REIT White Paper

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Subject: Resulting from the recent financial crisis, this white paper discusses how to better defend shareholders’ investments in Real Estate Investment Trusts (REITs) for the long-term and how to reduce volatility in the REITs market.

Introduction

In 1960, the U.S. Congress created Real Estate Investment Trusts (REITs) in order to promote large-scale investments and to provide an opportunity to possess real estate as liquidity of security notes. Prior to this policy, commercial real estate investments were only accessible to institutions and wealthy individuals being able to afford direct real estate investments (REIT, 2011a).

In order for a company to qualify as a REIT in the U.S., it must comply with certain ground rules specified in the Internal Revenue Code. These include: investing at least 75 percent of total assets in real estate; deriving at least 75 percent of gross income as rents from real property or interest from mortgages on real property; and distributing annually at least 90 percent of taxable income to shareholders in the form of dividends (REIT, 2011a).

In the early stage of the industry, mortgage REITs, which loan money for mortgages to owners of real estate or invest in (purchase) existing mortgages or mortgage-backed securities, dominated the market. On the contrary, equity REITs, which invest in and own properties such as commercial properties and are responsible for the equity value of their real estate assets, were restricted because ownerships and management of assets were compelled to remain separate. However, in 1986 the Tax Reform Act allowed them to manage and own their properties as virtually integrated companies. This act permitted a secular interest for initial public offerings
(IPOs) in the mid-90’s. Presently, 83% of the 134 publicly traded U.S. REITs are equity REITs that own and most often manage commercial real estate and obtain most of their revenue and income from rents (REIT, 2011a).

In July 2008, REIT Investment and Diversification Act became law, thus allowing REITs to buy and sell assets more efficiently and increasing the size of taxable REIT subsidiaries. In 2009, most REITs opted for the recapitalization of their balance sheets in order to respond to the recent global credit crisis, thus reducing their leverage and strengthening their financial statements (REIT, 2011b).

The REIT industry celebrated its 50th anniversary in September 14, 2010 (REIT, 2011b). For the last half of a century, REITs have become a large and important segment of the U.S. economy. As a matter of fact, in the last decade only the capitalization of the REITs equity market surged from $90 billion to about $200 billion (REIT, 2011a).

In 2011, the REIT industry represented $54.3 billion in revenue and a profit of $7.8 billion. The annual growth between 2006 and 2011 only averaged 4.4% including a 2.1% jump in 2011. The industry annual growth expectation for the next 5 years (from 2011 to 2016) is 5.1% or $69.7 billion. The latter should be driven by economic recovery and a rebound in the real estate market. The industry encompasses 178 businesses and $2.3 billion in wages (IBISWorld, 2011b).

During the last economic downturn, which was caused by the subprime mortgage crisis, the industry assets lost 26.2% of their value or $90.1 billion. This was the worst financial crisis and property decline since the Great Depression (IBISWorld, 2011b).
Background

**Global Environment.** The impact of globalization is a critical factor in the REIT industry. International business agreements or even organization such as the World Trade Organization (WTO) have also an important impact in the REIT Industry. On one hand, in developed countries, REIT companies demand/require international investors. On the other hand, the U.S. REIT industry wants to continue growing beyond its borders and globalization gives this opportunity of growth. Joint ventures is often required and advised to gain a deep understanding of the local market (Chen and Mills, 2004).

**Economic environment.** Undeniably, the subprime mortgage crisis is a great example of how a bad economy can globally affect the REIT industry. Until this recent crisis, firms acquired properties through debt purchases but once the credit markets tarnished and real estate prices declined, REIT companies could not manage their debt level anymore. Consequently, REITs had to find ways such as issuing preferred stocks and issuing equity security notes instead of dividends to hold on to cash and to raise funds (IBISWorld, 2011b).

Due to globalization, economic factors such as currency exchange rate affect new real estate construction costs or new property purchases. For instance, China’s currency manipulation makes it more expensive for U.S. firms to invest in the Chinese market. In the same reasoning, oil price increase and/or scarcity of raw construction materials will trigger a price increase in such products that may affect REITs investment and expansion (D. McDonald-Amini, personal communication, December, 2011).
IBISWorld (2011b) identifies two most important key success financial factors in the REIT industry.

- Access to investment funding

In order to fund the growth of their businesses, most REITs rely on external financing. Access to funding from debt and equity markets is an important success factor.

- Superior financial management and debt management

Property acquisitions are financed by a significant amount of capital and debt. Hence, REIT firms must properly manage their cash flows, cash reserves and debt levels to grow and manage portfolios.

The importance of cash flow from operating activities—a cash flow statement includes operating, financing, and investing activities—is vital for the REIT industry. With this cash, companies can meet discretionary needs such as reinvestment, debt reduction, stock buybacks, and dividends (C. Cooper, personal communication, fall 2011).

**Problem**

A REIT is not estimated on the cash generated by its operations but rather on its Funds From Operations (FFO)—Equal to a REIT's net income after the add-back of real estate depreciation and amortization (Efmoody, n.d.). According to the NAREIT's white paper on Funds From Operations (2002):

Historical cost accounting for real estate assets implicitly assumes that the value of real estate assets diminishes predictably over time. Since real estate values instead have historically risen or fallen with market conditions, many industry investors have considered presentations of operating results for real estate companies that use historical cost accounting to be insufficient by themselves. The term Funds From Operations was created
to address this problem. It was intended to be a standard supplemental measure of REIT operating performance that excluded historical cost depreciation from—or "added it back" to—GAAP net income (as cited in Woon, 2008).

In other words, REITs add depreciation and amortization expenses to their net income to measure their performances. Then, they add interest, taxes & insurance expenses in order to obtain the EBITDA (Earnings before interest, taxes, depreciation, and amortization). In a crude way, EBITDA=FFO+Interest+Tax. The latter is used to estimate the selling value of a property—the value equals 10 to 12 times its EBITDA (C. Cooper, personal communication, fall 2011).

The argument for such a practice is based on the fact that if a REIT can afford to pay back its creditors, the cash used to do so (depreciation expenses) should then be added to its performance/value (C. Cooper, personal communication, fall 2011). The FFO practice not only overinflates performances and therefore, the REIT value but also contributed to the housing bubble that demonstrated that real estates do not always go up in value!
**Solution**

Needless to say that this practice creates a fallacious value of the property, as it does not take into account economic factors such as interest rates and yield on 10-year treasury bond that determines the price of capital (REIT, 2011b). There are house price indices such as Moody's/REAL CPPI and NCREIF Property Index that allow investors to guide their portfolio investment decisions. However, theses indexes are based on market transactions rather than on economic fundamentals (Philipp, 2007).

In order to create less volatility in the market and to take into account long-term cash profitability, I suggest that when a REIT value is adjusted downward due to economic downturn to its fair market value, FFO (depreciation expenses) should be adjusted downward as well. This should limit and minimize the overinflating process that occurred since the FFO practice started.

It is important to note that the FFO and EBITDA calculation are nor Generally Accepted Accounting Principles (GAAP). My point is that from a GAAP point of view, deprecation expenses should remain steady using the straight-line or double-declining methods; but because FFO and EBITDA will greatly distort the value of the REIT in difficult times, an adjusted method should also be used to calibrate depreciation expenses, thus modifying the FFO, when selling/purchasing of REIT.

**Conclusion**

In order to meet with REIT global expansion and growth expectations, the suggested method– when a REIT value is adjusted downward, FFO (depreciation expenses) should be adjusted downward as well–not only will reestablish investors’ confidence but will also foster a more steady market, thus reducing volatility.
References


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