

The Real Estate Investment Market

A Discussion of REITS – March, 2009

By John T. Schmick

Introduction

Investment real estate encompasses a broad range of real property types. Transactions frequently involve large properties which are bought and sold by institutional investors at the national level or in the national investment market. Participants include pension funds, investment advisors, insurance companies and investment banks. In general, these are buyers and sellers that take direct ownership of an investment property and manage it for their own benefit. Defining or measuring the health of the investment market on the basis of transaction activities of this nature is somewhat unreliable. One is limited to basic data such as: descriptions of capitalization rates, prices per square foot and vacancy rates. Little information is publicly available on the periodic returns earned from these types of transactions until an individual property is resold. How, then, does one gain an understanding of the real estate investment market on a broader scale?

The answer may be found in a specialized form of real estate ownership known as a Real Estate Investment Trust, or REIT. While some form of REIT has been authorized since 1913, the modern day REIT was established by the Real Estate Trust Act of 1960 and modified to its current form by the Tax Reform Act of 1986 (as amended by the Technical and Miscellaneous Revenue Act of 1986).

A basic REIT is an entity that “pools investor money to purchase and manage real estate” for the benefit of its owners. Entities include corporations, trusts or associations. All REITs have in common the following requirements established by U.S tax laws:

- A board of directors or trustees
- At least 100 shareholders
- At least 75% of total assets in real property
- At least 75% of gross income from real estate operations
- No more than 30% of gross income from the sale of real property
- Annual dividends equal to not less than 95% of taxable income

In exchange for meeting these criteria, REITs are exempt from paying federal income taxes. As a result of this structure, REITs offer liquidity in investment real estate through ownership of shares in an entity that directly owns and manages investment real estate. Furthermore, the standard unit of reporting a REIT’s performance is FFO or Funds From Operations. FFO is a reflection of how the real estate in an individual REIT’s portfolio is functioning in the market and it directly impacts the ability to pay dividends. Consequently, a review of the REIT industry provides us with an effective surrogate for profiling the national investment real estate market. The ability of REIT data to reflect the overall market is related to the overall composition of REITs. In general, equity REITs include all property types, all age brackets, all geographic locations and all levels of demographics.

Property Types

REITs come in a variety of types that include equity REITs, mortgage REITs, and hybrid REITs. Generally speaking, equity REITs invest directly in real estate through purchase or development. They generate revenue through rent and lease payments, and generate gains through the eventual sale of individual properties. In contrast, mortgage REITs invest in mortgages secured by real estate or various types of mortgage-backed securities. In this type of REIT, mortgage payments are collected and, for the most part, passed through to the shareholders. In some respects, a mortgage REIT is similar to a financing company that specializes in lending or financing products specifically related to real property. Finally, the hybrid REIT, as the name indicates, is an entity that combines the best of both equity and mortgage REITs by looking for opportunities in real estate in any form.

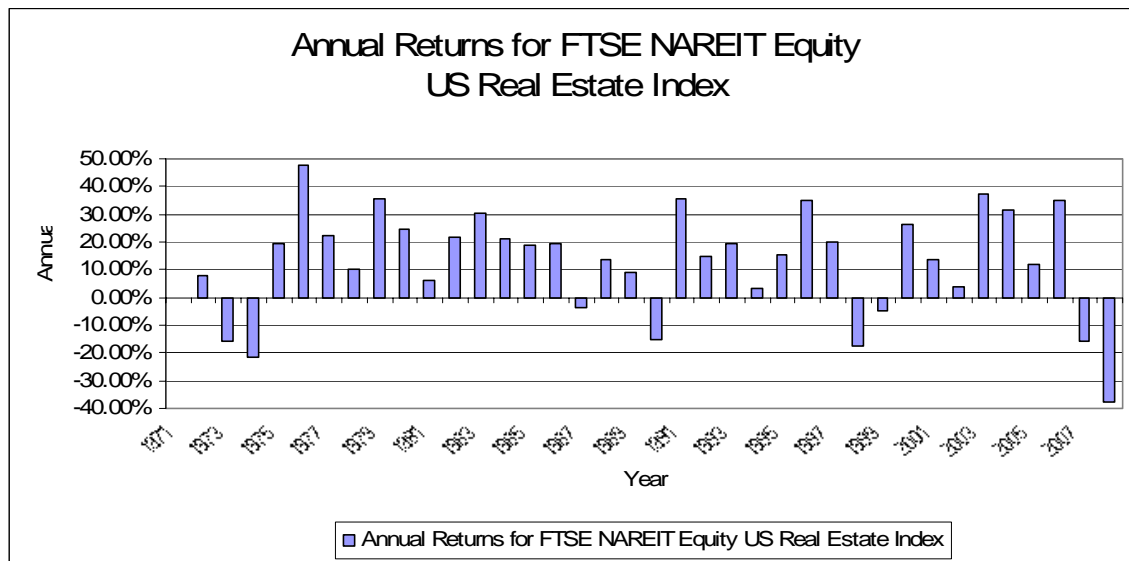
Equity REITS are, by far, the largest segment of the industry and also the purest reflection of market conditions for investment real estate. In 2008, the estimated total capitalization of the REIT market was \$191.65 billion of which equity REITs accounted for almost 92% or \$176.24 billion. In addition, one can find equity REITS that specialize in specific types of real estate such as retail properties, hospitality properties, office properties, residential properties, etc.

NAREIT

The National Association of Real Estate Investment Trusts (NAREIT) is the largest and most widely recognized professional organization involving REITs. The reach of its membership and its research support provide opportunities for market analyses ranging from academic papers and articles to public reporting of aggregate returns for the REIT industry.

Published data from NAREIT indicates the national investment market is not immune to business cycles and goes through boom and bust periods relative to the overall economy. Between the start of the FTSE NAREIT Equity US Real Estate Index in 1971 and 2008, the last full year of data, equity REITs have experienced five downturns (periods of decline in value). These include downturns in 1973-74, 1987, 1990, 1998-99, as well as the current downturn which began in 2007. Each period of decline correlates to an economic event. The recession of 1973-74 reflected a market correction following a period of rapid growth of the industry which sent too much money chasing after too few quality projects. Another period of rapid growth occurred just before the Tax Reform Act of 1986 which reduced tax benefits for real estate by reducing depreciation deductions. Inappropriate lending by the Savings & Loan industry combined with the fact that supply once again outpaced the demand for quality real estate led to a small decline in 1987. In 1990, the overall economy reflected higher capital costs and taxing disadvantages for larger investors resulting in lower returns on investments. The 1998-99 economic downturn is attributed to an unfortunate series of events: yet another period of rapid expansion within the REIT industry combined with ill-advised loans in foreign markets sent capital costs higher at a time when prices by real estate investors were over-bid.

However, as the chart illustrates, the REIT market is resilient and recovered anywhere from one to three years after the start of the downturn.

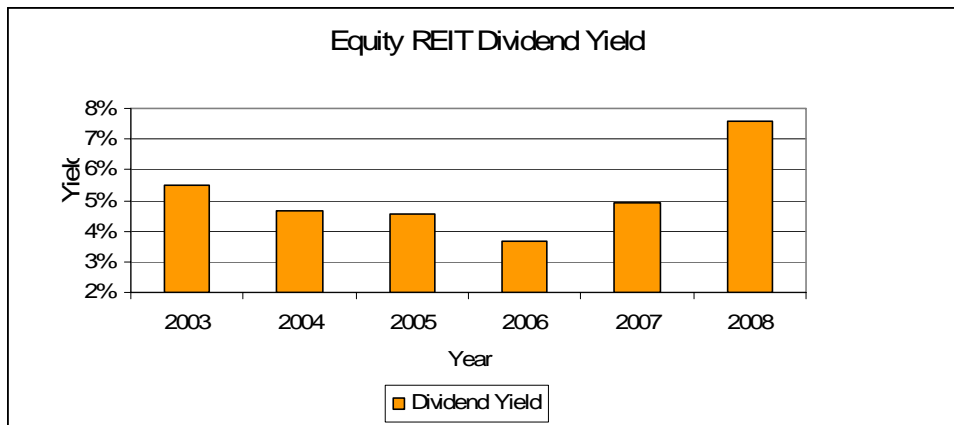
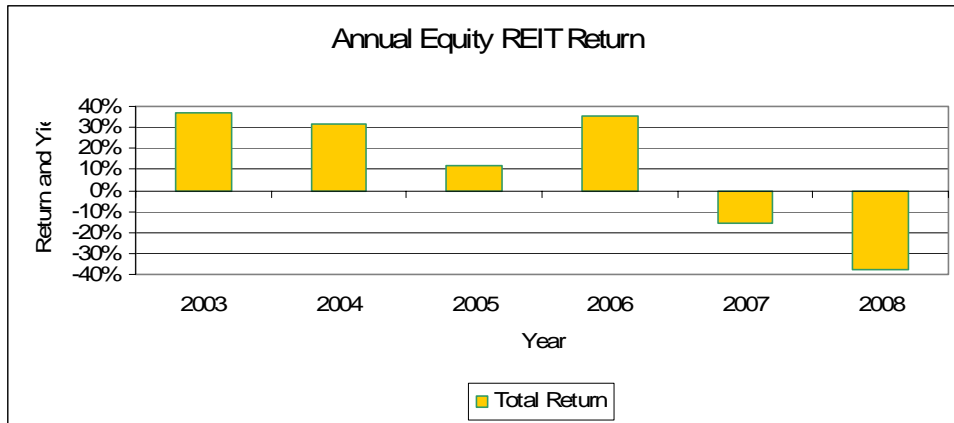


The current downturn is generally considered to be in its early stages with further decline expected. Following an increase of 34% in 2006, total annual returns subsequently declined a total of -52% in the last two years.

The composition of total returns is instructive when reviewing the overall national investment market. Overall return on investment for a REIT comes from two main sources. The first is rent or lease payments and the second is growth in value of the asset. Rental income is derived from either short term situations such as one year leases or month-to-month rents in an apartment complex, or longer term leases such corporate office complexes with 20 year leases. Length of term and quality of tenant will impact the consistency of rent income. Shorter term leases usually reflect current market conditions and general competition within the market. Long term leases, on the other hand, reflect better quality tenants with financial prospects strong enough to sustain a lengthy commitment to a property. As the lease becomes more seasoned, the lease conditions may no longer reflect the current market creating either an advantage or a disadvantage to the tenant.

Growth in value is somewhat dependent on outside influences and property management. For example, if the cost of capital goes up, the cost of ownership also increases because equity yield requirements increase relative to alternative investment opportunities. Thus, values will decline relative to a stated income level to produce the higher returns necessary to remain competitive. The run-up in technology stock prices in the late 1990s attracted investment funds away from real estate. The result: real estate prices dropped to increase yields to remain competitive and attract capital. Also, consider what happens when there is a shift in the demographics of a particular market. As a local market segment matures and its housing stock ages, household makeup may change. This, in turn, affects retail spending patterns. Higher-paying retail tenants are likely to leave the

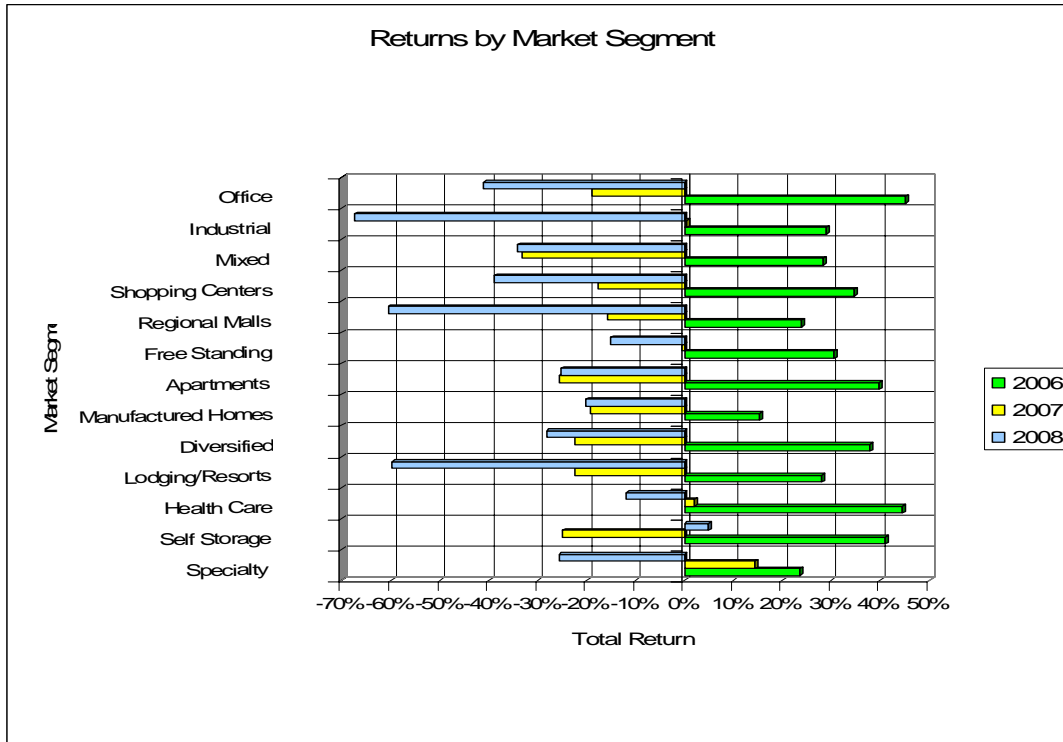
area. Replacement tenants, reflecting more value-oriented retailing, negotiate leases at a lower rent. Finally, as in the case of the current downturn, when consumers reduce spending, a larger number of retailers fail producing an increase in vacancies and further loss in value. In an attempt to survive the economic downturn, existing retailers may demand a reduction in rent. If the request is granted, the impact on value is mitigated, but not eliminated.



The chart above indicates that, as the current downturn developed, dividend yields increased becoming a more important part of total returns. This is consistent with declining prices of real estate as the quality and consistency of rental income take precedence over asset growth. With capital markets currently restricting access to credit, consumer spending declining and overall lackluster general economic conditions, the risk of ownership requires higher yield to attract investors. At the same time, lenders now require a larger equity investment to secure loans. The natural outcome is higher yields and lower prices.

Market Segments

While the overall total return on equity REITs is down, a review of property types within the index reveals a wide range of returns based on property type.



The annual return data indicates that market segments have been impacted unequally. Health Care, Free Standing Retail, Self Storage and Specialty markets appear to have been impacted the least. In contrast, the Industrial, Mixed, Regional Malls and Lodging/Resort markets have taken a beating. A review of the individual segment price indices indicates the market for national investment real estate peaked in the December 2006/January 2007 time period. By comparing the peak price index from that period to the end of 2008, we can see the relative degree of value lost in each market segment.

EQUITY REIT PRICE CHANGES			
	Dec. 2006 to Dec. 2008		
Market Segment	Price Index Dec. 2006	Price Index Dec. 2008	Indicated Change
Office	391.45	170.92	-56.45%
Industrial	403.95	119.75	-70.36%
Mixed	267.51	102.90	-61.53%
Shopping Centers	304.09	138.80	-54.36%
Regional Malls	424.83	128.38	-69.78%
Free Standing	242.67	183.19	-24.51%
Apartments	278.22	140.97	-49.33%
Manufactured Homes	150.11	88.64	-40.95%
Diversified	194.73	99.02	-49.15%
Lodging/Resorts	136.39	37.645	-72.40%
Health Care	211.82	169.58	-19.94%
Self Storage	483.26	357.09	-26.11%
Specialty	89.35	69.65	-22.05%

It should be noted that Diversified Equity REITs generally own and operate a wide range of assets including office, retail, residential, land and ownership interests in other REITs or corporations. Specialty REITs tend to be focused in one or two specific areas. Examples include timber and timberland, cold storage, or railroads.

Vacant land for residential development is most likely to be found in the Diversified REIT market segment. However, the vacant land market is not a dominant property type in the overall Equity REIT market. Cash flows from residential land development come from the sale of finished lots only. As a result, land development represents a higher risk investment than other types of property that generate rental income which can support long term ownership positions.

Forecasts

Capital markets are currently in disarray with financial institutions reporting billions of dollars in losses and the US Government making dramatic efforts to stabilize the banking system. To that end, the government has invested billions of dollars to increase bank capital, buy loans and make loans to selected banks. In turn, lenders have increased equity requirements for all types of loans and are restricting credit availability to their highest credit quality customers only. As reflected in the NAREIT data, higher capital costs lead to lower returns in investment real estate. Until credit and the cost of credit are available at reasonable prices, the real estate market will likely decline further.

Complicating the cost of capital problem are the decline in consumer spending, the rise in unemployment and the oversupply of housing. Much of the loss suffered by large financial institutions relates to the large increase in residential mortgage defaults. A period of low-cost money, easy credit and poor lending decisions fueled an over-building of housing and sales to consumers who should not have qualified for mortgages. These mortgages were then bundled and sold to government-sponsored entities or investment banking institutions on Wall Street and, subsequently, resold to individual investors. As house sales slowed and mortgage defaults increased, these pools of mortgages lost value ultimately leading to investor losses. Currently, the market values of these investment pools are generally unknown and they are, for the most part, illiquid. Further losses are anticipated as more mortgages go into default. In the final analysis, the supply and demand for housing is out of balance with the ability of consumers to purchase housing.

To the extent that consumer spending has declined and unemployment has increased, corporations have scaled back their demands for real property. Retail vacancy is rising and additional corporate bankruptcies are expected. Manufacturers are cutting back on production thereby impacting all forms of industrial space needs. Service industries are suffering a decline in demand. Even law firms are reducing staff and space needs. This downturn in investment property is unlike any reflected in the NAREIT data. It is likely to be deeper and longer than any previous downturn.

Summary & Conclusion

The national investment real estate market is characterized by participants who take direct ownership of property or who pool ownership interests and sell stock to others with the majority of the benefits flowing to the stockholders. We obtain some insight into the overall national real estate investment market when the direct ownership groups report actual transactions that reflect prices, vacancy rates and capitalization rates.

At this point in time, it is difficult to obtain a comprehensive understanding of the general market, so we look to REIT data. REITs provide liquidity to investors and, at the same time, they invest in pools of various types of real estate. Because of the diversity in the number of REITs, their product types, and their earnings and dividend requirements to investors, they provide a good measure of how the overall market views the performance of the underlying real estate assets. As real estate markets fluctuate, investor attitudes may change quickly to reflect the changing environment and anticipation of future performance.

As quarterly and annual reports are made public by the individual REITs, investors react by bidding prices up or down based on the strength or weakness of the real estate assets in the REIT portfolio. A more detailed review of individual REIT-required financial reports reveals that development projects are being put on hold, inventories of properties are being reduced as needed, debt is being reduced, and credit is difficult to obtain for refinancing. This is consistent with REIT performance and investor pricing of REITs.

The above discussion is general in nature; the use or application of information from this article may or may not be relevant to a particular situation.