REITS AND THE PRIVATE MARKET: ARE COMPARISONS MEANINGFUL?

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REIT shares are securities. They are paper entitlements representing a financial interest or claim to a return. An individual real estate asset can be an office building, shopping center or similar type of property that is privately owned.

REITs were formed in the 1960s as vehicles to hold or finance real estate and to offer tax advantages to investors. REITs must distribute 95 percent of taxable income to shareholders, which many consider to be equivalent to 80 percent to 85 percent of cash flow. REITs act as a conduit for the transfer of cash flow from real estate to investors without being taxed as a corporation. There are a variety of REITs including equity REITs, mortgage REITs, UPREITs, hybrid REITs and others. Recently, REITs have focused on specific property types and have evolved into shopping center REITs, hotel REITs, office building REITs, etc. The current attitude on Wall Street is that real estate is essentially a local, specialized business. Thus, if investors seek diversification, they can buy shares in REITs consisting of other property types or REITs that concentrate in specific geographic locations.

Equity REITs own, manage, buy and sell real estate. REITs are more than just real estate, however. They are operating businesses that include tangible assets (i.e., real estate) as well as intangible assets such as the quality and expertise of management. As a result, the value of a REIT can be more or less than the value of the underlying real estate. Some say REIT shares that trade at a premium above the value of the real estate have franchise value. While real estate assets are undoubtedly important, other factors influence share price as well.

Advantages Of REITs

In addition to greater liquidity, advantages of securitization over private investment include diversification, a larger pool of available capital, known value, more abundant information and elimination of the cost and burden of direct management. These attributes explain why market participants may accept cash on cash returns from REITs that are lower than cash on cash returns from direct real estate investments in the private market.

The REIT market is efficient and liquid. Shares are bought and sold at central locations (i.e., stock

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exchanges). Once a buy/sell decision is reached, ownership can often be transferred instantaneously. Some REITs do, however, have thin liquidity. The liquidity of REITs is measured by bid-ask spreads.

Another benefit is the vast supply of capital in the public markets, which has been growing steadily. Although debt and equity funds raised in the public markets tend to be more expensive than conventional sources (i.e., banks, insurance companies, private placements, etc.), this cost may be more than offset by the availability and supply of capital for securitized transactions.

The value of REIT securities can be known instantaneously and with virtual certainty simply by viewing a quotron. There is no need to wait for an appraisal which may take several weeks to prepare and only provide a best-guess estimate.

One of the most striking features of the public markets is its abundance of information. This is attributable to governmental regulation, constantly improving technology and the insatiable appetite of decision-makers for information. This also contributes to the efficiency of the market.

Finally, REIT investment can reduce the cost and burden of direct management, an important characteristic of private ownership. This is particularly significant to institutional investors, such as insurance companies and pension funds. Direct investment in real estate might represent only 5 percent of a pension fund's assets but may require 40 percent of its staff to manage.

The typical anticipated holding period is also an important factor to consider. REITs appeal more to a trading mentality than to traditional participants in the private markets. Unlike individual assets, REITs are subject to short-term volatility. This is attractive to traders because such volatility creates opportunities for profit as they move in and out of different stock positions. One body of knowledge considers that REIT values also are immediately sensitive to interest rate movements, similar to stocks and bonds. Studies indicate a higher degree of correlation between the general stock market and REIT share prices, regardless of local market real estate trends. Private real estate owners typically have long-term investment horizons that often extend through several market cycles.

REIT Renaissance

The recent surge in REIT popularity was caused by the focus of the RTC on securitization and a favorable interest rate environment. In addition, there was general illiquidity pervasive throughout the national real estate economy in the early 1990s resulting from the banking crisis and the temporary disaffection of traditional capital sources for real estate. This forced owners to seek alternative capital sources. REITs enabled them to recapitalize their private investment in real estate at a time when more conventional forms of financing were unavailable. Paradoxically, some observers now are predicting a wave of de-REITing similar to the leveraged buyouts in the late 1980s. In any event, new attention has been given to REIT valuation methodology and, consequently, a body of knowledge has begun to develop.

Terms Define The Industry

Before public market valuation is compared to private valuation theory, it is necessary to understand some basic terminology. *Dividends* are the net income of a company after debt and taxes and represent a portfolio cash flow. *REITs* can incur additional expenses at the corporate level such as corporate management and advisory fees that are not incurred by a property. The REIT benefits from the income derived from the operating entity, i.e., leasing commissions and management fees which can represent savings to the REIT. *Corporate dividends* are distributions to shareholders of corporate assets generally in the form of cash. In valuing single real estate assets, *net operating income* is income before debt and taxes, while *cash flow* is described as net income after deduction for debt.

A *price/earnings (P/E) ratio* is the relationship of a stock's price to the company's earnings. It is calculated by dividing the current share price by earnings per share. It is the relationship of price (equity value) to earnings (net income). Stated another way, a P/E ratio is an income multiplier. It is the reciprocal of an equity capitalization rate (as opposed to an overall capitalization rate) in single asset real estate valuation.

Capitalization rates are also used in estimating the value of corporations. "In the capitalization-of-income method of valuing a business, a cap rate is used to convert a single year income into a value estimate for the business as a whole. This method is appropriate when future income is expected to grow at a constant rate,"[1] says Randy Swad. This is similar to direct capitalization in real estate valuation.

Swad also notes that "A *discount rate* is used in the discounted future income method of valuing a business . . . the value . . . is the present value of all future after-tax cash flows."[2] This is similar to applying a discounted cash flow analysis, a form of yield capitalization, in the valuation of real estate in the private marketplace. Swad warns, however, that ". . . the discount or cap rate and the measure of income must be compatible, e.g., an after-tax discount rate should be applied to after-tax income."[3]

One method to value operating entities is to capitalize income utilizing a weighted average rate of return on invested capital. The weighted average rate of return is developed using the band-of-investment technique.

WARR = (After-tax rate of return on debt capital)
× (% of debt capital to sum of the debt)
+ (rate of return on equity capital)
× (% of equity capital to total equity).

The cash flows expected to be generated by a business are discounted to their present value using a WARR that reflects the relative risk of the investment as well as the time value of money. As illustrated by the above equation, the WARR is an overall return based on individual rates of return for invested capital (equity and interest-bearing debt), calculated by weighting the required returns on interest-bearing debt, preferred equity and common equity in proportion to their respective percentages of the company's capital structure.

The *rate of return on debt capital* is the rate a prudent investor would pay on interest-bearing debt. One method used to estimate the return on equity capital is known as a *Capital Asset Pricing Model (CAPM)*. CAPM estimates the rate of return on common equity as the current risk-free return on United States Treasury Bonds plus a market risk premium expected over the risk-free rate of return which is multiplied by the beta for the stock. *Beta* is a risk measure which reflects the sensitivity of a company's stock price to movements of the stock market as a whole.

Public Market Valuation

In the case of REIT valuations, various other measures of performance have evolved due to the peculiar capital structure of those entities. One of the most important measures is *Funds From Operations (FFO)*. FFO is net income or "earnings" excluding gains or losses from debt restructuring and sales of property plus depreciation and amortization (excluding amortization of deferred financing costs and depreciation of non-real estate assets) and adjustments for unusual items. This is a revised definition of FFO as established by the National Association of Real Estate Investment Trusts (NAREIT) that became effective in 1996. Wall Street analysts have also developed FFO multiples for comparative purposes. Some critics maintain that FFO may not be representative of true operating profitability because it may not account for leasing commissions, tenant improvements and recurring capital expenditures. Although this is an important measure of performance used by the securities market, analysts are continuously developing other units of comparison, such as cash available for distribution (CAD) and many others.

FIGURE 1

REIT Yields — Year-End 1994

Yield on Equity (Ye) (%)
Ye = Dividend Yield ÷ Dividend Payout Ratio
Ye = 7.67% ÷ 85%
Ye = 9.02[1]

Yield on Overall Assets (Ya)
Ya = Equity Yield × (% Equity) + Debt Yield × (% Debt)
Ya = 9.02% × (0.65) + 7.75% × (0.35)
Ya = 8.5%

Implied Capitalization Rate (Yo)
Yo = FFO Yield on Assets + Corporate Overhead (Management Expense[2])
Yo = 8.58% + 0.70%
Yo = 9.28%

[1]Some people adjust for floating-rate debt.
[2]Management expense is the average "reasonable cost of doing business" for a REIT.

Glen Mueller succinctly presented three measures of REIT yield performance for year-end 1994: yield on equity or dividend yield, yield on overall assets (i.e., debt and equity, similar to WARR), and an implied capitalization rate consisting of FFO yield on assets plus corporate overhead. They are presented in Figure 1.[4]

Mueller also observed that "public market vehicles react more quickly to economic and financial market movements than do private market prices"[5]. Because the capital markets are better informed and capable of reacting quickly to change, damage in relative terms can be minimized. At the same time and perhaps more important, opportunities for profit can be exploited.

Private Marketplace

The private marketplace is characterized by inefficiency but also by control. The latter is perceived by some as the single greatest advantage of private ownership. Price variations in this market reflect differences in a property's physical condition and economic attributes, the legal interest conveyed, perceived level of risk, competitive investment environment, buyer/seller motivations, exposure to the market and structure of the transaction. However, there is no central marketplace. Information is often dated and incomplete, capital sources are limited, exit strategies are difficult to execute because of the time required to dispose of an asset and concepts of pricing are often imprecise.

Private Market Valuation

Property values in the private market are measured by direct and yield capitalization techniques. One of the most common methodologies consists of developing an overall capitalization rate, which can

reflect assumptions on changes in a property's value or cash flow. Since this market is motivated by opportunities for leverage, overall capitalization rates also reflect the requirements of debt and equity positions. In other situations, particularly those involving institutional investors, overall capitalization rates can be developed assuming a property is free and clear.

Overall rates are applied to a property's net operating income (NOI) or income after property expenses but before debt and taxes. That there is no true equivalent of NOI in the REIT format underscores the differences between business and real estate valuation and the danger of casual comparisons. Capitalization rates can also be applied to a property's net income after income taxes. As Swad points out in REIT valuations, care must be exercised to apply pre and after-tax capitalization rates depending on the appropriateness of the situation.

Another variation is to apply capitalization rates to a property's cash flow or income after debt service. This is known as equity capitalization, because it derives an estimate of the value of the equity position in a property. The equity capitalization rate is also known as the cash-on-cash return. Cash flow to a property is not similar to the earnings of a REIT because cash flow in the private market is before debt and taxes.

Cash flow before debt and taxes is also normally used in discounted cash flow analysis of a single property. In business valuation, future earnings are discounted to a present value. Some contend that analysts should discount FFO.

The Business Of REITs

Comparison of REIT values to individual property values is difficult notwithstanding that many general valuation principles are common to both markets and academic exercises that derive adjusted capitalization rates purported to quantify the difference between REIT cap rates and those of individual properties. While there are considerable variations in terminology, other differences are more profound. In addition to issues of liquidity, trading and informational efficiency and accessibility to capital, the most obvious difference is one of basic nature. REITs are operating businesses. When investors purchase REIT shares they are acquiring not only the company's real estate portfolio of cash flows but also its management and other intangible assets. REITs can capture certain expenses, such as management fees and leasing commissions. When properties are purchased privately, investors acquire the bricks and mortar as well as the income stream secured by the leases which is reduced by the cost of property management and leasing fees.

There also has been a collision of the securities and real estate industries. Traditional participants in the private real estate market are generally small, highly independent and entrepreneurial, proprietary and strongly resistant to change. Attendant disciplines have developed their own valuation methodologies and pricing mechanisms. While many writers indicate that appraisals are backward looking, in actuality, when properly prepared the value in an appraisal represents the anticipation of future benefits with a longer term investment horizon than anticipated by stock market investors. Wall Street, including the rating agencies, has imposed new standards of analysis on real estate, but these standards are comparable in some respects to traditional factors considered by real estate appraisers. Wall Street analysts treat real estate as corporations, sometimes ignoring the effect of long term contractual obligations (i.e., leases greater than five years). Cash flow has become king but that is also true in the private market with less emphasis placed on forecasting.

Conclusion

This article was not intended to be judgmental. Rather, it presented several differences between the public and private real estate markets and methods of analyses. The intent was to better understand how the public and private markets relate to one another and to demonstrate how casual comparisons are often misleading or sometimes incorrect. At the same time, it is absolutely essential for participants in one market to understand the other market, because they are inextricably linked. The emerging public market will continue to grow and profoundly influence privately traded real estate, capital formation, pricing and market fundamentals. For short periods, capital availability is likely to have as much influence on price as actual demand. Information, even in the inefficient private market, will become increasingly more important.

NOTES

1. Swad, Randy, "Discount and Capitalization Rates in Business Valuations," *The CPA Journal* (October 1994): 40.
2. Ibid., 40.
3. Ibid., 40.
4. Mueller, Glen R., Ph.D., Keith R. Pauley, CFA, William K. Monrrill, Jr., "A Primer For Private And Public Equity Choices In A Real Estate Portfolio Management Context," *Real Estate Finance*, 17.
5. Ibid., 17-18.