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INVESTMENTS IN REITS IN TURBULENT MARKETS

by

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In today's challenging economic environment, REITs have maintained their value and appeal both to outside investors, who purchase REIT shares in the stock market, and to developers, who create REITs to operate their properties and grow their portfolios.

What is a REIT?

A REIT is a company that owns, and typically operates, properties such as office buildings, apartment buildings, warehouses, shopping centers and hotels. REITs, which were created by Congress in 1960 to encourage investment in income-producing real estate by small investors, enjoy certain tax advantages if they meet certain requirements. In general, REITs must:

- invest at least 75% of its total assets in real estate assets,
- derive at least 75% of its gross income from rents or interest on mortgages, and
- pay dividends to shareholders of at least 90% of its taxable income.

By meeting these requirements, a REIT can "pass through" income to its shareholders without being taxed. As a result, most REITs distribute all of their taxable income to shareholders and do not pay any corporate tax.

REITs are generally classified as having one of three investment approaches:

- *Equity REITs* – own and operate income-producing real estate,
- *Mortgage REITs* – engage in the lending of money to real estate owners and operators either directly or indirectly through the acquisition of loans or mortgage-backed securities, or
- *Hybrid REITs* – engage in a combination of the activities engaged by equity and mortgage REITs

Among equity REITs, they are often structured as either "upREITs" or "downREITs." In the typical upREIT, the REITs holds its properties and conducts all of its business through an operating partnership, the general partner of which is the REIT. The founders and others who contribute properties to the REIT become limited partners in the operating partnership. In a typical downREIT, the REIT holds most of its properties directly, but some properties are owned through a partnership, the general partner of which is the REIT.

Advantages of Investments in REITs in Turbulent Markets

REITs have certain characteristics that make them especially attractive investments in a difficult economic climate. It is notable that, as of February 28, 2003, the five-year return of the NAREIT Composite Index (comprised of all REITs on the NYSE, AMEX and Nasdaq National Market) was 3.24% compared to the S&P 500 Index return of (2.99)%.

Liquidity

Because REITs are required to have at least 100 investors, most REITs are public companies and are listed or traded on a stock exchange. There are approximately 300 REITs operating in the United States and approximately 190 of them are listed on the three national exchanges – the New York Stock Exchange, the Nasdaq National Market and the American Stock Exchange. This makes shares in REITs very liquid and available to all types of investors. Investors are thus able to time their entry and exit in and out of real estate investments.

While some other real estate investment vehicles, such as limited partnerships, may be public, the vast majority are either privately owned or offered on a limited basis to selected investors. As a result, most limited partnerships are not publicly traded and limits are placed on the resale of the units. Without a public market, it is difficult for a seller to find a willing buyer for his or her interests, and if a buyer is found, sale prices are usually deeply discounted.

Strong Balance Sheets and Portfolio Diversification

Another reason REITs have been more somewhat insulated from recent market downturns is their strong balance sheets. Historically, income-producing commercial real estate often was financed with high levels of debt. Prior to the real estate recession of the early 1990s, it was not uncommon for individual properties to carry mortgages of over 80 percent to 100 percent of their estimated market value or cost of construction. As a result of the mistakes of the early 1990's, today, properties owned by REITs are financed on average with far less debt, with most REITs maintaining a debt to market capitalization ratio of less than 50%.

Since REITs are publicly traded and have strong balance sheets, they have greater access to capital making it easier for them to acquire existing properties or develop new ones. Their growing portfolios make it easier for REITs to minimize investment risk over a greater number of tenants, property types and property locations. This cushions the effect of adverse conditions in a particular industry or economic downturns in specific markets.

Acquisition Currency

REITs that are structured as upREITs and downREITs have competitive advantages when attempting to acquire properties. These REITs offer sellers of commercial real estate attractive tax benefits. Sellers can exchange their property for operating partnership units which the sellers are able, after a period of time (often one year), to tender for either cash or REIT shares (at the option of the REIT or the operating partnership). This structure enables sellers to defer their tax liability on any gain on sale of the properties until the units are converted into cash or REIT shares. In addition, when the seller holds the units until death, the estate tax rules oper-

ate in a such a way as to provide that the beneficiaries may tender the units for cash or REIT shares without paying income taxes.

Income Potential

Because REITs are required to distribute 90% of taxable income to shareholders, REITs are particularly attractive investments in the current economic climate because of their high dividend yields. REIT shares help to diversify an investment portfolio because they often have both stock-like and bond-like qualities. REITs offer moderate, long-term capital appreciation (like value stocks) with high dividend yields. In fact, in the past decade, annual REIT dividend growth has exceeded the rate of inflation. Because of their high dividend yields, REITs have been attractive investments to those investors disillusioned by the "tech bubble" and inflated stock prices of the late 1990's.

Transparency

As publicly traded companies, REITs are subject to the rules and regulations of the Securities and Exchange Commission and the exchanges on which their shares are traded, as well as enhanced scrutiny by independent analysts, the media and the public markets. As a result, the operation and performance of REITs is characterized by a high degree of accountability and transparency. With the recent passage of the Sarbanes-Oxley Act of 2002, rules and regulations of the Securities and Exchange Commission thereunder and the adoption of stringent corporate governance rules by the major stock exchanges, investors have been provided with additional measures of protection.

Summary

Even in turbulent markets, REITs offer investors a number of advantages, including liquidity, income potential and greater transparency. At the same time, REITs are better able to ride through rougher waters because of the strength of their balance sheets and their ability to diversify and spread many of the risks inherent in real estate acquisition and development.