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REITs 101

A Greenfield Advisors White Paper
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The investment world is filled with a variety of vehicles in which to stow one's wealth. Generally, stocks, bonds, and real property are the primary investment assets that can be purchased with cash and held for income and capital gains purposes. In 2012, talking babies during the Super Bowl have demonstrated the ease with which these assets can be acquired. Yet, some investment options are better suited for different types of investors, and individuals are wise to consult a professional wealth manager for guidance.

A note about terminology: When we discuss land and the things attached to land (i.e., buildings), we are referring to *real property*. When we discuss ownership interests, contractual interests, and financial interest associated with real property, we are referring to *real estate*. For instance, a house built on 5 acres of land is real property. Fee-simple home ownership—the legal right to use and enjoy that property in any lawful way—is real estate.

Commercial real estate (e.g., office buildings) can be an attractive investment that generates lots of cash when operated by a skilled property manager. Unfortunately, direct investments in quality commercial real estate are cost-prohibitive for many people. Even "cheap" properties can have six-figure price tags, and assembling a portfolio of real assets can take millions of dollars. Despite this barrier to entry, typical investors may participate in commercial real estate investments by purchasing shares in a real estate investment trust (REIT).

What Is a REIT?

In the most basic sense, a REIT is an organization that derives the majority of its income from investments in real estate. Publicly traded REITs may issue stock, which can then be purchased and sold in the public stock market (such as the New York Stock Exchange). Shareholders enjoy regular dividend payments (which come from the operating income of the REIT's real estate portfolio), and capital gains (which reflect the increase in value of the real estate assets). Also, REITs benefit from a tax structure that allows them to operate "tax-free" so long as they pay out 90% of their annual operating income to shareholders.

Generally, REITs fall into two categories: equity REITs and debt REITs. Equity REITs own and operate real estate assets, such as apartment buildings. An apartment REIT will buy (or build) apartment buildings, manage the apartment units, and pay the net operating income from the buildings to shareholders.

Debt REITs (sometimes referred to as mortgage REITs) hold loans that are secured by real estate. Usually, debt REITs do not originate any loans. Rather, a residential mortgage REIT will buy a bundle of home loans made by a regional bank. The REIT will earn interest on the loans and pay that interest to shareholders.

A third type of REIT, a mixed REIT, is precisely what the name implies—a REIT that owns property and loans on property.

A Brief History of REITs

The earliest REITs were formed in the late 1800s, as the United States began to develop a federal income tax. At the time, provisions in the tax code allowed for some entities to avoid paying income tax at the corporate level, and instead pass the tax burden on to the shareholders. Some property owners recognized that by bundling their real estate into trusts, they could enjoy a lower tax rate. In the wake of the stock market crash of 1929, the pass-through income provision was removed from the tax code as part of sweeping regulatory reforms. The new rules made direct, non-securitized real estate ownership the more tax-efficient strategy, thus REITs disappeared.

For nearly 30 years, commercial real estate ownership was only accessible by the wealthiest investors. To cure this inequity, the provisions that allowed for untaxed pass-through income were included in the Cigar Tax Excise Tax Extension of 1960, signed into law by Dwight Eisenhower. New REITs began to form, mostly debt REITs that originated construction loans. The managers of these new REITs typically focused on one specific property type, such as healthcare facilities, rather than casting a wide net over a variety of property types. The principle of specialization remains in effect today.

The REIT Boom

Many of today's REITs did not form until well after 1960. In fact, it wasn't until the "REIT Boom" of the early 1990s that the market saw a significant number of equity REITs join the market. This can be attributed to two significant events.

First, the advent of self-administered REITs after the 1986 Tax Reform Act. For many years, REIT managers were mostly limited to overseeing the collection and distribution of funds to shareholders. They relied on third-party agents to actually manage the portfolio of real estate. This arrangement caused many REITs (typically equity REITs) to be burdened by excessive agency costs. Many third-party agents, although bound by fiduciary duties, had incentives that did not align with shareholder interests. For example, a third-party agent's fee may be based on a percentage of assets under management. Yet, sometimes REIT managers must strategically sell off properties to realize capital gains for the shareholders. If a v manager chooses to hold a property at a time when it can be sold at a significant premium, then the manager's fee will remain constant although the shareholder's opportunity is lost. The Tax Reform Act clarified that REIT managers may internalize this process.

Second, and somewhat counter-intuitively, the economic downturn of 1989–1991 proved to be a time of opportunity for many large real estate investors (especially REITs). As real estate prices dropped dramatically, investors with plenty of cash were able to buy properties at a significant discount. Although REIT share prices were driven down, the newly realized ability to self-manage, plus the tax advantage, made REIT formation an attractive option for large opportunistic real estate investors. This also helped define an evaluation benchmark that is still in use today. Funds from operations (FFO) is a measure of real cash flow that a REIT may use to fund new property acquisitions (typically described on a per-share basis). Assuming a competent manager, a REIT with a high FFO is more likely to be able to buy into value opportunities even when the value of the REIT asset portfolio is depressed.

The Modernized and Diversified REIT

The latest development to the structure of REITs—the ability to own and operate taxable REIT subsidiaries (TRS)—became law in 2001 and expanded in 2008. REITs must still abide by the 95% of revenue from real estate, dividends, or interest rule, but they may also invest no more than 20% of their assets into taxable subsidiaries. Originally intended for hotel and healthcare REITs, this provision allows REITs a way to own properties while simultaneously operating the businesses that occupy the

properties. Hotel REITs must provide services that fall outside of typical real estate property management (restaurants, day spas, site-seeing excursions), and they may do so through a subsidiary which is taxed like a normal S-Corporation.

Intrinsically, REIT values tend to be sensitive to

- The value of the underlying real estate portfolio
- Debt/asset ratio
- Availability of cash (such as FFO)
- Interest rates (and individual borrowing rates)
- Management efficiency and effectiveness

REITs, much like the real estate market as a whole, are very diverse in form and function. Although they each must follow the same set of guidelines, they must be evaluated for their individual strengths. Further, investors must not consider REIT ownership to be synonymous with real estate ownership. A share of a REIT is ownership in a company that invests in and operates real estate. As REIT shares trade on the public market, their prices tend to experience more volatility (that is, upward and downward movements) than real estate prices.