Chapter 21

Real Estate Investment Trusts (REITs)

Introduction

The concept of the real estate investment trust dates back to the 1880s. In the early years, trusts were not taxed if trust income was distributed to beneficiaries. In the 1930s, however, a Supreme Court decision required all passive investment vehicles that were centrally organized and managed like corporations to be taxed as corporations. This included real estate investment trusts.

Stock and bond investment companies, also affected by the same Supreme Court decision, promptly secured legislation (in 1936) that exempted regulated investment companies, including mutual funds, from federal taxation. At this time, real estate trusts were not organized to press for equal consideration, and the trust did not develop into importance as a legal form for investing in real estate.

After World War II, however, the need for large sums of real estate equity and mortgage funds renewed interest in more extensive use of the **real estate investment trust,** which also became known as the **REIT** (pronounced "reet"), and a campaign was begun to achieve for the REIT special tax considerations comparable to those accorded to mutual funds. In 1960, Congress passed the necessary legislation.

An underlying, very important concept relating to REITs is that in many ways their creation was intended to create a passive entity that would operate much like a mutual fund in the public securities sector. The concept was that REITs should provide investors with an opportunity to buy into a diversified portfolio of income-producing real estate. The portfolio would be assembled by the REIT then it would be operated more like a passive entity with limits on buying, selling, operating, and managing certain real estate assets. Then, if income was distributed in accordance with federal tax regulations, REITs would be viewed more as a conduit than as an active, corporate entity. If these conditions were met, REITs would not be taxed as a corporation and could pass through income and capital gains to shareholders.

Legal Requirements

A real estate investment trust is basically a creation of the Internal Revenue Code. It is a real estate company or trust that has elected to qualify under certain tax provisions to become a pass-through entity that distributes to its shareholders substantially all of its

taxable earnings in addition to any capital gains generated from the sale or disposition of its properties. In accordance with the tax provisions under which it was established, the real estate investment trust can deduct distributions to shareholders when calculating taxable income. Because REITs distribute most if not all of their income to shareholders, this means they generally pay little or no federal income tax. The distributed earnings do represent dividend income to its shareholders and are taxed accordingly. Similarly, any distributed capital gains are taxed at the shareholder's applicable tax rate.

Effective January 1, 1961, special income tax benefits were accorded a new type of investment institution by an amendment to the Internal Revenue Code (Sections 856–858). Under this amendment, a real estate investment trust meeting prescribed requirements during the taxable year may be treated simply as a conduit with respect to the income distributed to beneficiaries of the trust. Thus, the unincorporated trust or association ordinarily taxed as a corporation is not taxed on distributed taxable income when it qualifies for the special tax benefits. Only the beneficiaries pay the tax on the distributed income. To qualify as a real estate investment trust for tax purposes, the trust must satisfy the following general requirements:

Asset Requirements

- At least 75 percent of the value of a REIT's assets must consist of real estate assets, cash, and government securities.
- Not more than 5 percent of the value of the assets may consist of the securities of any one issuer if the securities are not includable under the 75 percent test.
- A REIT may not hold more than 10 percent of the outstanding voting securities of any one issuer if those securities are not includable under the 75 percent test.
- Not more than 25 percent of its assets can consist of stocks in taxable REIT subsidiaries.

Income Requirements

- At least 95 percent of the entity's gross income must be derived from dividends, interest, rents, or gains from the sale of certain assets.
- At least 75 percent of gross income must be derived from rents, interest on obligations secured by mortgages, gains from the sale of certain assets, or income attributable to investments in other REITs.

Prohibited Transactions

As indicated above, the REIT concept was originally intended to restrict certain activities and to retain a more passive nature as far as its operations were concerned. In other words, Congress did not want REITs to enter activities such as regularly trading real estate assets or actively developing land and improvements with the purpose of selling such developments as a regular, on-going business activity. These activities could be viewed as being more active in nature, similar to activities carried out by corporations, and as such, they should be taxed at the corporate level. During 2008, in its Housing Act, Congress created a series of tests, such that if complied with, would provide REITs with a "safe harbor." These safe harbor tests, if satisfied, would ensure that certain sales of property would not be treated as "prohibited transactions." This is a very important rule that REITs must comply with as any net income produced by prohibited transactions would be subject to a 100% penalty tax. These tests generally include the following:

- REITs must own propertyies for at least two years prior to sale;
- Cost of any capital improvements to the property during that period cannot exceed 30 percent of the sales price;

- REITs cannot (1) have sold more than seven properties, or alternatively, (2) have sold properties with an aggregate adjusted basis in excess of 10 percent of the aggregate basis of all the REIT's assets as of the beginning of the taxable year; and
- For land or improvements not acquired through foreclosure, properties must have been held for the production of rental income for at least two years.

Distribution Requirements

- Distributions to shareholders must equal or exceed the sum of 90 percent of REIT taxable income.

Stock and Ownership Requirements

- The REIT must be taxable as a corporation.
- The REIT must be managed by a board of directors or trustees.
- Shares in a REIT must be fully transferable.
- Shares in a REIT must be held by a minimum of 100 persons.
- No more than 50 percent of REIT shares may be held by five or fewer individuals during the last half of a taxable year.

Management Activities

One of the ongoing challenges in the REIT industry is (1) the extent to which portfolios of income properties can be managed effectively (that is assets must be acquired, maintained, financed, sold, etc.) while (2) continuing to maintain many of the attributes of a trust, (3) avoiding the corporate income tax while (4) retaining favorable federal income tax treatment of dividends and capital gains passed through to its investors. In past years, REIT management generally limited its activities and performed oversight responsibilities by outsourcing most of the property management functions, sales, and so on to third parties. In recent years, the industry has succeeded in becoming more self-administered, or active in managing trust assets. However, this evolution has come with a considerable amount of regulation from Congress.

Prior to 1986, a management activity restriction existed to ensure the passive nature of REITs. Trustees, directors, or employees of a REIT were not permitted to actively engage in managing or operating REIT property, rendering services to tenants of REIT property, or collecting rents from tenants. These functions were generally performed by an independent contractor. In 1986, the Tax Reform Act relaxed the management limitations, allowing REITs to render normal and customary maintenance and other services for tenants, eliminating the need for an outside independent contractor for property-related functions like property management. The result of this change is that REIT managers now have the ability to internalize these functions, creating vertically integrated operating companies and fundamentally altering the REIT vehicle.

In the pre-1986 era, many REITs were organized or sponsored by a financial institution, such as an insurance company, a commercial bank, or a mortgage banker. The sponsoring institution also served as an advisor to the REIT, either directly or through an affiliate. Responsibility was delegated to the advisor for managing the operations of the REIT, including management of the REIT's assets and liabilities. Following the 1986 Tax Act, the REIT became a more attractive vehicle for real estate developers who had not been interested in a passive investment vehicle. Real estate developers and operators have become the dominant sponsors of REITs, particularly for larger companies.

Two landmark initial public offerings helped shape the modern REIT industry. The first was the 1991 Kimco Realty offering, which was the first offering of a modern vertically

integrated REIT, providing its own property and asset management. Although some existing REITs adapted following the 1986 Act, Kimco Realty was the first significant REIT initial public offering designed to be internally managed and advised. The second significant offering was the Taubman Realty offering, which launched the public **umbrella partnership REIT**, or **UPREIT**.

An UPREIT is a REIT that owns a controlling interest in a limited partnership that owns the real estate, as opposed to a traditional structure in which the REIT directly owns the real estate. This structure was created in 1992 as a tax-deferred mechanism through which real estate developers and other real estate owners could transfer their properties to the REIT form of ownership. Since the transfer is an exchange of one partnership interest for another, it is not a taxable event. These partnership interests, known as operating partnership units, or OP units, are generally convertible into shares of the REIT, offering voting rights and dividend payments matching those of the REIT shares.

In 1992, traditional real estate capital sources were largely absent from the market, creating a credit crunch. In these conditions, the "modern" REIT structure featuring active management and tax-deferred exchanges of assets was attractive to owners and investors alike. The result was massive growth in REIT equity market capitalization.

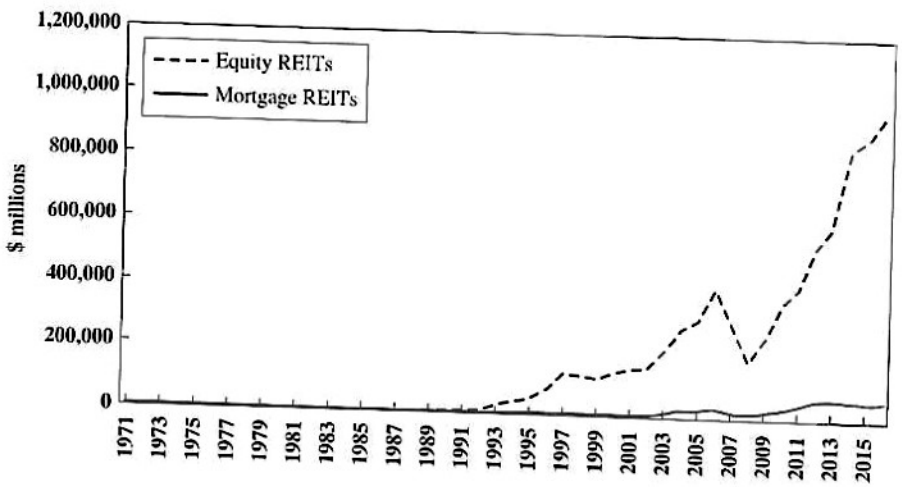
In 2007 and 2008, the U.S. financial system was rocked by the fallout of the subprime mortgage crisis, resulting in a very severe credit crunch in which many REITs were unable to refinance corporate debt or property-level debt when it came due, irrespective of operating performance. REIT pricing declined dramatically, and as of December 31, 2008, there were 136 REITs registered with the Securities and Exchange Commission that were trading on one of the major stock exchanges, with the majority trading on the New York Stock Exchange. These REITs had a combined equity market capitalization of $192 billion, as compared to 183 REITs with a combined equity market capitalization of $438 billion as of December 31, 2006. The growth of the REIT industry and the impact of the global credit crisis on REITs are shown in Exhibit 21–1.

As the U.S. financial system recovered from the subprime mortgage crisis, REITs recovered strongly. As of December 31, 2016, there were 224 REITs registered with the Securities and Exchange Commission trading on the major stock exchanges. These REITs have a combined equity market capitalization of $960 billion, as compared to $192 billion at December 31, 2008.

The vast majority of today's equity REITs are self-advised, vertically integrated operating companies. They actively manage their portfolios in an effort to grow their cash flow and their portfolios, a fundamentally different entity from the earlier "passive" REIT.

EXHIBIT 21–1
Market Capitalization of Publicly Traded REITs

Source: See: "Data and Research" at the NAREIT website: www.nariet.org.



They also actively manage their capital structure, securing capital through public equity and debt offerings, property- and portfolio-level debt, and joint ventures with institutional and foreign investors. The industry continues to change in response to real estate market dynamics, capital market dynamics, and investor preferences.

Tax Treatment

One area of importance in accounting for REITs is the treatment of depreciation for financial reporting and the determination of taxable income. For example, a REIT may use an accelerated method of depreciation in its determination of taxable income, but when determining income available for dividends it is required to use a 40-year asset life. The use of inconsistent methods of income calculation sometimes results in shareholders receiving dividends in excess of the REIT's calculated taxable income. However, to the extent that the distribution represents a return on investment, these dividends will be taxed as ordinary income. In May 2003, the U.S. Congress passed the Jobs and Growth Tax Relief Reconciliation Act, which cut income tax rates on most dividends to a 15 percent maximum, subject to certain income tests. Because REITs do not generally pay corporate taxes, the majority of REIT dividends continue to be taxed as ordinary income at prevailing tax rates. Any additional amounts distributed, such as those representing depreciation, will be considered a return of original capital and thus will simply reduce the shareholder's tax basis. REITs report the breakdown of their distribution annually on Form 1099 and investors may choose to hold specific REITs in taxable or nontaxable accounts based on the breakdown of their distribution.

Violation Penalties and Status Termination

In the event that an entity fails to qualify as a REIT or voluntarily revokes its REIT status, the entity's election to be taxed as a REIT terminates for that and subsequent years. Once this termination has occurred, the entity cannot make a new election to be taxed as a REIT until five years after the termination date. However, if the entity's REIT status was terminated as a result of a failure to satisfy the qualifying requirements, the entity may reelect REIT status within the five-year time period if it can prove to the IRS that its failure to qualify was due to reasonable cause and not willful neglect. In October 2004, a corporate tax reform bill was signed into law that provided the IRS with the ability to impose monetary penalties in lieu of loss of REIT status for reasonable-cause violations, reducing the risk of loss of REIT status through errors of omission and protecting shareholders from the negative consequences associated with loss of REIT status.

Taxable REIT Subsidiaries

In 1999, the REIT Modernization Act (RMA) was signed into law. The RMA contains several provisions designed to allow REITs to compete more effectively with other owners of commercial real estate. Prior to the RMA, there were restrictions that prohibited REITs from providing services to tenants beyond those "usual and customary" to their industry. For example, an office REIT might lease furniture to tenants. A shopping center REIT might offer its own credit card to customers. If REITs provided services beyond usual and customary, the income from the property where the services were provided was treated as not being qualifying real estate income. As the real estate industry continued to evolve, usual and customary became more difficult to define and monitoring compliance became very expensive. Given the risk associated with large amounts of nonqualifying income (possible loss of REIT status), some REITs were reluctant to provide services, limiting their ability to compete.

The RMA also provides for the establishment of the taxable REIT subsidiary (TRS) that can be 100 percent owned by a REIT. Under the new law, a TRS can provide services

to REIT tenants and others, pay any associated income tax, and pass the income up to the REIT as qualifying income. Taxable REIT subsidiaries were designed to replace a previous structure under which REITs owned partial interests in non-REIT C corporations. Those C corporation structures had significant conflicts of interest. The TRS structure eliminates many of those conflicts. The RMA also provides for limitations on debt and rental payments between the REIT and the TRS and a 100 percent excise tax on any transaction between the TRS and an affiliated REIT not negotiated as an arm's-length transaction.

TYPES of REITs

The two principal types of publicly traded real estate trusts are *equity trusts* and *mortgage trusts*. Prior to 2010, there was a third classification, hybrid REITs, which generally consisted of REITs with a mix of equity and debt real estate investments. As of December 17, 2010, NAREIT discontinued tracking these REITs, as only four hybrid REITs remained at that time. There are also REITs that are public companies but are not listed on an exchange or traded over the counter, which are generally called *private* REITs. Up until the 1970s, the equity trust was the most prevalent type of REIT, but during the mid-1970s, the mortgage trust became more important. More recently, the equity trust has again grown in importance and is now the dominant REIT type by both number and market capitalization figures. As of June 30, 2014, 81 percent of REITs were equity REITs and 19 percent were mortgage REITs.

The difference between assets held by the equity trust and those held by the mortgage trust is fairly obvious. The equity trust acquires property interests, while the mortgage trust purchases mortgage obligations and thus becomes a creditor with mortgage liens given priority to equity holders.

Equity REITs

Most REITs specialize by property type; some specialize by geographic location. Others specialize by both property type and location. Not all REITs specialize; some diversify by both property type and geographic location. Specialization implies a concentration of effort to create a comparative advantage. REITs and analysts generally use the term *specialization* to cover a fairly broad range of concentration. In reality, specialization is a matter of degree. The extent to which a REIT is specialized impacts the risks associated with ownership of the REIT. Therefore, it is important to determine how specialized an individual REIT is in comparison with other REITs, in order to assess relative risks. For purposes of description, equity trusts have generally been broken down by property type specialization. The National Association of Real Estate Investment Trusts (NAREIT) divides equity REITS into the following property types:

1. **Industrial/Office.** These REITs are further subdivided into those that own industrial, office, or a mix of office and industrial properties. Some analysts further segregate these REITs by property location (i.e., whether they are in central business district [CBD] or suburban locations, whether they specialize in medical office properties).
2. **Retail.** These REITs are further subdivided into those that own strip centers, regional malls, and free-standing retail properties.
3. **Residential.** These REITs are further subdivided into those that own multifamily apartments and manufactured home communities. Some analysts further segregate those REITs that own student and military housing.
4. **Diversified.** These REITs own a variety of property types, or own properties of one type that is not otherwise categorized, such as single-family rental housing, data centers, or prisons.

5. **Lodging/Resorts.** These REITS primarily own hotels, motels, and resorts.
6. **Health Care.** These REITs specialize in owning hospitals, seniors housing, medical office and related health care facilities that are leased back to private health care providers who operate such facilities. This is a highly specialized form of REIT and one which many do not consider to be a "true, real estate–backed" security.
7. **Self-Storage.** These REITs specialize in ownership of self-storage facilities.
8. **Timber.** These REITs specialize in owning timberland.
9. **Infrastructure.** The REITs specialize in owning various types of infrastructure, including railroads, electric and gas transmission and distribution, cell towers, and other forms of infrastructure.

The distribution of REIT ownership by property type changes over time. In September 1991, residential properties accounted for more than half of all total publicly traded REIT real estate investments, followed by office, retail, health care, industrial, hotels, and other properties. By mid-year 2003, industrial/office REITs represented the largest sector at just over one-quarter of the total, followed by retail, residential, diversified, lodging/resorts, health care, self-storage, and specialty properties. As of June 30, 2014, the office/industrial sector and the retail sector each account for approximately 22 percent of REITs, followed by the diversified, residential, lodging, health care, timber, self storage, and infrastructure sectors. Concept Box 21.1 lists the largest U.S. REITs as of July 2014.

REITs may also be categorized by other variables, including duration of the trust, or finite-life versus nonfinite-life REITs. A finite-life (or self-liquidating) REIT is undertaken with the goal of disposing of its assets and distributing all proceeds to shareholders by a specified date. These REITs were instituted in response to the criticism of many investors that the prices of REIT shares tended to behave more like shares of common stock; that is, they were based on current and expected future earnings instead of the underlying real estate value of the REIT. Hence, by the establishment of a terminal distribution date, it is argued that REIT share prices would more closely match asset values because investors could make better estimates of the terminal value of the underlying properties. This, it is argued, is not the case with nonfinite-life REITs, which reinvest any sale and financing proceeds in new or existing properties and tend to operate more like a going concern, as opposed to an investment conduit. One potential problem with finite-life REITs has to do with general market conditions at the time the REIT plans to dispose of assets. If interest rates are high and occupancies and rents are low, the timing of such disposition activity may not be good and distribution dates may have to be extended. Most new REITs are nonfinite-life REITs, and several existing finite-life REITs have amended their articles of incorporation to become nonfinite-life REITs. Finite-life REITs are not publicly traded on exchanges.

The Investment Appeal of Equity REITs

The equity-oriented real estate investment trust has provided investors with opportunities to (1) invest funds in a diversified portfolio of real estate under professional management and (2) own equity shares that trade on organized exchanges, thus providing more liquidity than if a property were acquired outright. Because the individual investor has the opportunity to pool his or her resources with those of persons of like interests, funds are assembled to permit purchase of buildings, shopping centers, and land in whatever proportion seems to offer the most attractive returns. Investments must be approved and management activities reviewed by a board of trustees who are accountable to shareholders and are ordinarily well qualified to make such decisions. The REIT shares are usually readily salable in the over-the-counter market or on major stock exchanges. Investments in REITs may also be

Thirty Largest U.S. REITs by Market Capitalization, *as of July 2014*

Concept Box 21.1

Company	Ticker	Type	Market Capitalization (billions)
Simon Property Group, Inc.	SPG	Equity	52,250
American Tower Corporation	AMT	Equity	37,438
Public Storage	PSA	Equity	29,204
Crown Castle International Corp.	CCI	Equity	24,781
Equity Residential	EQR	Equity	23,273
General Growth Properties, Inc.	GGP	Equity	20,652
Prologis, Inc.	PLD	Equity	20,333
Vornado Realty Trust	VNO	Equity	19,735
Health Care REIT, Inc.	HCN	Equity	19,546
AvalonBay Communities, Inc.	AVB	Equity	19,157
HCP, Inc.	HCP	Equity	19,023
Ventas, Inc.	VTR	Equity	18,684
Boston Properties, Inc.	BXP	Equity	18,113
Host Hotels & Resorts, Inc.	HST	Equity	16,438
Weyerhaeuser Company	WY	Equity	16,395
American Realty Capital Properties, Inc.	ARCP	Equity	11,904
Essex Property Trust, Inc.	ESS	Equity	11,791
Annaly Capital Management, Inc.	NLY	Mortgage	10,514
SL Green Realty Corp.	SLG	Equity	10,226
Realty Income Corporation	O	Equity	9,532
Macerich Company	MAC	Equity	9,136
Kimco Realty Corporation	KIM	Equity	9,083
Digital Realty Trust, Inc.	DLR	Equity	8,715
American Capital Agency Corp.	AGNC	Mortgage	8,235
Federal Realty Investment Trust	FRT	Equity	8,159
Plum Creek Timber Company, Inc.	PCL	Equity	7,319
UDR, Inc.	UDR	Equity	7,276
W.P. Carey Inc.	WPC	Equity	6,508
DDR Corp.	DDR	Equity	6,301
Camden Property Trust	CPT	Equity	6,139

Source: Brad Case, NAREIT.

made through mutual funds specializing in REIT securities. There are also a number of real estate and REIT exchange-traded funds (ETFs) and closed-end funds.

The REIT market is continually evolving as new investment alternatives emerge and mature. A recent development has been the emergence of international REIT investments. Capital flows have increased substantially as investors explore and invest in global real estate opportunities in an effort to diversify their portfolios. International REIT investment has occurred in two major ways: via cross-border investment in U.S. and foreign REITs and via existing U.S. REITs that are building international portfolios. It is now relatively easy for investors to find alternative mechanisms that allow them to get exposure to international real estate. The worldwide credit crisis that began in 2007 resulted in a decline in capital flows to all types of real estate investment, including international real estate investment. As capital market conditions recovered, investor interest and investment in international real estate have continued to grow.

The introduction of REITs and similar vehicles in over 30 countries has eased the flow of capital in and out of international markets. As of December 31, 2012, the FTSE

EPRA/NAREIT[1] Developed Market Real Estate Index included more than 290 listed companies in 20 countries across the globe. On an equity market capitalization basis, approximately 50 percent of the index's value was in North America, approximately 36 percent was in Asia, and approximately 14 percent was in Europe. See Concept Box 21.2 for an overview of international REITs.

Caveats

As described above, when an equity REIT is created, existing properties or projects to be developed will be acquired as investments. In addition, during the life of the REIT, management fees, advisory fees, and commissions will be paid to affiliates and other parties doing business with the trust. Typically, a real estate owner working with an investment banker can form a REIT that is capitalized through a public securities offering. The REIT may then use the funds it has raised to acquire the owner's properties. The prices that prevail in these transactions are generally not based on arm's-length negotiations and there is generally no appraisal or other independent indication of value.

Obviously, the formation transactions and the close association of REITs with other real estate organizations or individuals who sponsor them can create potential conflicts of interest. These conflicts can come in several forms, including preferential treatment given to properties owned by management but not owned by REIT investors, and so on. Investors have reacted harshly to REITs perceived as "holding out" properties of exceptional value and have forced management to make provision for the REIT to acquire all noncontributed properties. Other conflicts include managers negotiating an excessive price for their contributed real estate operating companies, including third-party management contracts. The UPREIT form adds more potential conflicts, including the fact that OP units holders, often the managers, have a different tax position relative to contributed properties, and a sale or refinancing of properties they contributed may be taxable. A number of safeguards attempt to protect investors against the problems of such conflicts, including the provision in the articles of incorporation of most REITs that a *majority* of the trustees or directors may not be affiliated with the sponsors of a REIT. Some REITs also engage independent appraisers to determine whether the purchase prices of properties acquired from the sponsors are at fair market value and that "fees paid to the REIT's management and advisory companies are reasonable." Many REITs are self-advised and avoid many of these conflicts by not using external advisors. Self-advised REITs will disclose and identify specific managers, their responsibilities, compensation, and so on, thereby providing information that investors can use when evaluating the shares. Additional safeguards have been put in place via the Sarbanes-Oxley regulations regarding disclosures by publicly traded companies.

Public Nonlisted REITs

Although most REITs trade on one of the established securities markets, there is no requirement that REITs be publicly traded. REITs that are not listed on an exchange or traded over-the-counter are called *public nonlisted REITs*. These REITs are public companies but are not listed.

The National Association of Real Estate Investment Trusts (NAREIT) classifies three typical types of private REITs as follows: (1) REITs targeted to institutional investors that take large financial positions, (2) REITs syndicated to investors as part of a package offered by a financial consultant, and (3) "incubator" REITs that are funded by venture capitalists with the expectation that the REIT will develop a sufficient track record to launch a public offering in the future.

While there are some prominent REITs that are targeted to institutional investors or formed as an incubator, REITs syndicated to investors have experienced rapid growth and

[1] European Public Real Estate Association/National Association of Real Estate Investment Trusts.

International REITs: An Overview

Concept Box 21.2

The real estate investment trust (REIT) system was born in the United States in 1960 and REIT markets later opened in the Netherlands, Australia, and Puerto Rico. The Japanese REIT market was launched on the TSE in March 2001, making Japan the thirteenth country in the world to launch a REIT market.

After the Japanese REIT market was launched, REIT structures were introduced in South Korea, Hong Kong, Taiwan, and other Asian countries. Later, in Europe, France launched a system in 2003. The United Kingdom and Germany adopted REITs in 2007 and they were adopted in Finland and Spain in 2009 followed by Hungary in 2011 and Ireland in 2013. In total there are now 31, counting Hong Kong and China as the same country.

This chapter focuses on REITs, which have become the dominant fund real estate securitization product in the world today. The following is a summary of overseas REIT structures that are currently being used and analyses of characteristics, common areas, and differences of the respective systems.

This chapter presents overseas REITs from the eight countries of America (REIT), Canada (C-REIT), the Netherlands (FBI), Belgium (SICAFI), France (SIIC), Australia (LPT), Singapore (S-REIT), and South Korea (K-REIT). The table below presents a direct comparison between the various REIT systems and also includes Japan (J-REIT), Malaysia (PTF), Hong Kong (H-REIT), and Turkey (REIC).

For ease of comparison between the world's primary REITs, the table below has organized the REIT comparison by the four categories of (1) date established, (2) legal system, (3) fund format, and (4) REIT requirements.

The structures of REITs are largely dependent on the tax law of each country as it is essential for REITs to serve as nontaxable conduits for tax purposes and that there be no double taxation at the REIT level and investor level specifically for the REIT investment. REITs can be broadly categorized into those systems that are purely based on the taxation system such as in America and the Netherlands and those that are based on an investment trust law where real estate investments have been

Comparison of REIT Systems

		1	2	3	4	5
	Country	**United States**	**Canada**	**The Netherlands**	**Belgium**	**France**
	System	**Real Estate Investment Trusts (REIT)**	**Real Estate Investment Trusts (C-REIT)**	**Fiscale Beleggingsinstelling (FBI)**	**Société d'Investissement à Capital Fixe Immobilière (SICAFI)**	**Société d'Investissements Immobiliers Cotées (SIIC)**
1	Data Established	1960	1993	1969	1995	2003
2	Legal System					
2-(1)	Tax law	Internal Revenue Code (IRC)	Income Tax Law	Corporation Tax Law	Income Tax Law	Income Tax Law tax bulletins
2-(2)	Related laws	Corporate law of each state, Trust Law, Securities Act of 1933, Securities and Exchange Act of 1934	Trust law of each province and securities law of each province	Act on the Supervision of Collective Investment Schemes	Act of December 4, 1990, Royal Decree of April 10, 1995	2003 Budget Law
2-(3)	Stock exchange	New York (NYSE), NASDAQ	Toronto (TSX)	Euronext Amsterdam	Euronext Brussels	Euronext Paris
2-(4)	Competent regulatory authorities	Securities and Exchange Commission	Securities and Exchange Commission of each province	Netherlands Authority for the Financial Markets (AFM)	Banking, Finance and Insurance Commission (BFIC)	Financial Market Authority (AMF)
2-(5)	Collective Investment Scheme	No	Yes	Yes	Yes	No
3	**Fund Format**					
3-(1)	Listed/Unlisted	Both	Both	Both	Only listed	Only listed
3-(2)	Closed-end/Open-end	Closed-end	Both types exist	Closed-end	Closed-end	Closed-end
3-(3)	Externally managed/ Internally managed	Both (most internally managed)	Large internally managed, small externally managed	Both	Both	Internally managed
3-(4)	Fund vehicle	Corporation, Trust	Corporation, Trust	Corporation, Trust	Corporation, etc.	Corporation
4	**REIT Requirements**					
4-(1)	Organizational requirements	Not financial institution or insurance company taxed as domestic company; managed by more than one officer or trustee	Canada resident unit trust, business objective is limited to the acquisition, ownership, maintenance, renovation, and management of real estate	Approval from AFM	Permission from the Belgian BFIC, after initial registration, 30% or more of stocks with voting rights must be publicly placed within one year	Main business objective is the acquisition and construction of rental property (including direct and indirect ownership of other corporations with the same objectives)
4-(2)	Minimum paid-in capital			BV 180,000 euros, NV 450,000 euros	1.2 million euros	15 million euros
4-(3)	Minimum number of stockholders	100	150			
4-(4)	Public offering requirements				Public offering of 30% or more of stocks with voting rights	
4-(5)	Specific stockholder shareholder ownership regulations (including foreign ownership)	Five people or less must not hold more than 50%	Foreign ownership up to 49%	Specific foreign stockholders cannot hold more than 25% directly or indirectly; retail investor must not hold more than 25% of B1 stocks		

Source: Reprinted from pages 178 and 179 of the *Real Estate Securitization Handbook 2005*, with permission from the Association for Real Estate Securitization (ARES), in Tokyo, Japan.

International REITs: An Overview (Continued)

Concept Box 21.2

incorporated into collective investment structures and the taxation system.

Although REITs are based on either the American structure (tax) or Australian structure (trust law), most countries base their structure on the closed-end Australian style that uses a trust as the vehicle to collect the investors' investments and is externally managed by an asset management company. However, there is a clear trend toward the American style of external management rather than internal management, and from just being engaged in passive investment rental real estate to also include development properties.

There are many methods for securing the pass-through nature of the investment entity, the most popular being either pay-through or pass-through. The most common method employed is pay-through: this allows paid dividends to be deducted as expenses. Each country has established different requirements for being recognized as a REIT including dividend requirements, various organizational requirements, asset and income requirements, and liability limitations. A structure is recognized as a REIT when the organizational requirements are met. These include minimum capital amounts, minimum number of stockholders, public placement requirements, listing requirements, asset and income requirements such as the content and ratio of owned assets, investor restrictions' business content, and limits on debt ratios. Almost all of the countries require a certain level of dividend to be paid as a minimum dividend requirement.

The capital gains from selling the real estate are handled very differently between countries. There are countries that make the capital gains tax free, others that make them tax free if reinvested, others that do not include them in dividend requirements, and others that tax the capital gains by including them in ordinary income.

6	7	8	9	10	11	12
Australia	**Japan**	**Singapore**	**Korea**	**Malaysia**	**Hong Kong**	**Turkey**
Listed Property Trust (LPT)	Real Estate Investment Trust (J-REIT)	S-REIT	K-REIT (Ordinary REIT, CR-REIT)	Property Trust Funds (PTF)	H-REIT	Real Estate Investment Trust Company (REIC)
1971	2000	1999	2001	1986	2003	1985
Income Tax Law	Corporation Tax Law	Income Tax Act, Individual bulletins	Corporation Tax Law	Income Tax Act	Income Tax Law	Income Tax Law
Corporate Act, MIA Law	Investment Trusts and Investment Corporations Law, Securities and Exchange Law	Securities and Futures Act 2001, Guidelines for Property Funds	Real Estate Investment Company Law	Securities Commission Act 1993, Guidelines on Property Trust Funds	Securities and Futures Ordinance, Code on Real Estate Investment Trusts	Capital Market Law, communiques
Australia (ASX)	Tokyo (TSE)	Singapore (SGX)	Korea	Kuala Lumpur (KSE)	Hong Kong	Istanbul (ISE)
Australian Securities and Investments Commission (ASIC)	Financial Services Agency	Monetary Authority of Singapore (MAS)	Ministry of Construction and Transportation, Financial Supervisory Commission (CR)	Securities Commission (SC)	Securities and Futures Commission (SFC)	Capital Markets Board (CMB)
Yes	Yes	Yes	No	Yes	Yes	No
Both	Both	Both	Both	Both	Only listed	Only listed
Closed-end	Both (only closed-end exists)	Closed-end	Closed-end	Closed-end	Closed-end	Closed-end
Externally managed	Externally managed	Externally managed	Internally managed (general), externally managed (CR)	Externally managed	Externally managed	Internally managed
Trust	Corporation, Trust	Corporation, Trust	Corporation	Trust	Trust	Corporation
Register with ASIC managed by external Management company (RE)	Investment corporation registered with Financial Services Agency, investment corporation that satisfies the following "Minimum number of stockholders" or "Public offering requirements"	Management by management company approved by MAS, the management company must be a listed firm established in Singapore	At establishment, the stockholders shall own at least 10% of stocks (limit of 30%)	Management company must be a listed firm established in Malaysia: management company shall be a subsidiary of a financial institution or subsidiary of a developer	Management company must be certified by SFC	Use the "real estate investment trust" trade name: stockholders must have a certain income and satisfy asset ownership requirements; must not be involved in business, industry and agriculture outside of legally allowed transactions; must not be involved in capital market activities other than for managing its own portfolio; must not be involved in construction activities
	100 million yen		50 billion won	100 million ringgit		1 trillion Turkish lira
	Ownership by more than 50 individuals or qualified institutional investor			1,250 (each stockholder must own at least 1,000 stocks)		
	On establishment, publicly offered and total amount of at least 100 million yen		Public offering of at least 30% on establishment (general)	Public offering of at least 25%		Publicly place 49% or more
	Three or fewer stockholders may not own more than 50% of the total stock value. More than 50% of stock must be placed domestically (written in bylaws)		Specific stockholders limited to 10% ownership of stocks (general)	Foreign ownership of up to 30%		

have become a major factor in property markets. In the low interest rate environment that has accompanied the recovery of the financial markets, public unlisted REITs have experienced very large inflows of cash as investors have purchased their securities in part due to their high dividends relative to alternative investments. Robert A. Stanger & Company, which tracks the unlisted REIT Industry, reported $10.3 billion in funds raised in 2012, followed by a record $19.8 billion raised in 2013. They have become major players in prominent markets, largely in response to their need to invest this new capital.

Unlisted REITs typically sell subscriptions of shares through financial planners to investors at a fixed price. Some portion of that initial price is paid out to the financial planner as a "marketing" fee, and some portion of that price is paid to the unlisted REIT's advisor. The remaining funds are then used to purchase assets that fit within the unlisted REIT's stated investment policy. In most cases, the fees are well in excess of 10 percent, leaving less than 90 cents on the dollar to be invested in properties.

Critics suggest that unlisted REITs are very expensive and illiquid compared to listed REITs. Proponents suggest that unlisted REITs are not subject to short-term market price volatility and that there are generally provisions in their prospectuses that lead to liquidity. Generally, unlisted REITs have "list or liquidate" provisions under which the REIT must liquidate the assets and return the net proceeds of the liquidation if the stocks are not listed by a particular date. This adds additional risk to these investments in that these companies may be forced to liquidate at a very disadvantageous point in time. There were several very well-publicized collapses in the unlisted REIT industry in the wake of the subprime crisis.

There are significant differences among listed and unlisted REITs. Investors and their advisors should be familiar with these differences and incorporate all associated risks in making investment decisions or recommendations.

Importance of FFO (Funds from Operations)

FFO stands for **funds from operations**, which most analysts consider the REIT equivalent of earnings in industrial stocks. FFO is used by analysts and investors as a measure of the cash flow available to the REIT for distributions (dividends) to shareholders. Most investors are familiar with the use of earnings per share in this capacity. However, for REITs, earnings are not the best measure of cash flow, largely due to the element of depreciation. Recall that REITs own real estate assets that are subject to large depreciation allowances, also gains or losses from the sale of properties may be significant in any given year. These two items can be very important when determining net income based on GAAP accounting rules. The reader should be aware of the difference between REIT earnings per share (EPS) and funds from operations (FFO) per share. The distinction between the two can best be made with a simple example:

	REIT Income Statement	REIT FFO
Gross Income	$100	$100
−Operating expenses	40	40
Net operating income	60	60
−Depreciation	40	—
+ Gains on sale of property	20	—
Net income	40	—
Cash flow	—	60
EPS	$ 4	—
FFO per share	—	$ 6

Assuming that the REIT above has 10 shares of stock outstanding, its earnings per share (EPS) would be reported as $4.00 per share. However, its funds from operations (FFO) per share would be $6.00. *Generally accepted accounting principles* (GAAP) provide for depreciation of assets over time as their useful life is expended. Depreciation is assumed to occur in a predictable fashion and the time periods and rates of depreciation for different types of assets are well established. Most people are familiar with the concept and logic of depreciation based on their experiences with automobiles and other durable goods. As these goods get older, their mechanical parts break down and function less efficiently, decreasing their value. Real estate values tend to rise and fall over time based more on market conditions than physical conditions, although physical conditions can and do play a role in value. The result is that GAAP earnings calculations that use historical cost depreciation do not provide an accurate or meaningful picture of REIT financial performance.

The National Association of Real Estate Investment Trusts (NAREIT) recognized this problem and has worked to develop and promulgate FFO as a more representative measure of REIT performance. In 1991, NAREIT adopted a definition of FFO that was refined slightly in 2002 as follows:

> *Funds from operations* means net income (computed in accordance with generally accepted accounting principles), excluding gains (or losses) from sales of property, plus depreciation and amortization, and after adjustments for unconsolidated partnerships and joint ventures. Adjustments for unconsolidated partnerships and joint ventures will be calculated to reflect funds from operations on the same basis.

The definition was well accepted in the industry and FFO has become a standard measure of REIT performance. FFO provides analysts and investors with an "apples to apples" measure for comparing performance among REITs. NAREIT suggests that the adoption of the FFO measure has made it easier for investors to understand REIT operations. It claims that increased understanding has facilitated the growth in REITs as an ownership form, a claim that has some merit.

As REITs have grown, FFO and its reporting have emerged as an important issue. The definition adopted by NAREIT was, of necessity, rather broad. It left considerable room for interpretation. During the IPO boom in 1992 and 1993, REIT initial pricing was generally couched in terms of a **dividend yield** supported (at least in theory) by a projected FFO. The value of management's ownership position was a function of the initial price, so there was a strong incentive to project FFO at maximum levels. By mid-1993, the page of the prospectus dealing with the projected FFO had become known as the *magic page*. The implication was that FFO was being created to support overly aggressive initial pricing.

Many analysts and investors have gone beyond the FFO to look at adjusted funds from operations (AFFO), funds available for distribution (FAD), or cash available for distribution (CAD). AFFO, FAD, and CAD are largely interchangeable, with different analysts using the term they prefer. The major difference between FFO and these supplementals relates to the issue of capital improvements, particularly ongoing capital improvements. To understand the difference, consider a multifamily apartment building. There are several major expenditures, such as painting and replacement of carpets, that have to be made on a recurring basis. For example, carpeting may be replaced every five years, and painting redone every three years. Accounting policies vary from REIT to REIT on how to handle these expenses. The most conservative treatment is to classify them as expenses, counting them against the current year's income. Others choose to classify them as capital improvements, capitalizing them on the balance sheet and amortizing them over time. In the latter case, the amount spent for capital expenditures will not affect FFO because amortization is added back to EPS when calculating FFO. Thus, although either treatment is valid, the variation causes difficulty in comparing income and expense figures across

REITs. NAREIT has encouraged REITs to provide supplemental disclosure to FFO in several areas, including capital improvements, straight-line rents, and results of discontinued operations.

REIT Expansion and Growth

Because of the requirement that 90 percent of earnings be paid out as dividends, REITs have limited opportunities to retain earnings or cash flow to acquire additional real estate assets. Stated another way, REITs have very little free cash flow. Consequently, most REITs must plan for expansion by reserving the right to issue additional stock at some future time. This is referred to as a secondary, or follow-on, stock offering to raise more equity capital, which may in turn be used to acquire additional real estate assets. Analysts may view eventual issuance of these shares as a potential source of *dilution* of future earnings. The general tendency in the industry is to evaluate the use of funds from follow-on offerings to determine if they will generate an increase in cash flow that more than offsets the dilution. In the industry, this is referred to as an *accretive* transaction. This is particularly important when looking at the period just after additional shares are issued and before additional cash flow is realized from the newly acquired assets. Furthermore, any interim problems with developing, leasing, managing, and renovating the new real estate assets could require time to correct and thus serve as a potential drag on earnings. The dilution of earnings from issuing additional shares might also have a depressing effect on the stock price of the REIT, through the impact on the dividend.

REITs also make use of significant amounts of debt financing, including individual property mortgages, mortgage pools, secured debt, unsecured debt, and corporate lines of credit. Many REITs have been assigned investment ratings by the various ratings agencies and use multiple sources of debt capital for growth. Proceeds from debt financing may be used to finance additional asset acquisitions. In some cases, lines of credit or unsecured debt financing can be used as an interim source of funds until long-term mortgage financing or a supplemental stock offering can be accomplished. In any event, because REITs are "asset-intensive" entities with a considerable restriction on earnings retention, their ability to finance any future expansion must be planned with great care. Because real estate investments are long-lived assets, it is important for REITs to balance their capital structure to avoid large concentrations of risk, particularly with respect to timing of refinancing. Concept Box 21.3 discusses the impact that the recent global credit crisis has had on REIT distributions and capital structure decisions.

There are five ways in which a REIT can grow income and increase funds from operations, thus securing its dividend and making dividend increases possible. These five methods are (1) growing income from existing properties, (2) growing income through acquisitions, (3) growing income through development, (4) growing income through provision of services, and (5) financial engineering. The relative balance among these areas is a strategic decision, as are the mechanisms for operations within the areas.

Growing Income from Existing Properties

The most obvious method for growing income in an existing portfolio is increasing occupancy by renting more space. The second is by raising rents. Obviously, the two are intrinsically related and both are dependent on the supply and demand conditions in the market. Redevelopment offers a third alternative. Redevelopment primarily refers to remodeling of space to meet changing tenant needs. This can result in income growth because it results in either more aesthetically appealing space or space that is more suitable for prospective tenants, both of which can result in higher rents. Redevelopment may address other physical problems, such as the lack of an elevator in a three-story office building. Expansion can increase income by providing more physical space for rental purposes and is fairly

Changing Capital Structure of REITs

Concept Box 21.3

In traditional finance, evaluation of refinancing risk includes the risks associated with the cost of debt and the availability of capital. Prior to 2008, most analysis of REIT capital structure risks focused on the *cost* of capital, as opposed to the *availability* of capital. In 2007 and 2008, the U.S. financial system and the global financial system were rocked by the fallout of the subprime mortgage crisis, resulting in a very severe credit crunch in which many REITs were unable to refinance corporate debt or property-level debt when it came due, irrespective of operating performance. In some cases, cost was not an issue as replacement debt capital was, in a practical sense, nonexistent. Analysts and rating agencies began to talk about REITs in terms of sustainable capital structures, focusing on the availability of capital to refinance debt maturing in the short or intermediate term. The focus of discussion became the topic of "survivability." Not surprisingly, many REIT investors were troubled by these changes to the REIT market, and there was a massive sell-off in REIT shares.

REIT pricing declined dramatically, and one very high-profile REIT, General Growth Properties, which had been one of the largest REITs in existence, sought bankruptcy protection. Other REITs, including REITs that had previously been viewed as best in class operating companies, faced similar pressures due to capital structure issues. In most cases, these REITs had substantially greater capital structure risk than analysts, ratings agencies, and investors recognized prior to the credit crisis.

REIT capital structures have changed substantially since 1992. At the inception of the modern REIT era, most REITs' capital structures consisted of a combination of common equity and individual property-level debt. As REITs gained greater market acceptance, common equity offerings were supplemented with preferred equity issues and property-level debt was replaced or supplemented by debt secured by larger portfolios. REITs increasingly began to issue debt at the corporate level, making use of bonds, lines of credit, and unsecured debt. Over time, the percentage of unsecured debt and floating-rate debt used by REITs increased substantially. At the same time, debt maturities shortened, as REITs increasingly relied on intermediate term notes, typically three to five years in duration. While the interest rates on this debt were initially lower than those offered on longer term fixed rate debt, the risks attendant on refinancing increased. In an era of plentiful capital, these risks seemed small relative to the perceived benefits, but there was a fundamental mismatch of long-lived assets being financed with short-term capital.

In dealing with the limitations on their ability to secure debt financing, the boards of directors of some REITs were forced to consider measures for securing capital that would not have been seriously considered under more "normal" capital market conditions. When debt comes due and similar replacement debt is not available, the primary alternatives are to seek alternative debt (i.e., replacing unsecured debt with secured debt) or secure additional equity capital.

In 2008, many REITs facing liquidity constraints found it difficult to distribute 90 percent of their taxable income in the form of cash dividends, risking their qualification as a REIT. On December 10, 2008, the Internal Revenue Service issued Revenue Procedure 2008-68, which provides that a stock distribution by a REIT may be treated as a taxable dividend for tax years ending on or before December 31, 2009, which provided that a stock distribution by a REIT could be treated as a taxable dividend for tax years if certain requirements are met. Essentially, this measure allows REITs to meet mandatory distribution requirements through the issuance of a stock dividend. While this measure allowed REITs to suspend cash dividends and retain cash to meet liquidity needs, it also created a debate in the REIT industry. In essence, a stock dividend results in existing shareholders making a required additional equity investment. Many shareholders invest in REITs as a means of securing regular cash flow, and stock dividends represent a "double whammy" to these investors, as they do not receive any cash associated with the distribution but incur the tax liability associated with that distribution, and the tax liability is required to be paid in cash. As a result, the investor is forced to either pay the tax from other cash resources or sell the stock and use a portion of the proceeds to pay the tax obligation, incurring trading costs in the process.

Some in the industry view the ability to issue stock dividends as a valuable and essential capital management tool, while others view REITs making distributions in the form of stock dividends as breaking an implied contract with REIT investors with potential long-term negative consequences.

Some REITs elected to deleverage their capital structure by issuing new equity, despite the fact that some of those offerings were at stock prices substantially below the net asset value of the company's assets, resulting in substantial dilution. Market reception of these offerings was very positive, largely because these offerings, while dilutive, provided replacement capital for maturing debt at a critical juncture, removing the survivability question facing many REITs. Other companies elected to sell properties despite declining prices and difficult marketing conditions and have used the proceeds to pay down debt.

In the short term, these capital structure changes, along with improving global credit market conditions resulted in stabilization and as markets improved there has been significant recovery in REIT market pricing. REITs that had been viewed as seriously at risk of bankruptcy gained time to allow markets to recover. In many cases, these REITs have recovered to pricing levels and market capitalizations in excess of those in place prior to the credit crisis.

common in retail facilities, where an anchor tenant may expand, or outlying parcels may be developed to generate additional rental income. Office and industrial REITs, particularly those that specialize in industrial/office parks, often hold substantial amounts of land in close proximity to their existing parks. This land, which is usually permitted and approved, is simply held in anticipation of growing demand for space. Where the demand does not emerge, the property can be sold and the assets reallocated to more productive areas. Another means of growing income is in altering the market segments addressed. A mall might shift to a fashion focus, essentially developing a retenanting focus. Marketing and policies may also change, as is the case in eliminating a no-pets policy at an apartment community. REITs may also grow net income by controlling expenses. For example, many apartment REITs have provided submetering at the individual apartment level, transferring utility costs and associated volatility directly to tenants.

Growing Income through Acquisitions

There are two methods of growing the portfolio through acquisitions. These two methods are (1) purchasing properties with cash at positive spreads, utilizing the arbitrage between cost of capital and the yield of the property and (2) swapping shares in the REIT or operating partnership units for interests in properties, taking advantage of the tax and form benefits. Positive spread acquisitions are fairly common in periods when REITs are trading at low cap rates relative to the underlying real estate, but they are more difficult to achieve as REIT yields come closer to or exceed the cap rates on the underlying properties. Another way of looking at this is in terms of **net asset value (NAV).** Net asset value is the net market value of all of a company's assets, including but not limited to its properties, after subtracting all its liabilities and obligations. When a REIT is trading above NAV, it is more likely to find attractive spreads than when it is trading below NAV. When yields (prices) are very close, it may not be wise to acquire properties in this fashion because of the costs associated with securing capital.

Swapping shares in the REIT or operating partnership units for interests in properties has the advantage of a minimal cash requirement. As a general rule, operating partnership swaps are the more attractive of the two options because of the potential for tax timing. Existing shareholders can benefit because the swaps are generally done at favorable cap rates, with the owners of the acquired property willing to accept a discount for their properties in exchange for liquidity. In some cases, these swaps also include other business

enterprises or personnel that are beneficial to the acquiring REIT. For example, an existing REIT with limited development capacity might work out a swap with a private company in the REIT IPO pipeline that has development capacity. The acquiring REIT gets the benefits associated with a larger portfolio and a set of skills that it did not have before the transaction. The owners of the acquired properties satisfy some of their goals that led to the consideration of going public, without incurring the substantial costs associated with the legal process of becoming a REIT.

Growing Income through Development

REITs may also choose to grow their income through development of properties. Risk is generally higher than in redevelopment or acquisition, but can be mitigated. For example, the risks associated with build-to-suit development of properties subject to long-term net leases with quality credit tenants are considerably lower than those associated with speculative development. In either case, thorough market analysis is an absolute necessity. Development offers an opportunity to secure entrepreneurial profits and increase funds from operations significantly. However, the returns are offset by a series of risks. There are always risks of construction delays, cost overruns, and lease-up problems. In the market, many investors are extremely concerned with quarterly performance, a focus where it probably does not make a great deal of sense to invest in a long-term asset like real estate, but which can influence pricing. As acquisition opportunities decline, REITs may shift to a development orientation. In some cases, the REITs have a long and distinguished development history and are capitalizing on in-house expertise. In other cases, the REIT does not have the expertise in-house and is forced to acquire it through acquisition of operating companies or through hiring. A third alternative is to develop a relationship with an existing developer and act as the take-out on its construction projects.

Growing Income through Provision of Services

REITs may also derive a portion of their income from provision of services to related and unrelated third parties. The income from these activities varies substantially across REITs. Some companies derive a significant portion of their income from these activities, while others do not produce any external income. These services may include property management, development, licensing agreements, or provision of other real estate–related services to related parties and unrelated third parties. In many cases, REITs enter into joint-venture arrangements with institutional investors under which the REIT owns a minority interest in a joint venture that owns a portfolio of properties. The REIT acts as the property and asset manager for the joint venture and is generally compensated at competitive market rates for its efforts. REITs may also provide real estate–related services to unrelated third parties, for which they receive competitive market rates. Increasingly, REITs are marketing telecommunication, financial, and other services to their tenants and their tenants' customer base. The result is that REITs have an opportunity to leverage off their real estate expertise and human capital to generate additional earnings, often through taxable REIT subsidiaries.

Financial Engineering

A fifth alternative is to grow the funds from operations through financial engineering. Financial engineering includes a variety of accounting treatments and uses of leverage that tend to magnify the funds from operations, which many view as the best short-term measure of the REIT's income-producing ability. Financial engineering also includes the ability to secure favorable rates, financing terms, and sources of capital. These factors can influence the long-term cost of capital for the REIT. Essentially, the idea is that REIT management can manipulate the capital structure in order to maximize distributions. Some of the risks and rewards of various financial engineering alternatives are discussed next.

Accounting treatments can be used to magnify funds from operation (FFO). Since REITs have tended to trade at some multiple of funds from operations, magnifying funds from operations often results in higher stock prices. The risk is that the REIT will be unable to meet its shareholders' expectations based on magnified FFO numbers. The shareholders may view these magnified numbers as indicative of future growth and expect corresponding increases in dividends. REITs that fail to meet FFO projections or sustain high growth levels have been treated harshly by investors.

As an example of the influence of accounting treatments, some recurring expense items can be either expensed or capitalized. In some property types, particularly multifamily residential properties, recurring expenses are cyclical, impacting the REITs' ability to distribute funds on a regular basis. REITs vary as to their treatment of these expenses, making comparisons among REITs difficult. As a result, many analysts have moved to **cash available for distribution (CAD)**, as discussed earlier. Cash available for distribution treats recurring expenses as expenses rather than capital items, providing a more conservative estimate of the potential stream of income available for dividend purposes. The problem is that CAD calculation is not standardized, and the information necessary for standardization is often not available.

REITs can also use leverage to magnify FFO in the short term. One way is for the REIT to use short-term variable-rate loans to acquire properties. The rates on this type of loan are lower than those that can be obtained for long-term fixed rate debt, so the rate of return on the investment is higher, at least in the short run. Higher return on the investment leads to higher FFO and dividends, which in an ideal situation will lead to an increased multiple, making it feasible to replace the debt with attractively priced equity. Unfortunately, the higher rates of return are accompanied by greater risks and the leverage can reverse, magnifying losses and moving prices in the other direction. The result can be an inability to replace debt with equity and a need to refinance at a less-than-opportune time. This refinancing risk needs to be evaluated and priced.

REITs can also alter payout ratios. The payout ratio is the percentage of FFO, or alternatively CAD, that is used to pay out the dividend. The payout ratio is an important indicator of the financial flexibility of an organization and its ability to maintain its dividend. As an example, consider two REITs. REIT 1 has FFO of $1.00 per share and pays a dividend of $0.85, resulting in a payout ratio of 85 percent. REIT 2 has FFO of $0.93 and a dividend of $0.85, resulting in a payout ratio of 91.4 percent. If both REITs were subject to a $0.10 per share drop in income, then the resulting payout ratios at the same dividend rate would be 94.4 percent and 102.4 percent, respectively. While REIT 1 can maintain its dividend without dipping into cash reserves, REIT 2 is required to dip into cash reserves, essentially giving the shareholders their money back. While this type of distribution can be maintained for short periods under unusual circumstances, it cannot be maintained indefinitely without hampering growth prospects.

Important Issues in Accounting and Financial Disclosure: Equity REITs[2]

When analyzing financial statements, one must understand that REITs, like other economic entities, have considerable latitude when accounting for their operations. This section covers some issues and interpretations that REIT investors should bear in mind when

[2] The authors thank Eric Hemel and Neil Barsky for providing them with the report, "Do You Believe in Magic? Understanding a REIT IPO's Pro Forma Funds from Operation" (Morgan Stanley: *U.S. Investment Research*, January 24, 1994).

performing a financial analysis based on financial statements and other documents. These issues are widely covered in various industry reports provided by investment bankers and other REIT market analysts. The following presents some of the basic issues and explains their significance in evaluating REITs and their financial statements.

Tenant Improvements and Free Rents: Effects on FFO

When markets are soft and vacancies are above normal, tenants may be induced by owners to sign leases with free rent or improvements provided by REIT management. This possibility is important to understanding REIT revenue, particularly where leases are long term. Occupancy and revenues are obviously important items when reporting income for industrial, office, and retail properties. Occupancy rates can be raised and rental revenues increased by providing important concessions to tenants, often in the form of tenant improvements. Generally, new commercial tenants must always incur some costs to reconfigure the space and make it suitable for their operations. Landlord allowances for some tenant improvements are a common practice in much of the real estate industry, but concessions could be a concern if they are very large relative to what other owners are offering. Tenant improvements paid by the landlord are often capitalized and then depreciated. Thus, the cash flows for tenant improvements are not included in FFO calculations because FFO represents earnings before depreciation. Therefore, the investor should be aware that this cash outflow may be occurring currently but accounted for in depreciation expense *over time*. Investors should also pay particularly close attention to any notes to FFO estimates that include "signed leases scheduled to commence." This may indicate that the REIT is currently including the effect of leases not taking effect until a future date.

One way investors can evaluate the implications of new leases is to determine the cost per square foot and the extent that tenant improvements and free rent are included in the leases. This determination may be particularly important when the REIT is about to go public with an initial public offering (IPO). For example, suppose that tenant improvement costs averaged $7 per square foot of newly leased space during the three years before the IPO. However, the company spent $20 per square foot *in the year prior* to the IPO. The additional amounts spent on tenant improvements could suggest that the company was preparing for the impending IPO by attempting to boost its occupancy rates and nominal rent levels to make itself more attractive to investors. Many companies do not explicitly disclose the cost per square foot of tenant improvements, but they may disclose enough information about historical leasing activity and aggregate tenant improvement levels so that investors can make their own estimates.

Leasing Commissions and Related Costs

A number of REITs pay outside leasing brokers a commission to solicit tenants. These commissions are usually paid in cash, and the cost is capitalized over the life of the lease. These costs are included in depreciation and amortization expense. Because investors traditionally measure REIT profitability according to funds from operations (earnings before depreciation and amortization), any deferred leasing costs may be overlooked. There is no single, accepted standard for disclosing deferred leasing costs. Many REITs do their own leasing and pay their employee-brokers salaries or commissions, or both. These REITs may then either expense or capitalize and defer the costs. The deferral of leasing costs raises two issues: (1) Leasing costs are an ongoing source of operating expense; omitting them as an operating expense reduces expenses and increases FFO. (2) In rare instances, brokers are paid commissions over the life of the leases instead of up front. In that case, investors in a REIT that is about to embark on an IPO will be paying commissions incurred on leases signed *prior* to the IPO; this means that the REIT may have to pay out cash in the future for leases signed in previous periods.

Use of Straight-Line Rents

Another accounting issue arises when a REIT relies on long-term leases with rent increases contractually stipulated over the life of the lease. This is rarely a factor in apartment companies, which usually have year-to-year or month-to-month leases, but it can be important for REITs with long-term leases, and this includes virtually every category of commercial and industrial property.

To understand the potential problem, consider a simple situation in which a tenant signs a 10-year lease with step-ups: The lease is $8 per square foot in years 1 through 3, $10 per square foot in years 4 through 7, and $12 per square foot in years 8 through 10. If revenue recognition is based on straight-line reporting, the rent will be averaged over the full lease term, which in this case is $10 per square foot. Thus, rental revenues in year 1 are counted as $10 even though the actual cash flow is $8. Since FFO is calculated as earnings before depreciation, a pro forma FFO may use $10 instead of the actual $8, unless the assumptions underlying the pro forma calculation clearly specify otherwise. Obviously, the FFO estimate will be lower than the actual revenue in the later years of the lease, when $12 of cash flow exceeds the $10 average. However, in an IPO, considerable attention is given to the initial or near-term estimates of FFO. In this case, investors may want to bend the straight line of the rental stream. Management should provide clear guidance to investors about the cash flow without the straight-line rent adjustment in year 1. In this way, investors can better assess the dividend-paying ability of the REIT and accurately evaluate the company on the basis of potential cash flow growth resulting from contractual rent adjustments well into the future. This is one of the primary reasons that many analysts have moved to estimating adjusted FFO, CAD, and other supplemental measures of cash flow as previously discussed.

FFO and Income from Managing Other Properties

As noted previously, a number of REITs receive third-party management income, or income in exchange for managing other properties not owned by the REIT. While third-party management income may provide additional earnings, its associated revenue stream is likely to vary more than the underlying rental income from REIT-owned properties because many management contracts may be cancelable by third-party owners on short notice. Moreover, other events might affect this source of income: Many REITs have sold off portions of their portfolio in joint ventures with institutional investors, often retaining a minority interest in the portfolio (20% is typical) and deriving fee income from managing the properties while freeing equity capital for other corporate purposes. The joint-venture partner's control over properties and right to replace the REIT as manager is typically established in the joint-venture agreement, so it makes sense for investors and analysts to be familiar with the terms of these agreements. Other properties managed by the REIT may be sold, or the management of REIT-owned properties could suffer if the REIT gives too much attention to managing third-party properties. As a result, many REIT security analysts assign a lower multiple to the portion of FFO produced by management income. Investors should always be aware of any fee based on other sources of income that the REIT reports because a large portion of these fees may be short term. The character of the third-party relationship is also important, in that the REIT's managers may have a partnership interest that effectively locks in the contracts. It is important to understand the nature of third-party management contracts and other sources of income. In addition, some sources of income may not constitute income from real properties and may jeopardize the REIT's tax status if in excess of allowable levels. Taxable REIT subsidiaries were designed and implemented largely to "clean" the income from these activities.

Types of Mortgage Debt and Other Obligations

When one examines a REIT investment, it is important to consider the terms of the company's mortgage debt. Mortgages may be either short- or long-term, floating rate or fixed, and nonamortizing or amortizing. As a practical matter, most REITs do not amortize much of their debt. The result is a continual return to the debt market to replace maturing debt. By using short-term, floating-rate debt, the REIT borrower may enjoy a lower mortgage rate in exchange for assuming some portion of the risk of inflation and increasing interest rates. The use of a short-term floating rate may be favorable in the near term because of low interest charges, but it exposes the REIT to significantly greater risk. The REIT can hedge this risk through the use of interest rate caps or swaps, the extent and cost of which should be disclosed to shareholders. REITs may also issue corporate debt of varying terms, both secured and unsecured.

Existence of Ground Leases

As the name suggests, ground leases encumber the land underneath buildings. They are typically made for long periods of time, sometimes up to 99 years. Ground leases tend to be "net" leases, which means the tenant pays for all costs associated with operating the building, including utilities, taxes, renovations, and so on. The landowner, or "fee" owner, plays no operating role other than to collect land rents from the building owner or operator. At the time the lease expires, the landowner owns residual rights to all buildings and improvements situated on the land.

Two basic arrangements of ground leases are likely to apply to REITs. First, the REIT *owns buildings subject to* a ground lease owned by another party. The REIT may have a potential advantage if the ground-lease payments are *fixed.* In this event, the REIT is using the equivalence of leverage because, if the cash flow from the building rental income continues to grow relative to the fixed ground-lease payments, a higher return on equity will be achieved. The universal disadvantage of the ground lease is that the REIT will give up ownership of the buildings at the time of lease expiration or it must renegotiate the lease prior to its expiration. In their valuation process, investors should heavily discount the cash flow from any buildings on a ground lease with an approaching expiration date. In addition, some ground leases may call for the lessor to participate in revenue growth. This is similar to a participating debt and may be negative from a REIT investor's perspective. Obviously, the terms and conditions of all ground leases should probably be renegotiated *long before* the lease term expires.

The second case applies to a REIT that *owns a ground lease* that it has acquired from the landowner. Ground leases are allowable investments for REITs, which simply put the REIT between the landowner, who retains all rights of reversion, and the building owner. This arrangement is known as *spread investing,* where the REIT takes the risk of collecting a stream of rents from the building owner and pays a lower and perhaps fixed payment to the landowner. Ground leasing to third parties, depending on their credit, can be a safe and reliable way to ensure an income stream.

Some ground leases are important and complex enough to warrant detailed financial analysis. Many *retail* REITs, for example, own shopping malls subject to ground leases. In this case, lessors and landowners usually enjoy a substantial share of the cash flow once certain retail revenue thresholds are exceeded, but payments to the ground lease may reduce the ultimate growth prospects of the REIT.

Lease Renewal Options and REIT Rent Growth

Investors should review the lease rollover schedules of REITs. This is particularly important for REITs that concentrate in sectors with long-term leases: regional malls, industrial properties, and offices. Most initial public offerings for these REITs should disclose the

average rent of recently expired leases as well as the new rents. Following the initial public offerings, most REITs disclose a schedule of aggregate annual lease expirations in the supplemental materials to their financial statements. This, combined with notes and management's discussion and analysis, should enable investors to determine how many new leases are being made at or below previous rents and how much or how little growth is occurring from lease rollovers.

Expected lease rollovers should be examined to determine the amount of space subject to *renewal options* and the range of rent levels at which those options are set. Rents could be far below the prevailing rents at the time of lease expiration. Investors should also question the likelihood that some tenants will elect not to renew their leases. This may occur because tenants find that the existing space is inadequate for their expanding operations, or for any one of a number of reasons. Therefore, investors must consider the probability that the space will be leased to new tenants, and how long it will take and how much it will cost a REIT (lease commissions and finish-out) to attract new tenants.

Occupancy Numbers: Leased Space or Occupied Space?

When discussing occupancy numbers, nearly all REITs use the term *occupied space* in notes to financial statements and operating results. Like other disclosure issues, this at first appears innocuous, but on closer examination it opens the way for potential distortion. Occupied space quantifies the space for which tenants are now paying rent. *Leased space* includes all space for which leases are signed, even if the lease does not go into effect for another 6 to 12 months. The amount of leased space is often several percentage points higher than occupied space. Investors who compare occupied space in one REIT against leased space in another may be using two different—and noncomparable—methods of counting occupancy. For example, one REIT may report space as occupied that is currently leased but that has been, or is about to be, vacated by tenants, while another may report that space as vacant. There is also variation by property sector, largely due to differences in the structure and length of leases. To be conservative, REITs should either not claim credit for occupied space that it has reason to believe will be vacant in the immediate future or disclose the impending vacancy.

Retail REITs and Sales per Square Foot

There is no standard way to measure retail sales per square foot of a small store. Several methods of calculation have evolved, but investors should beware of the implications of each. For example, one method excludes sales per square foot from "in-line stores in regional malls." Another method uses "mall store sales" but excludes sales of "large space users" where space is used less intensively or where a portion of the total space is owned by the tenant or governed by a highly restricted operating agreement. The problem with both definitions is that total retail sales and sales per square foot in a mall are affected by excluding large space users. Even though many large space users may own their space in a mall or have a very strict operating agreement that gives them considerable control over their space, investors are in a sense paying for the lease portfolio or tenant roster and "sales power" of all tenants. A better approach may be to report total sales per square foot rather than to exclude large space users. Some REITs separate anchor tenant sales from in-line tenant sales.

One legitimate defense of excluding large space users from financial statements is that many older malls have large variety-type stores that bring down average sales per square foot. Lease rollovers may provide the mall with significant opportunities for sales and revenue growth, particularly if the leases of variety-type stores are about to expire. Consequently, the more inclusive definition of sales per square foot may tend to understate the long-term sales potential of a mall.

A third definition of sales per square foot is based on "mall store tenants that reported 12 months of sales for the operating period." This definition may exclude tenants that reported less than 12 months of sales, possibly because of bankruptcy or deliberate lease terminations. This measure may suffer from "tenant survivorship bias," or the counting of only those tenants that survived and the exclusion of those that did not. The excluded tenants probably experienced lower sales per square foot than their healthier counterparts; if included, they would have pulled down the average. Alternatively, the measure leaves off sales of seasonal kiosk or cart operators that sell goods in common areas during holidays and other periods of heavy demand. These operators can contribute significantly to income, as they typically have percentage rent provisions in their leases, and income can be highly variable.

Additional Costs of Being a Public Company

REITs typically have to purchase insurance for directors and officers, pay directors' fees, pay for listings on the stock exchanges, and file annual and quarterly reports with the Securities and Exchange Commission. While these costs are usually included in general and administrative costs, the actual amounts may be considerably more than a REIT initially estimated.

A major recent development is the Sarbanes-Oxley law of 2002, the congressional act designed to prevent financial scandals like those at Enron and WorldCom. The law amended the regulatory provisions of the Securities Commission Act of 1934. The Securities Exchange Commission (SEC) is the principal governing body charged with making the rules to enforce the Sarbanes-Oxley changes. Sarbanes-Oxley set forth or revised several standards for corporate boards of publicly traded companies and required rule making by the national stock exchanges to impose additional standards. Parts of the law have taken effect already, like rules for audit committees, reporting supplemental financial information, and auditor independence. Other parts will be phased in over the course of the year, like including accelerated filing requirements for periodic reports. The final standards for still other parts of the law dealing with additional disclosure requirements are still being written. The cost of complying with the regulations enacted so far does not vary proportionally with the size of the company, so the reality is that smaller REITs face a disproportionate burden in meeting the requirements. Some smaller REITs that merged with other companies or which been taken private subsequent to the act cited the act as one of the reasons it felt a business combination or sale was necessary.

The Investment Appeal of Mortgage REITs

The mortgage real estate investment trust is unlike the equity trust in that it does not own the real property. Rather, it owns mortgage paper secured by the underlying real property. Income generated by the mortgage paper is affected by the interest rate on the mortgage note, the discount (or premium) at which the obligation is acquired, and the amount of funds outstanding on the loans. REIT expenses applicable against this income are the interest paid for the funds to make payments on loans, management company costs, and other lesser expenses incident to the operations of this kind of investment company.

During the late 1960s and early 1970s, the mortgage REIT was used as a source of loans, particularly for construction and development that were beyond the legal or policy limits of the highly regulated banks, savings and loans, insurance companies, or other real estate–oriented financing institutions. Because their lending policies were relatively unregulated and because they had access to public securities markets, mortgage REITs were in a position to fill a void in the real estate financing market. Even though their cost for short-term borrowed funds was relatively high, there was always the reasonable expectation that the trust could make construction

or development loans at rates 3.5 percent to 4 percent higher than rates available from other lending sources. The spread between borrowing costs and loan income thus held the promise of increasing earnings on the shareholders' equity as the loan portfolio grew. This earnings growth would support further sales of shares in the trust at higher prices, and so on. Following this pattern, the expansion of mortgage trusts during the early 1970s was spectacular.

However, during 1974 a general economic recession set in, and the prime bank lending rate rose to unprecedented heights. Because of the unanticipated rise in their cost of funds, many mortgage trusts were forced into an operating loss position because they were not able to pass on a sufficient amount of these higher costs to borrowers. Further, many advance mortgage commitments had already been made at lower rates with inadequate flexibility for upward rate adjustments. During this period of rising interest rates, many developers were unable to sell completed units or could not complete projects because of rapidly inflating construction costs. Consequently, they were thrown into default on their construction loans. The share values of mortgage trusts fell dramatically, thus reducing the possibilities for further stock offerings as a source of funds.

Because of loan default expectations, the commercial paper market also dried up for trusts and forced them to rely almost exclusively on bank credit lines. As the defaults continued to increase during 1975, many large commercial banks were forced to extend the maturities on notes taken pursuant to these credit lines, which had usually been extended by banks as a group under a revolving credit agreement. The extensions were granted to avoid the cumulative impact on the total financial system if the trusts were forced to undertake mass foreclosures during a serious business recession. When credit became so tight that commercial bank lines could no longer be reasonably renewed, a number of bank sponsors took large blocks of mortgages out of the trust portfolios and put them into their own loan and liquidation accounts to reduce trust debts. These actions had an impact on overall commercial bank liquidity and removed the mortgage trusts generally from the construction and development loan markets as a supplier of funds for the foreseeable future. As a practical matter, many mortgage REITs invested in commercial mortgage-backed securities (CMBS) of pools of residential mortgages rather than whole loans. Increasingly, mortgage REITs are engaging in more diversified investment, including mezzanine loans and construction loans.

During the global credit crisis that began in 2007, mortgage REITs were severely impacted by capital limitations, higher than expected default rates, and short-term interest rate fluctuations. These factors, along with general market conditions, led investors in mortgage REITs to demand greatly increased risk premiums. Meanwhile, stock prices declined dramatically and companies were forced to declare bankruptcy when they were unable to refinance their debt. In some cases, mortgage REITs were able to sell some portion of their loan portfolio to repay their debt, but those sales typically occurred at dramatically reduced pricing, resulting in a loss of value to shareholders.

Mortgage REITs faced difficult market conditions following the subprime crisis and underperformed other REIT sectors as Federal Reserve policies contributed to historically low interest rates over an extended period of time. As the Federal Reserve has tapered its quantitative easing, mortgage REITs saw some growth and recovery. Mortgage REITs raised $16.2 billion in total equity offerings in 2012 and $7.3 billion in 2013. As of December 31, 2013, there were 26 listed residential mortgage REITs with a market capitalization of $42.3 billion and 19 listed commercial mortgage REITs with a market capitalization of $19.7 billion.

Caveats

As was the case with equity REITs, the potential for a conflict of interest exists when sponsors and affiliates of mortgage REITs (e.g., mortgage companies, thrifts, commercial banks) are also originators of mortgage loans. In these instances, there may be incentives

to sell the submarginal loans of REITs while charging fees for servicing them. As indicated earlier, the rules governing the appointment of nonaffiliated trustees and the use of outside appraisers must also be followed in the creation and operation of mortgage REITs. In addition, CMBS portfolios often contain fairly high risk tranches, known as "B" pieces, that offer significantly higher risks and returns than other tranches. Mortgage REITs, under pressure to grow income, were at one time prime buyers of "B" pieces. Investors should review a mortgage REIT's investment policy and the quality of its loans as carefully as an equity REIT's properties. Many mortgage REITs focus much of their attention on managing interest rate risk. Essentially, they are purchasing long-lived assets using short-term financing. As a result, income streams can be very volatile, particularly relative to equity REITs.

Financial Analysis of an Equity REIT Illustrated

What follows is an analysis of an equity REIT that a prospective investor or shareholder might make. The financial statement for Midwestern America Property Trust is provided in Exhibit 21–2. Midwestern America (MA) owns and manages approximately five million square feet of suburban office, office/warehouse, and specialty office/distribution space, which it has assembled over the years in three Midwestern states. The cost basis for these assets is $300 million; the REIT has made or assumed mortgages totaling $80 million as part of financing its asset acquisitions. Midwestern America's stock is currently trading at $75 per share, making its current market value worth $375 million. Midwestern did not sell any of its real estate assets during the current year.

When you analyze an equity REIT, two key financial relationships must be understood: (1) the judgment of investment performance and risk and (2) the comparison of the prospective equity REIT with other equity REITs. Referring to Exhibit 21–2, we see that MA earned $13,600,000 in net income, or $2.72 per share, during the past year. However,

EXHIBIT 21–2 Financial Statement Midwestern America Property Trust

Panel A. Operating Statement Summary

Net revenue	$70,000,000
Less:	
Operating expenses	30,000,000
Depreciation and amortization	15,000,000
General and administrative expenses	4,000,000
Management expense	1,000,000
Income from operations	$20,000,000
Less:	
Interest expense	6,400,000
Net income (loss)	$13,600,000
Net income (loss) per share	$ 2.72

Panel B. Balance Sheet Summary

Assets			Liabilities	
Cash		$ 500,000	Short term	$ 2,000,000
Rents receivable		1,500,000	Mortgage debt	80,000,000
Properties @ cost	$300,000,000		Total	$ 82,000,000
Less: Acc. depr.	130,000,000		Shareholders' equity	90,000,000
Properties—net		170,000,000		
Net assets		$172,000,000	Total liabilities and equity	$172,000,000

EXHIBIT 21–3
Summary Indicators of Financial Performance: Midwestern America Property Trust

I. **General Summary:**
Properties: 5 million sq. ft.
Original cost: $300 million
Depreciated cost: $170 million
Mortgage debt: $80,000,000
Avg. interest 8%, 10 year maturity
Number of common shares: 5 million

II. Profit Summary:	$ Amount	Per Share
Earnings per share (*EPS*)[1]	13,600,000	$2.72
Income from operations plus depreciation and amortization (*NOI per share*)[2]	35,000,000	$7.00
Funds from operations (*FFO per share*)[3]	28,600,000	$5.72

III. Other Important Financial Data:	
Market price per share of common stock	$75.00
Dividend per share	$4.00
Shareholder recovery of capital (*ROC per share*)[4]	$1.28
Cash retention per share (*CRPS*)[5]	$1.72
Earnings yield[6]	3.62%
FFO yield[7]	7.62%
Dividend yield[8]	5.33%
Current earnings multiple[9]	27.6X
Current FFO multiple[10]	13.1X
Net assets per share (*NAPS*)[11]	$34.00
Equity or book value per share (*BVPS*)[12]	$18.00

IV. **Explanation and Calculations:**

[1]EPS: Net Income $13,600,000/5,000,000 shares outstanding = $2.72
[2]*NOI*: Income from operations plus depreciation and amortization ($20,000,000 + $15,000,000)/5,000,000 shares outstanding = $7.00
[3]FFO: Net Income + Depreciation & Amortization ($13,600,000 + $15,000,000)/5,000,000 shares outstanding = $5.72
[4]ROC: Dividend per share – EPS = $4.00 – $2.72 = $1.28
[5]*CRPS*: FFO – Dividend per share $5.72 – $4.00 = $1.72
[6]EPS/Market price per share = $2.72/$75 = 3.62%
[7]FFO/Market price per share = $5.72/$75 = 7.62%
[8]Dividend per share/Market price per share = $4.00/$75 = 5.33%
[9]Current price per share/EPS = $75/$2.72 = 27.6*x*
[10]Current price per share/FFO = $75/$5.72 = 13.1*x*
[11]*NAPS*: Net assets $172,000,000/5,000,000 = $34.00
[12]*BVPS*: (Assets – Liabilities)/shares = $90,000,000/5,000,000 = $18.00

additional data (see Exhibit 21–3) indicate that other interesting and important relationships must be understood. As is always the case with real estate investment, considerable emphasis is given to *cash flow*. For example, section II of Exhibit 21–3 includes additional performance measures. **Net income from operations** is the income before interest or depreciation deductions. It is somewhat analogous to net operating income (*NOI*), which we have discussed in earlier chapters for the income before taxes and before financing for individual properties. However, this is the net income from operations of the entire REIT, and it includes deductions for expenses associated with operating the REIT, such as general and administrative expenses and REIT management expenses. In order to calculate the *NOI* from all of the individual properties, we would deduct the operating expenses for the properties from the net revenue received from properties. This would be $70,000 – $30,000 = $40,000 for Midwestern America Property Trust. Net income from operations represents the operating cash flow exclusive of interest, which was $7.00 per share for

the past year. The second measure, funds from operations (FFO), is analogous to net cash flow per share. As you may recall, it is derived by adding all noncash expense items to net income (loss). Noncash accounting charges generally include depreciation and amortization. Most industry analysts rely heavily on FFO when making judgments and comparisons among REITs. We can see that the FFO per share for MA was $5.72 during the past year versus **earnings per share (EPS)** of $2.72. The difference in this simplified example is due to the $15 million depreciation allowance.

One REIT regulation previously detailed indicates that 90 percent of taxable income must be paid out as dividends. Therefore, another very important relationship shown in section III of Exhibit 21–3 is the dividend payment per share. In our example, the payment of $4.00 per share meets the 90 percent requirement, but this amount is also greater than the earnings per share; thus, MA paid dividends of $4.00 per share even though EPS was only $2.72. This can occur because FFO, or *cash flow* per share, was $5.72, which exceeded earnings per share. Indeed, MA could have paid dividends of $5.72 per share even though it was required to pay only 90 percent of $2.72 or only $2.45 per share. By paying a $4.00 dividend, Midwestern America met the 90 percent of earnings requirement and retained cash of $1.72 per share for operations and acquisitions of new assets.

The difference between REIT earnings and dividends has a very important effect on the taxes that shareholders pay. Tax regulations provide that even though investors in Midwestern America receive $4.00 per share, only $2.72 of earnings are reported as a taxable dividend. The remaining $1.28 is treated as **recovery of capital (ROC)** and serves to reduce the cost basis of the stock acquired by the investor. For example, if a share of MA stock was purchased for $75 prior to the dividend declaration date, the investor would reduce the investment basis of the stock by $1.28, from $75.00 to $73.72. When the stock is eventually sold, the investor would then calculate any gain or loss based on the sale price, less $73.72, or the reduced basis of the stock. If the stock has been owned for one year or more and results in a gain, it would be taxed at the prevailing capital gains tax rate. This also means that if there is a difference between ordinary and capital gains tax rates, the investor saves taxes in the amount of $1.28 times the difference in the two tax rates. Consequently, this treatment allows investors to receive a portion of the dividend ($1.28) tax free until the stock is sold or the REIT is liquidated. At that point, if the investor has owned the stock long enough to qualify for capital gains treatment and capital gains tax rates are lower than tax on ordinary income, the investor will also save taxes.

When REITs report operating losses, none of the losses can be passed through to investors. Instead, losses must be carried forward to offset income in future periods. The passive loss limitation provision does not materially affect REITs because their losses cannot be passed through to investors. REIT dividends are considered to be *portfolio income* and thus do not qualify as passive income to offset passive losses.

With respect to capital gains from the sale of property, REITs may either (1) retain the gain and defer its distribution to shareholders, in which case the gain is taxed at the appropriate corporate capital gains rate, or (2) distribute the gain as a dividend to shareholders. In the latter case, the REIT is not taxed on the distributed gain; however, the REIT is required to designate such dividends as a capital gain distribution to shareholders, who must recognize it as a capital gain in their individual taxes. Capital losses cannot be passed through to individual investors but must be carried forward by the REIT and offset against any future capital gains.

Also important in section III of Exhibit 21–3 is cash flow retention, or the difference between FFO per share and dividends per share, which amounts to $1.72. Midwestern America may have retained this amount as a cash reserve or to acquire properties during

the past year. As pointed out, MA could have paid this amount as a dividend and been taxed at ordinary income rates. However, because it was not paid currently, the cash flow retention is converted eventually into a capital gain if the *price* of MA stock responds favorably to management's decision to retain and invest these funds instead of paying dividends. Unlike corporations that may choose not to pay any dividends and retain all earnings for future expansion, MA must pay at least 90 percent of $2.72 or $2.45 per share. In other words, MA has far less discretion than corporations with respect to paying a minimum dividend—a major difference between REITs and corporate entities, which affects REIT dividend reinvestment and expansion policy in very important ways.

Valuing REITs as Investments

In previous chapters we have discussed how to estimate the value of individual properties. Estimating the value of a REIT is much more challenging because REITs tend to own and operate large, geographically diversified real estate portfolios. Thus, we need to estimate the value of a portfolio of properties in different locations and also consider the value of the REIT management and any goodwill established by the REIT as a going concern. Furthermore, as was the case when valuing individual properties, estimating the value of a REIT requires an understanding of both real estate space and capital market fundamentals.

There are analysts that publish investment research and recommendations with respect to REITs, but this information is not often available to the general investing public on a timely basis. Also, there is considerable variation in terms of methodology and content across analysts. Some analysts look at REITs from a real estate perspective, while other analysts focus on the analysis of financial statements and ratios. Other analysts take a blended approach, looking at the real estate, capital structure, management, and technical stock market factors.

REIT public filings provide a great deal of information, but they do not typically provide estimates of the value of the real estate owned by the REIT. The Financial Accounting Standards Board (FASB) has been active over recent years in its efforts to require fair value accounting of real assets as part of its efforts to bring U.S. financial reporting in line with the standards prevailing internationally. While there is no policy in place requiring fair value accounting for U.S. REITs currently, there is some chance that U.S. REITs will either elect to be required to the value of its assets on a fair value basis in the future. In the absence of this type of reporting, investors need to develop their own estimates of the value of the real estate owned by REITs. In this section we describe different methods that can be used to estimate the value of a REIT using Midwestern America Property Trust (introduced earlier in this chapter) as an example.

Valuation of Midwestern America Property Trust

Our previous analyses of Midwestern America Property Trust focused on the company and its performance at a specific point in time. To estimate the value of Midwestern America Property Trust, we need to make some assumptions about future performance. These assumptions will be added as we discuss the various approaches to valuation of the REIT.

Gordon Dividend Discount Model

A REIT security is a stock that can be valued using methods typically used to value other stocks. One simple and commonly accepted way of valuing stocks is the **Gordon dividend discount model.** This traditional model assumes a constant dividend growth rate for the stock. The model assumes that the value of a stock is the present value of expected future dividends, and it is particularly applicable for REITs because they tend to pay a relatively

high dividend rate. The model states that the value (V) of the stock equals the dividend to be paid in the next year (D_1) divided by the difference between the required rate of return (K) and the dividend growth rate (g), or

$$V = D_1/(K - g)$$

In regard to our analysis of Midwestern America, let's assume the following:

- The current dividend of $4.00 per share is projected to increase by 5 percent to $4.20 next year and continue to increase by 5 percent per year thereafter.
- The required rate of return for a REIT like Midwestern America Trust is 10.5 percent, which is a reasonable long-term rate of return for REITs.

Applying the above assumptions to the constant dividend growth stock valuation model, we can conclude that the stock value should be $4.20/(10.5% - 5%) = $76.36 per share.

Income (FFO) Multiple

Another valuation method analysts apply is to estimate income and then multiply that income by an appropriate multiple of income or price-to-earnings ratio. Analysts often look at multiples for comparable companies and then select an appropriate multiple for the company being valued based on its characteristics relative to the comparable companies.

In the case of developing income multiples for REITs, the most common practice is to use FFO for income for the reasons we discussed earlier (one being FFO is a better measure of the cash flow that a REIT can generate than earnings per share). Next, comparable REITs that own the same general type of properties in developing the multiples would be selected. In the case of Midwestern America Property, the FFO is $5.72 per share, and the current FFO multiple is approximately 13.1×, resulting in a share price of $75.00.

Suppose that we find that there are four comparable REITs in the market, trading at FFO multiples ranging from 12× to 15×. Thus, we see that Midwestern currently trades at a multiple slightly below the midpoint of the range of the comparable REITs.

If we believe that Midwestern is expected to improve its performance relative to the comparables, it is possible that a higher multiple would be appropriate. In the final analysis, determining the appropriate multiple is a subjective process, although objective data play an important role in the process. However, it is common to rank REITs on a relative basis and assign a multiple that reflects a REIT's placement in that ranking. So, we might elect to apply a 14× multiple to the FFO for Midwestern because we believe the market will eventually recognize that it has improved its performance relative to the comparables. Applying the 14× multiple to the $5.72 in FFO results in an expected share price of $80.08.

Net Asset Value

The final valuation method we will consider is based on analyzing a REIT's net asset value (NAV). A REIT's primary asset is real estate and a REIT's primary liability is the debt associated with that real estate. Logically, if one can estimate the total current value of the real estate and other assets owned by a REIT, then subtract the total debt and other liabilities owed by the REIT, the remainder will be the REIT's net asset value (NAV), which is an indication of shareholders' equity.

REITs report real estate holdings at book value, which can differ substantially from current market value for various reasons. What we want is an estimate of the current market value of the real estate. Unfortunately, REITs do not routinely provide NAV estimates, so the analyst needs to do that.[3]

[3] There are also companies like Green Street Advisors (www.greenstreetadvisors.com) that provide NAV estimates for REITs to subscribers.

A significant divergence between the NAV and the market value of a REIT stock may indicate a difference between what public market investors are willing to pay for properties versus what private market investors are willing to pay for those properties. If private market investors are willing to pay more, the REIT may elect to go private, or it may be taken over by a private company. Alternatively, if public market investors are willing to pay a premium, more private companies may decide to go public.

To estimate NAV, we estimate the net operating income (*NOI*) for the entire REIT and then divide that by a **blended capitalization rate** that would be applicable to the entire REIT. A blended capitalization rate means one that is an average of the capitalization rates that would be used for the individual properties in the portfolio if we were valuing each property separately.[4] The problem is that we do not typically have the *NOI* on each individual property. Thus, we need to try to value all the properties at once by applying a blended capitalization rate to an estimate of the aggregate *NOI* from all the properties held by the REIT. Thus, we have

$$\text{NAV} = NOI/r$$

where *NOI* is for all the properties held by the REIT and r is the blended cap rate.

To estimate the NAV of the real estate assets, we need to look at the properties separately from the entity. We do this by using net operating income from the property operations, using property level income and expenses, and not including entity level expenses such as general and administrative expenses, depreciation, and interest expense. Midwestern has rental revenue of $70 million ($14 per share) less operating expenses of $30 million ($6 per share), resulting in real estate *NOI* of $40 million ($8 per share). At an implied 8.75 percent capitalization rate, the total value of Midwestern's assets is approximately $457 million ($91.40 per share). We then subtract debt of $82 million ($16.40 per share), resulting in a net asset value for Midwestern's real estate of $375 million ($75 per share).

If the REIT is doing a significant amount of development, it may be more appropriate to use a projected stabilized *NOI* rather than the current *NOI* to estimate the value and then perhaps adjust that value down slightly, because there will be some rent loss until the properties are leased up.

Summary of Value Estimates

To summarize the estimates we found using the above valuation methods, we have

Gordon dividend growth model	$76.36/per share
FFO multiple	$80.08/per share
Net asset value (NAV)	$75.00/per share

In this case, the NAV estimate is a little lower than the others and is where the stock price is currently trading. But REITs often trade at premiums or discounts to their NAV depending on how the market views the management and its ability to identify good investment and development opportunities in the future. The FFO multiple approach assumed that the market would recognize that Midwestern is better than reflected in its current stock price and that it would start to trade at a price more in line with the better comparables. The Gordon dividend growth model approach resulted in a stock price of $76.36, which is between the other two estimates. All things considered, we may conclude that a price of

[4] The average would be weighted toward those locations that had the most properties.

Web App

Go to the NAREIT website (**www.reit.com**) and find the most recent value of the FTSE NAREIT Equity REIT Index for Equity REITs. Then go to the website for any REIT and find the following information: Full Company Name, Stock Symbol, Exchange, Property Type, Portfolio Composition (number of properties, units or square feet, and major markets), Current Price, Current Dividend, and Current Yield. Finally, go to the Dividend Discount Model site and value the REIT you selected using an appropriate discount rate. (One way to select a discount rate is to see what the expected return is for REIT indexes on the site.)

around $76 to $77 is appropriate. This suggests that the REIT might be slightly undervalued by the market at its current price of $75.

Further Considerations

The above analysis provides us with an estimate of the range in which we might expect the stock price for a REIT to fall. But of course, estimating stock prices is far from an exact science. All stocks tend to rise and fall with the overall market, and REITs are no exception. As will be discussed in Chapter 22, REITs are not highly correlated with the overall market so they do provide some diversification benefits. But they will still tend to be pulled in the direction of the rest of the market, so investors must also consider the likely direction of the overall stock market when valuing a REIT.

Another consideration is where the property types held by the REIT are in their investment cycle, as discussed in Chapter 10. For example, if the REIT invests in office properties and office properties are in a downward cycle in the areas where the REIT owns properties, this may impact their ability to generate the *NOIs* or FFO we had projected—especially if the REIT relies on income from newly developed properties.

Finally, an investor should try to determine whether there are reasons that the stock price should sell for more or less than the value of its underlying real estate based on the NAV calculations. REITs are not just a portfolio of properties. REITs are companies that buy, sell, develop, finance, operate, and renovate the properties. So keep in mind that the investment is a business—not just real estate. Factors such as the strength of the management, the trade name of the REIT, the loyalty of its tenants, and other factors that can affect a business must all be considered.

Conclusion

The resurgence of real estate investment trusts (REITs) in the early 1990s is another indication of the extent that real estate has become securitized. Compared with traditional methods of investing, real estate–backed securities appear to be gaining in importance because of their marketability, the public accountability of management, and numerous other reasons. REITs allow investors to participate in a portfolio of properties that may be geographically diversified and professionally managed. REITs own assets that consist of commercial properties, supplies, and intellectual capital, and manage those assets to maximize profit. Mutual funds, in contrast, own claims on the earnings produced by assets that are entirely under the management of others. Further, REITs usually pay no taxes so long as they pass through as dividends to investors most of the cash flow produced from managing the portfolio. Accounting practices for depreciation and amortization and the resultant effects on net income may allow a portion of the tax on REIT dividends to be deferred. Today the market value of REITs exceeds $816 billion, and many of the premier real estate operators in the United States are operating within the REIT format, so market research and analysis for individual REITs and the industry are widely available from investment banks and other investment firms.

Key Terms

book value per share, *723*
blended capitalization rate, *727*
cash available for distribution (CAD), *715*
dividend yield, *710*
earnings multiple, *723*
earnings per share (EPS), *724*
earnings yield, *723*
FFO multiple, *723*
FFO yield, *723*
funds from operations (FFO), *709*
Gordon dividend discount model, *725*
net asset value (NAV), *713*
net income from operations, *723*
real estate investment trust (REIT), *698*
recovery of capital (ROC), *724*
umbrella partnership REIT (UPREIT), *701*

Useful Websites

www.reit.com—The website for the National Association of Real Estate Investment Trusts (NAREIT). It provides programs, statistics, publications, and research, as well as information about REITs and REIT investing.

www.investopedia.com—This site is a complete, unbiased, easy-to-understand educational guide to investing and personal finance. It provides the biggest financial dictionary on the web, hundreds of articles and tutorials, and an investing simulator where you can practice managing a portfolio without putting your money at risk.

www.spglobal.com—This website provides fundamental financial data on more than 230 REITs, REOCs, and homebuilders. It gives detailed, descriptive property data, cost and performance data, and property mapping. It also is a good source for analyst coverage, FFO estimates, proprietary AFFO, and NAV consensus estimates.

www.treppREITcafe.com—This website provides numerous podcast programs focused on the REIT industry, consensus NAV estimates, REIT company conference calls in podcast format, and up-to-the-minute news on the industry.

Questions

1. What are the general requirements regarding income, investments, and dividends with which a REIT must comply to maintain its qualification to be taxed as a REIT?
2. What are the two principal types of REITs?
3. List and characterize equity REITs based on their property types.
4. What is the difference between earnings per share (EPS), funds from operations (FFO), adjusted funds from operations (AFFO), and dividends per share?
5. Explain how an investor in an equity REIT may receive a current dividend, part of which may be tax-deferred.
6. What are some important lease provisions which investors should be aware of when analyzing the financial statements of REITs?
7. What is a mortgage REIT?

Problems

1. You have been presented with the following set of financial statements for National Property Trust, a REIT that is about to make an initial stock offering to the public. This REIT specializes in the acquisition and management of warehouses. Your firm, Blue Street Advisors, is an investment management company that is considering the purchase of National Property Trust shares. You have been asked to prepare a financial analysis of the REIT.

Part A only

National Property Trust

Panel A. Operating Statement Summary

Net revenue	$100,000,000
Less:	
Operating expenses	40,000,000
Depreciation and amortization	22,000,000
General and administrative expenses	6,000,000
Management expense	3,000,000
Income from operations	29,000,000
Less:	
Interest expense*	6,400,000
Net income (loss)	$ 22,600,000

*At 8% interest only

Panel B. Balance Sheet Summary

Assets	
Cash	$ 51,500,000
Rents receivable	2,500,000
Properties @ cost	700,000,000
Less: Accumulated depreciation	450,000,000
Properties—net	250,000,000
Total net assets	$ 304,000,000
Liabilities	
Short term	$ 12,000,000
Mortgage debt*	80,000,000
Total	92,000,000
Shareholder equity†	212,000,000
Total liabilities and equity	$ 304,000,000

*At 8% interest only.

†10,000,000 shares outstanding.

a. Develop a set of financial ratios that will provide Blue Street Advisors with useful information in the evaluation and comparison of National Property Trust with other REITs.

b. Your research also indicates that the shares of comparable REITs specializing in warehouse acquisitions in the same regions are selling at dividend yields in the range of 8 percent. Price multiples for these REITs are about 12 current FFO. What price range does this suggest for National shares? What does this price range imply about the amount of dividend that National would have to pay to be in line with comparable REITs?

c. What is the NAV for National Property Trust assuming that a blended capitalization rate of 10 percent would be applicable for the properties owned by Blue Street Advisors?

2. Robust Properties is planning to go public by creating a REIT that will offer 1 million shares of stock. It is currently trying to develop a pro forma set of financial statements. Robust is faced with a number of questions about its handling of some accounting and financial disclosure issues.

Robust Properties	
I. Major Financial Information:	
a. Assets—properties (actual cost)	$100,000,000
b. Depreciable basis—buildings only	$80,000,000
c. Useful life	40 years
d. Operating expenses	38% of rents
e. Management expenses—third parties	5% of rents
f. General and administrative expenses	3% of rents
g. Mortgage @ 8% interest only, 10 years	$30,000,000
h. Financing fees	$900,000
II. Lease Information:	
a. Average lease term	5 years
b. Leasable space	1,000,000 sf.
c. Base rents (year 1)	$15 psf.
d. Escalation factor—rents per year	5%
e. Lease commissions	4% of year 1 rent
f. Tenant improvements	$10 psf.

The management of Robust Properties has asked you to prepare preliminary pro forma financials for the next *three years*. Specifically, you should have (1) a *beginning* balance sheet, (2) operating statements for each of the next three years, and (3) all relevant financial ratios for year 1 results only. Robust will pay all financing fees, tenant improvements, and lease commissions upon commencing operations. It would like to pay a minimum dividend of $4.00 per share.

In preparing your pro forma operating statements, Robust wants you to consider the effects of reporting in the following two ways:

a. What would EPS, FFO, and ROC be under both approaches? How should Robust think about its accounting policy?

Approach	(1)	(2)
Lease commissions	Amortize, 5 years	Expense in year 1
Finance fees	Amortize, 10 years	Expense in year 1
Tenant improvements	Depreciate, 40 years	Depr. over 5-year lease term
Buildings	Depreciate, 40 years	Depr., 40 years

3. Atlantis REIT expects an income of $8 per share. This includes a deduction of $2 per share for depreciation. Atlantis did not have any gains from the sale of real estate. Its properties are mainly apartments, and you believe that apartments are currently selling on average at about an 8 percent cap rate. Atlantis has 1 million shares outstanding and its balance sheet shows liabilities of $40 million. Comparable REITs have FFO multiples of about 10. Atlantis is expected to pay a dividend during the next fiscal year of $6 per share and to increase those dividends at about 2 percent per year in the future. Investors in REITs like Atlantis usually expect a return of about 12 percent.

a. What is the FFO and value per share based on an FFO multiple?

b. What value per share is indicated using a dividend discount model?

c. What is the value per share implied by the net asset value of the properties?