Part 1

Getting Started in REITs

Chapter 1

Real Estate as an Asset Class

More money has been made in real estate than all industrial investments combined.

—Andrew Carnegie, 1902

To understand *real estate investment trusts* (REITs), an investor needs a basic understanding of the real estate asset class. The recent popularity of real estate investing has helped to bring the investment opportunities in real estate broader exposure to noninstitutional investors. Until recently, real estate was one of the best kept secrets in the investment community. It is an asset that major investment institutions have formally embraced as a part of their portfolios for the last century. Among institutional investors it is no secret that well-located, high-quality real estate can provide an excellent return on investment, high current income, and a significant hedge against inflation.

real estate investment trust (REIT)
a tax conduit company dedicated to owning, managing, and operating income-producing real estate, such as apartments, shopping centers, offices, and warehouses. Some REITs, known as mortgage REITs, also engage in financing real estate.

Characteristics of Real Estate as an Investment

Institutional real estate investors own the vast majority of the estimated $11.0 trillion of

A Brief History of REITs

REITs actually date back to the trusts and robber barons of the 1880s. Investors could avoid taxation because trusts were not taxed at the corporate level if income was distributed to the trust beneficiaries. Over time this tax advantage was reversed. In 1960, President Eisenhower signed the tax provisions into law with the Real Estate Investment Trust Act of 1960, which reestablished the special tax considerations for qualifying REITs as pass-through entities. This allowed REITs to avoid taxation at the corporate level on income distributed to shareholders. This law formed the basis for present-day REITs.

REIT investment increased throughout the 1980s as the Tax Reform Act of 1986 eliminated many real estate tax shelters. The Tax Reform Act of 1986 allowed REITs to manage their properties directly, and in 1993 REIT investment barriers to pension funds were eliminated. This history of reforms continued to increase the opportunity for REITs to make high-quality property investments. Currently there are more than 200 publicly traded REITs in the United States and the REIT structure is being adopted in many countries around the world.

Real Estate Investment Trust Act of 1960
the federal law that authorized REITs. Its purpose was to allow small investors to pool their investments in real estate in order to get the same benefits as might be obtained by direct ownership, while also diversifying their risks and obtaining professional management.

investment-grade *commercial real estate* in the United States. By comparison, the total capitalization of all public U.S. equities is estimated to be $12.9 trillion, and the nominal value of all non-government U.S. bonds is estimated to be $36.4 trillion. U.S. domestic real estate as an asset class ranks third, behind stocks and bonds, and represents 18 percent of the total of the three asset classes (see Figure 1.1).

Positive Attributes of the Real Estate Asset Class

Each institution generally has its own particular investment policy when it comes to real estate. Normally, institutions are attempting to match the life of assets they own with that of forecast liabilities.

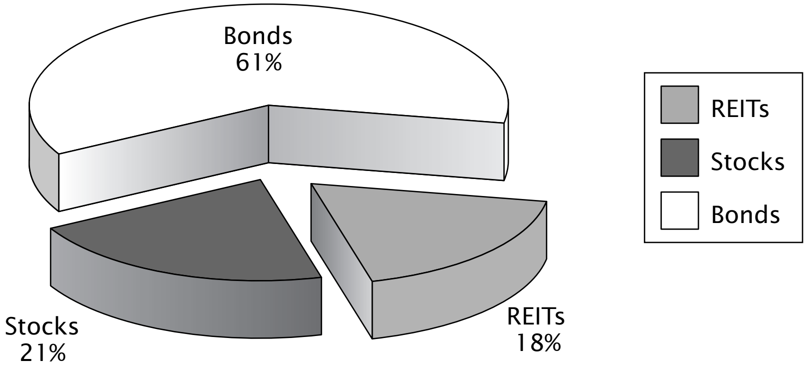

FIGURE 1.1 Commercial Real Estate versus Stocks and Bonds

> **commercial real estate**
> all real estate excluding single-family homes and multifamily buildings up to four units, raw land, farms and ranches, and government-owned properties. About half of commercial real estate as defined is considered to be of sufficient quality and size to be of interest to institutional investors. This real estate is known as *investment grade.*

Retirement funds, insurance companies, and commercial banks are among the major private sector investors in real estate. They all have projected liabilities that must be met at some future date.

The consistent and relatively predictable cash flows associated with real estate allow for a high degree of confidence when matching future liabilities. The cash flow comes in the form of rent paid to the building owner. The buildings that are owned by institutional investors tend to have *credit tenants.* (There will be more about credit tenants in Chapter 15.)

Consistent and predictable cash flow is just one attractive feature of the real estate asset class. Real estate also tends to perform better than financial assets in an inflationary environment. In reviewing the history of real estate performance, a number of studies have found that returns from real estate were higher during times of inflation and lower during periods of disinflation. Thus, a portfolio of largely financial assets can be hedged—to some extent—against the corrosive effects of inflation through the ownership of real estate. Taxable investors can also derive some additional tax benefits from the real estate asset class. For tax accounting purposes, the value of real estate other than land can be depreciated at a rate that is generally greater than the actual economic life of the property. In most cases, the value of a well-maintained property in a good location actually increases over time at a rate similar to inflation. This accelerated tax depreciation results in a partial sheltering of cash flow as well as the deferral of taxes, which can usually be treated as a more favorable long-term capital gain for tax purposes. So real estate can create current income in the form of cash flow that is partially sheltered from taxation until some future date. It is possible to capture some of the benefits of real estate's unique tax qualities for tax-exempt investors such as pension funds. Structuring partnerships and operating agreements in ways that allow taxable benefits to flow to those who can use them, while allocating higher levels of cash flow to tax-exempt investors, is one way tax-exempt investors can benefit from the tax advantages of real estate. In some instances, the tax benefits of certain real estate projects can be sold to taxable investors by tax-exempt investors, which allows incremental total return to be enhanced.

credit tenant
a tenant that has the size and financial strength to be rated as investment grade by one of the three major credit rating agencies: Moody's, Standard & Poor's, and Fitch. The investment grade rating increases the probability that the financial strength of the company will allow it to continue to pay rent even during difficult economic times.

There are some other primary reasons that large institutional investors are attracted to real estate. One factor that is often cited by institutions is that real estate returns behave very differently from stock and bond returns. How investment returns behave relative to one another is known as *correlation*. This low correlation of returns provides an added diversification benefit within an investor's portfolio. In general, adding real estate to a portfolio of stocks and bonds enhances return and lowers risk in a given portfolio. There is a large body of academic and professional work that suggests that investing 5 percent to 15 percent of a portfolio in real estate increases the total return and lowers the portfolio risk. This is consistent with the fact that the largest 200 retirement plans have an average total of 17 percent of their assets invested in real estate.

Attribution of Return in Real Estate

A fancy way of explaining where the return of a particular investment comes from is known as the *attribution of return.* The return attribution of real estate can be identified by a number of features, some of which are unique to real estate and some of which are common to other classes of investments such as stocks and bonds. As discussed previously, the value of well-maintained real estate in a good location will actually increase over time. This capital appreciation aspect of real estate is similar to the long-term growth in value seen as a primary component of return in the equity asset class. Investors buy stocks because they expect over time that the price will go up. The same is true of investors who buy real estate. But, unlike stocks, most real estate also has some bondlike characteristics. It is the consistent and predictable cash flow associated with rents paid on real estate that is the primary focus of most institutional investors. This steady stream of rental income attributable to a given property or portfolio is much like the regular interest paid as the coupon of a bond. The terms of these bondlike payments are typically detailed in a lease agreement between the owner of the real estate and the user or tenant of the real estate. It is the quality and completeness of these terms and conditions as stated in the lease that allow for the analysis of the underlying cash flows of a given property. The *term,* or length, of the rental payments as stated by the lease also produces duration characteristics similar to those of a bond investment. In a bond, the duration is, in part, a function of the term remaining before the bond matures. In real estate, the duration of the rental income is a function of the length of the underlying lease or remaining period of the rental stream. Rents derived from hotel and motel properties, which can change on a daily basis, have the shortest duration, followed by apartment rents, which are generally set for a term of one or two years (see Table 1.1). Office, retail, and industrial properties tend to have longer duration leases that can extend for a term of 10 years to 30 years or more.

TABLE 1.1 Average Lease Duration by Property Type

Hotels	1 to 3 days
Self-storage	6 months
Apartments	1 year
Offices	5 to 15 years
Industrial	5 to 20 years
Retail	10 to 30 years

Real estate also has a credit profile, much like the credit rating of a bond. This credit profile is determined by the credit quality of the underlying tenants that pay the lease and occupy the real estate. For example, an office building with 50,000 square feet leased on a long-term basis to IBM will have a much better credit profile than the same space leased to Bob's Pretty Good Computer Company, a new enterprise with an operating history of less than five years. Similarly, an IBM bond would presumably have a better credit rating than a loan to Bob's Pretty Good Computer Company, which would most likely be considered a higher-risk proposition.

There are also return attribution features that are unique to the real estate asset class. The physical attributes of a given piece of real estate can have an impact on value. For example, visualize two suburban office buildings, of the same size and age, in a similar location. One is built of brick and stone, the other using simple wood construction. It is likely that because the brick-and-stone office building has a higher replacement cost, it may also have a higher value than the wood-frame office building. Thus a building's physical quality can have a unique impact on its value.

Location is also a unique feature that can ascribe greater or lesser value to real estate. Because any given piece of real estate can only occupy a single location, each piece of real estate is, in essence, unique. Real estate in a highly desirable location may have a much greater value than identical real estate in a different, less desirable location. This location factor can be so important in that in some cases it is the overall value determinant of a real estate parcel. That is why companies like Walgreen's will close a store on the southwest corner of an intersection and reopen the store on the northeast corner of the same intersection! Location, Location, Location—always remember how important it is in real estate.

There is also the situation of what are called *externalities* in the economics of real estate. An externality occurs when an activity or event affects (for good or bad) another that is external to it. If Donald Trump builds a shining new skyscraper in the middle of a marginal neighborhood, this is a positive externality for the owners of many adjoining properties, who see the value of their holdings increase overnight as a result of no direct activity on their part. Conversely, if the house next door to an apartment building in an urban neighborhood is converted to a homeless shelter, it is likely to be considered a negative externality that lowers the value of the apartment building.

Because the problem of externalities is so crucial to real estate value, a high degree of zoning and entitlement exists in the real estate marketplace. Normally zoning considers what is commonly referred to as *highest and best use.* This is a use that is economically and physically feasible when considered relative to other adjoining real estate, economic activities in the area, the size of the site, and the intended design and use of the new building. Zoning and entitlement also extend to the regulatory level when examining real estate. Many localities have low- or no-growth policies that make it difficult to develop new real estate. Some localities adopt master plans that strictly limit the size, style, design, and use of a building in any given area of the planned community.

In some communities there is simply no more available vacant space on which to build. These are referred to as *urban infill* or *redevelopment* communities. Any *entitlement* in these areas becomes part of the removal and redevelopment of an existing site or the expansion and refinement of an existing property. The ever-growing political sentiment of "not in my backyard" among the residents of many communities often creates a situation of externalities that can have significant positive or negative impact on the value of a property. These are unique aspects of the real estate asset class. The features that are unique to real estate, physical attributes, location, local externalities, zoning, and entitlement, contribute to real estate's low correlation of return relative to stocks and bonds. The value of real estate is driven by supply and demand in the local real estate market. The best building imaginable might sit empty in a market where supply exceeds demand for that type of real estate. Because of its permanent physical nature, real estate cannot be moved to a market where the demand is greater than the supply. In its simplest terms, real estate is a very local asset class driven by all the macroeconomic and microeconomic factors of the local and regional marketplace.

This is not to say that real estate is insulated from more national economic factors. The aggregate demand for real estate in general is driven by the overall growth in the national economy. Population

entitlement

the legal right as granted by state and local real estate zoning authorities to build or improve a parcel of existing real estate, normally unimproved land. The grant of entitlement to improve property can take long periods of time and be expensive from a legal standpoint. But entitlement can create immediate value for previously unentitled parcels of real estate.

REIT Idea: *Kelo et al. v. City of New London et al.*

This supply and demand struggle was showcased in the recent Supreme Court case of *Kelo et al. v. City of New London et al.*, which was argued February 22, 2005, and decided June 23, 2005.

After approving an integrated development plan designed to revitalize its ailing economy, the city of New London, Connecticut, purchased most of the property earmarked for the project from willing sellers, but initiated condemnation proceedings when Kelo and the owners of the rest of the property refused to sell. The city claimed the proposed taking of their property qualified as a "public use."

Prior court rulings were clear that the city could not take the land simply to confer a private benefit on a particular private party. However, the property at issue here would be claimed pursuant to a carefully considered development plan, which was not adopted to benefit a particular class of identifiable individuals.

The city determined that the area at issue was distressed and that their program of economic rejuvenation was entitled to proceed. The city had carefully formulated a development plan that it felt would provide appreciable benefits to the community, including new jobs and increased tax revenue. The Supreme Court agreed with the city and the taking of the private land was allowed.

demographics, job creation, and the general business cycle all have an impact on the final demand for real estate. However, this demand manifests itself in very local ways. For example, the Internet frenzy that gripped San Francisco and San Jose in the late 1990s had a huge impact on the final demand for real estate in those cities, driving real estate prices to unsustainable levels. During the same time period, real estate prices in Atlanta, Georgia, remained relatively soft due to an excess supply of local property, which had to be absorbed before prices could again advance.

Real estate seems to have a litany of positive investment characteristics. It has both stock- and bond-type attributes as well as performance features that enhance portfolio diversification. It tends to perform well in an inflationary environment and achieves good outcomes in both rising and falling interest rate environments. Taxable investors also enjoy certain tax advantages when investing in real estate. These are the beneficial features that have made real estate a favorite among institutional investors.

Negative Attributes of the Real Estate Asset Class

Although real estate has a long list of positive investment attributes, there are also some negative characteristics related to direct investments in real estate. Lack of liquidity is the single most negative factor that goes along with owning a real estate investment portfolio. The process of buying and selling real estate can be long and involved. An investment-class property can easily take six months to a year to sell, depending on market conditions and the prevailing economic environment. The marketability of a property will often depend on the terms and conditions of a sale. The terms are often subject to negotiation at times, lengthy negotiation between any given number of potential buyers and the seller. Because real estate is often financed in part with debt, the type and amount of financing that is readily available for a given property or in a given marketplace will often affect these negotiations. This lack of liquidity, when compared to other financial assets such as stocks or bonds, adds to the potential risk inherent in the real estate asset class.

An investor in a share of IBM common stock is buying one share out of millions of identical common shares that trade freely on a daily basis. The buyer of an office building in Detroit faces an entirely unique set of facts and circumstances that are largely different from the facts and circumstances that may affect a similar office building in Denver. Furthermore, office buildings in Detroit and Denver similar to those described may only change hands every few years. At times it may be difficult to establish a relevant market price with which to compare similar real estate. This lack of liquidity, when coupled with the local market nature of real estate, can create a situation where real estate is a less efficient asset class. This is due in part to the uniqueness of each property as it is situated in each market. Local economic factors can lead to real estate values rising in one area of the country while falling in others. These same factors can lead to rising prices for industrial buildings and falling prices for office buildings in the very same market. The uniqueness of real estate causes these inefficiencies. The lack of liquidity and the less efficient local characteristics of real estate also create problems when attempting to measure the performance of real estate. Performance is most accurate when measured over the period the real estate is owned, which may be 5 to 10 years or longer. However, measuring annual or quarterly returns from a property or a portfolio can be difficult given the lack of market information. Appraisals are sometimes used to estimate periodic values over shorter periods of time, but this is not as accurate as the data from actual transactions. And it still leaves unanswered the question of how a real estate portfolio is performing relative to other similar portfolios. These inefficient aspects of direct real estate investment manifest themselves in the higher potential returns that result from superior market knowledge. The inefficiencies create advantages for investors who have cultivated local market knowledge and use it to the disadvantage of the less informed owner. This use of material inside information that may be gleaned from political and business relationships is not illegal in real estate transactions, as it is in securities transactions. On this basis, some observers argue that real estate is a less than level playing field for the small investor. This perception may have some basis in the recent history of the small investor and real estate.

The late 1970s and early 1980s saw a confluence of events that hurt the general credibility of the real estate asset class in the eyes of the small investor. The federal tax code had created a situation of positive incentives for the ownership of investment real estate. The inflationary environment of the period led to ever-escalating real estate prices, which, in turn, led to an excess amount of capital from small investors flowing into the real estate market. This took the form of a large number of private limited partnerships that were created to invest in real estate. Federally insured savings and loan institutions became lenders to the partnerships in an environment where lenders had little incentive not to lend. There was little regulatory oversight of the situation and a great deal of leverage and liquidity. This led to a speculative real estate bubble that resulted in a real estate crash during the mid 1980s and a near collapse of the entire U.S. savings and loan system.

It took nearly a decade for the economy to absorb the excess supply of real estate, and an entire generation of small investors was left with painful financial losses and a negative outlook on real estate as an investment. Many small investors view real estate as an institutional arena. Given the large amount of capital required to buy a real estate portfolio diversified by property type and geography, it is easy to understand the continuing negative sentiment of the small investor. The aftermath of the limited partnerships and the savings and loan crisis has led to a real estate market with a new sense of order. Tax law changes have resulted in more modest capital formation in the real estate markets. The increased regulation and scrutiny of lenders and their loan portfolios has lowered the propensity for excess leverage in the real estate sector by requiring more equity and higher loan underwriting standards. This has resulted in a more balanced real estate economy. Wall Street has also made a contribution to the real estate sector. The growth in *securitization* of real estate assets through such vehicles as *commercial mortgage-backed securities* (CMBS) and real estate investment trusts has created a public market discipline that has resulted in better transparency of the real estate markets and a more moderate real estate cycle.

securitization
the process of financing a pool of similar but unrelated financial assets (usually loans or other debt instruments) by issuing to investors security interests representing claims against the cash flow and other economic benefits generated by the pool of assets.

The growth of REITs as an asset class has created an opportunity for small investors to participate in the ownership of institutional-quality real estate. REITs have created a solution to the lack of liquidity, lack of efficiency, and lack of relevant performance measurement that confront real estate investors in general. In addition, they provide an efficient mechanism for small investors to participate in real estate portfolios that offer diversity by property type and geography. The advantages and benefits of REITs as an asset class and how to integrate them into a portfolio strategy are the focus of this book.

Points to Remember

- Real estate has been an important component of large institutional investment portfolios for the last century.
- Well-located, high-quality real estate provides excellent return on investment, high current income, and a significant hedge against inflation.
- Real estate behaves very differently from stocks and bonds. Its value is driven by supply and demand in the local real estate market.
- Real estate performs well in both rising and falling interest rate environments.

- Returns in the real estate asset class rival those of stocks on a long-term basis.
- Because it is a hard asset, real estate provides an inflation hedge, but, unlike most hard assets, real estate provides current income.
- In 1960, a vehicle was created by Congress that enabled groups of investors to collectively own real estate portfolios similar to those of institutions. This vehicle was known as the real estate investment trust (REIT).