30% of operating income can come from properties held less than 4 years.
- Ninety-five percent of taxable income must be paid out annually.

As noted, most successful REITs are fully integrated operating companies rather than passive conduits for investor capital. Most are focused by property type and by geographical area, although the latter is changing as larger national firms come onto the scene. Retail and apartments are the dominant property type, which could account for some of the performance premium over private pension fund portfolios where office properties often dominate.

In terms of organization, all REITs must be a corporation or a trust and be managed by a board of directors or trustees. The majority of trustees must be independent of the REIT management. In fact, any major conflict of interest is usually penalized through share pricing.

As a pass-through vehicle, REITs should be expected to trade on the yield of underlying real estate assets, less a liquidity discount. Today, however, successful REIT operating companies often sell at premiums over the underlying yield, largely in anticipation of growth in earnings through development, refinancing or restructuring investments, and a shift in the yield expectations of

real estate investors. The demand for REIT shares also is influenced significantly by dividend spreads over treasuries (institutional investors) and money market funds (retail investors).

Earnings usually are measured in terms of funds from operations (FOF) which is net income (GAAP), excluding capital costs, plus depreciation and amortization. Stock prices are increasingly compared to FOF flows, much the same as price/earnings ratios for non-real estate stocks.

Other factors that analysts and investors track are pay-out ratios (percent of distributable income that will be paid out as dividends), total debt to total capitalization (the market doesn't like leverage exceeding 45%), and the proportion of floating debt in the capital structure (60% of REIT IPOs in 1993 involved floating rate financing which averaged 16.3% of total capitalization).

Attraction Of REITs To Pension Investors

Pension funds are increasingly attracted to REITs as an investment vehicle. Much of this interest is no doubt related to continuing frustration with the lack of control and exit options associated with the illiquid private real estate market. For smaller plans, REITs unquestionably provide an opportunity, not otherwise available, to invest in real estate on a diversified basis with reasonable levels of liquidity.

There also is a certain attraction to the greater level of governance provided by the scrutiny of the public marketplace and the role played by outside directors. Side-by-side investment by management establishes a level of goal congruency not found in the typical investor-manager relationship utilized in the private marketplace. Some observers maintain that REITs provide more information to shareholders. While this may be true in the case of commingled funds, it is generally not true with separate accounts where the level of information is not only greater but customized to investor needs as well.

One thing is clear—REITs provide a welcome relief to the never-ending debate over the use of appraisals to establish investment value and as a way to measure investment and manager performance. In fact, there is some evidence that the performance of REIT shares can forecast changes in appraised values.[4]

In allocating assets to a portfolio, a crucial question is whether REITs behave like real estate or securities. (This is an integral part of the bigger issue—is real estate an asset class or merely an industrial sector? This debate is too lengthy to pursue here.) Most academic studies, to date, conclude that REIT returns correlate better with securities, specifically small cap stocks.[5] Since most of the REITs in these studies were small cap stocks, these conclusions are not surprising.

This is not just an academic concern. If REITs behave more like stocks than real estate, then the diversification advantage of having real estate in a multi-asset portfolio is lost or seriously diluted. In fact, the addition of REIT shares to a multi-asset portfolio may skew the performance of the portfolio by overweighing it with small cap stocks.

Where is the truth? I believe that we're simply going to have to wait to find out. Common sense would indicate that, since the income flows from REIT operations are exclusively from real estate, yields over time should perform more like real estate than securities. Perhaps with the increasing capitalization of the REIT market, future studies will confirm these intuitive observations.

Future Outlook

Over the next few months we can expect some turmoil in the REIT markets as interest rates increase and investment bankers (and investors) become more concerned with earnings quality and realistic growth scenarios. REITs utilizing floating rate financing will be particularly affected. UPREITs also can be expected to experience difficulties as they struggle to develop and implement a growth strategy. There will no doubt be several mergers and consolidations as REITs seek ways to achieve or maintain a growth pricing premium.

Generally, I expect REIT performance in 1994 to be good, but nothing like 1993. Fortunately, real estate values are still low enough to continue the REIT public-private market arbitrage strategy for at least another year, but these opportunities will become increasingly rare. On the positive side, more modest performance levels should provide a badly needed respite. The REIT market certainly does not need another major letdown like it experienced in the mid 1970s.

Over the longer term (5-7 years), I expect REITs to lead the way into a securitized future for real estate investing. There are simply too many positive features (e.g. liquidity, governance, etc.) for investors to avoid allocating at least a portion of their portfolios to real estate securities. Hopefully, this will, in time, lead to the same level of investor confidence enjoyed by the security markets.

The securitization of real estate has many far-reaching implications for current players. For plan sponsors, it means greater flexibility in establishing real estate portfolios, both in terms of portfolio management and in internal staffing to handle the process. Smaller plans and defined contribution plans will be able to effectively invest in real estate for the first time.

There has been considerable speculation regarding pension funds converting their private market real estate assets into securitized vehicles to gain liquidity. While this approach has been enhanced by the recent liberalization of the 5/50 rule, how many plan sponsors are going to want to convert at a time of improving real estate markets, particularly since, unlike developers with operating companies, pension plans cannot expect a pricing premium. Since most pension plans don't need liquidity to meet their investment goals, I doubt if many will be willing to take the additional discount in value. A similar set of circumstances may prove distasteful for private REITs trying to go public without a growth strategy premium. It may turn out to be more advantageous to sell/trade assets to an existing REIT or an IPO with a growth story to tell.

For real estate managers, securitization is a fundamental threat to business as usual. If managers do not position themselves in some manner to deal with securitization, they will witness the disintermediation of their role in the investment process and, if not corrected, possibly organizational extinction. Consultants must also transform their operations and, to some extent, their personnel to handle more complicated (and interesting) roles in the future.

Transaction players such as investment bankers, rating agencies, and accounting and law firms will no doubt continue to play strong roles. There also should be considerable growth in the role of both active and indexed real estate security managers who manage REITs and other securitized real estate. To date, these managers have been largely from security firms, but watch for new firms to emerge with a strong combination of security and real estate skills. In the retail area, a large proportion of real estate security advisors will be (or include) real estate mutual funds.

Securitization also enhances the move to international real estate investment. Public real estate companies are well established in many countries and often dominate real estate activity. Diversifying a global real estate portfolio at the share level is infinitely easier to implement than direct investment in fixed assets located in different legal and cultural environments. This will be particularly true of rapidly growing real estate markets in emerging economies.

As important a force as securitization will be, I believe it will supplement and not replace the private real estate market. Some investors will continue to prefer investing where they have greater control and believe they can achieve excessive returns from an inefficient marketplace. This will be particularly true for large players who have the market power and internal staff to successfully implement such programs. For all, REITs and securitization will bring a new dimension to real estate investing. Like an omelet, it ultimately should be very tasty, but a lot of eggs may be broken in the process.

NOTES

1. This article was originally presented to the *Institute for Fiduciary Education* in the Spring of 1994.
2. Kostin, David J., *Real Estate Investment Trusts—The 1993 REIT Explosion in Perspective*. Salomon Brothers, January 1994.
3. Recent legislation clarified that, for purposes of the 5/50 rule, REIT shareholders are the plan beneficiaries, rather than the plan itself.
4. Gyourko, Joseph, and Donald B. Keim. "What Does the Stock Market Tell Us About Real Estate Returns?", *Journal of the American Real Estate and Urban Economics Association*. Vol. 20, No. 3. (1992).
5. Giliberto, S. Michael, "Equity Real Estate Investment Trusts and Real Estate Returns," *The Journal of Real Estate Research*. 5. (1990).