SMART INVESTING IN REITS: AVOIDING THE HIGH-YIELD TRAP

By Donald Cassidy

One out-of-favor group that represents value and provides an attractive cash flow is REITs. Many currently are yielding 7% to 9%, while raising distributions by 5% to 6% annually. However, REITs come in several varieties with differing risks and attractions.

The major industry groups that traditionally provide above-average dividend yields include: grocers, banks, major oils, steels, and rails (if they pay any dividends at all). In recent years, pharmaceutical firms have been added to the list. And I am excluding tobacco companies because of the legal uncertainties.

But above-average dividend yields today aren't what they used to be. With the likes of Exxon and Chase Manhattan yielding 2.2%, when 6% and greater was the norm not that many moons ago, what's an investor to do?

For conservative, income-oriented equity portfolios, accepting today's yields of 1% to 2% will not provide suitable levels of current income; it may well prove injurious to capital if a significant market correction or rise in interest rates occurs.

One vastly out-of-favor group that represents value and provides an attractive cash flow is the real estate investment trusts, or REITs for short.

Like public utilities, REITs are becoming many investors' income favorites. Many currently yield 7% to 9% while raising distributions by 5% to 6% annually, implying attractive total returns with lower risk than industrial stocks at minuscule yields.

However, not all REITs are the same; they come in several varieties with differing risks and attractions. This article highlights both desirable and risky elements to note when researching REITs.

HOW THEY WORK

REITs are publicly traded companies that manage portfolios of real estate for their shareholders. However, they enjoy special status in the U.S. tax system. Under Internal Revenue Code Sections 856–858, REITs are considered conduits for income and therefore escape the double taxation borne by investors in other types of corporations (a tax on corporate income, and then a tax on shareholders' dividends). By complying with all applicable regulations, a trust qualifies for REIT tax treatment and therefore pays no federal income tax. Key provisions:

- A REIT cannot participate in operating any business or trade;
- It must have at least 75% of its assets in, and income derived from, real estate (through lending, leasing, or a combination);
- It must distribute at least 95% of its otherwise definable taxable income to shareowners each year; and
- If any person, entity, or combination of related parties, beneficially owns over 9.9% of a REIT's shares, that company loses non-taxed status.

Because realty is central to our economy, I see no realistic risk that the preferred REIT tax status will be withdrawn.

In general, there are two types of REITs: equity REITs that own realty and mortgage REITs that lend money for real estate. A few REITs hold a mix of equity and mortgage assets, but most are focused on one style.

Many investors rightly view apartments and office buildings as common

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TABLE 1. REIT HOLDINGS

CYCLICAL:	**RESIDENTIAL:**
Mortgages	Apartments
Franchise Funding	Mobile Home Parks
Railroad Right of Way	Mortgages
Industrial	Storage
Project Finance	Nursing Homes
Office/Commercial Space	
	TRAVEL/RECREATION:
CONSUMER, NON-CYCLICAL:	Hotel/Motel
Storage Facilities	Extended-Stay Inns
Mobile Home Parks	Restaurants
Retail–General	Golf Courses
Retail–Factory Outlet	Race Tracks
Restaurants	Other Amusement Parks
Nursing Homes	
	AVAILABLE CONFIGURATIONS:
HEALTH:	Locally Focused
Nursing Homes	Regionally Concentrated
Hospitals	Diversified by Type
Medical Office Buildings	Diversified Geographically
Miscellaneous Medical Care (Surgery Centers, etc.)	
Diversified Health Care	

REIT holdings, but in fact a very wide variety of asset-types is represented in publicly traded vehicles (see Table 1).

THE HIGH YIELD FLAG

As elsewhere in Wall Street, being contrarian serves well in REIT investing. However, strong total return rather than high current cash yield should guide your choices.

You should not expect to find incredible, undiscovered values in REITs, since investment markets are relatively efficient. Analysts spend their professional lives examining publicly traded firms' finances and prospects. So, prices of low-technology securities represent the combined judgment (and biases) of knowledgeable marketplace participants. Just as insurance companies demand higher premiums for accepting higher risks, informed REIT investors charge a risk premium for investing in less-secure situations. So when two REITs provide significantly different cash yields, expect to find that the higher yielder carries more risk; if you don't see the difference at first, dig until you find it.

In general, there are three sorts of high yield among REITs that should prompt prudent investors to look elsewhere:

- High yields relative to the competition;
- Unbelievably high yields; and
- Guaranteed distributions.

Relative Yields: You can easily track relative yields over time from readily available sources such as AAII's *Stock Investor* database (using conventional SIC code 6799) or The Value Line Investment Survey. Select perhaps 10 REITs and track their yields over time. Go back at least 10 years, since that will include the 1990–91 recession and the tightened-money period of 1994. Note the average yields for your sample, year by year. If a given REIT's yield has moved from below or average to a point well above the group average, investors collectively have perceived increasing relative risk and, therefore, will pay less for a dollar of its income stream. One example of this perception recently has been medical-care-related REITs.

Shifting relative yields should not be ignored: They signify that many investors perceive changed business or financial risk. Before investing in a REIT with an above-average yield, do considerable reading to discover and understand the yield difference, especially if it has been widening. Don't assume the market is wrong. Only after you've identified the point of perceived quality difference can you intelligently evaluate whether the higher yield pays you adequately for that risk; you might decide that factor is likely to recede—or worsen.

Questions to ask include the following:

- Is the debt ratio much higher, or is much of their debt short-term in nature?
- Should a major single tenant default, how much would cash flow, dividend-paying power, and stock price be decreased?
- Is some change in government rules pending?

High relative yields, although not absolute bars to purchase or holding, should alert you to be very circumspect.

Unbelievably high yields: These speak for themselves—they're too good to be true, which will probably soon be proven. Income payments are not automatic. REIT quarterly distributions will be cut if cash flow turns sour. Where yields are grossly higher than the norm, informed marketplace opinion expects a reduction or omission of cash payments, probably soon. (High yield has a stickiness: some owners never sell until the bad news is out, and they've already been ravaged—so yield probably should be higher than it actually is to reflect true risk.)

While this rule of thumb will differ over time, consider it a strong red flag if one REIT yields anything over one-third higher than those of its true peers. For example, in a

low-inflation, lower-yield climate, a red flag would pop up if an apartment-focused REIT was yielding 8% versus 6% for other apartment-focused REITs.

Another major hint of possible trouble would be no growth in dividends over a 12-month period. You can find dividend history, and dates of expected dividend meetings, in Value Line or in S&P's individual Stock Reports ("tear sheets").

A very handy, free Web site that tracks dividend history is chart.yahoo.com/w. At the site, enter a ticker symbol and a time window of several years; observe the pattern for predictable changes.

Guaranteed distributions: One condition leading to an unbelievably high yield can be the existence of a guaranteed-distribution period. High yield certainly sells more individual investors than does lower yield. Because of this magnetism, many income-related IPOs (REITs and partnerships, for example) are structured with a temptingly high initial annual distribution guaranteed for perhaps three to five years. That high yield entices enough investors to make the offering work, sometimes providing some of the needed extra cash. Often a related company (perhaps a major tenant) backs the distribution rate during the guarantee period. Thereafter, all bets are off and the REIT's distribution rate will depend on realistic cash flow from the underlying property base, net of interest and other costs. Often, when the guarantee lapses, distributions are slashed or ended and the stock price plummets. I advise avoiding any REIT until its guaranteed-distribution period has ended and a freely declared dividend is set, unless (as in rare instances) directors actually exceed the minimum promised rate before the pegged-payment period ends. If you are considering a fairly new REIT (under five years public), insist on a copy of the IPO prospectus. Make sure you scour it, including any footnotes in the latest annual and quarterly reports, for any discussion of pegged payments. If in any doubt, phone the treasurer and ask pointed questions.

EQUITY VS. DEBT REITS

Investors seeking attractive financial returns are better served in the long term by owning equities (stocks) rather than debt securities. Likewise, in real estate, being the owner rather than a lender works well when inflation pushes prices higher, as in 1966–1981. But in the circumstances we see going into the new century, inflation is not as likely to paper over and bail out shaky investments. Therefore, some investors prefer the position of mortgage holder, rather than owner of real estate, through REITs.

Suppose one or more tenants of a shopping center fail to renew their leases. The owner (possibly an equity REIT) faces a major reduction of monthly cash flow and must scramble to secure replacement renters. A lender holding the mortgage note on that property is in a considerably stronger position—protected because the (now-scrambling) landlord stands to lose the entire shopping center by defaulting on its mortgage. Borrowers must do all that's possible to avoid defaults, while tenants have an easier path out of trouble by simply closing and walking away. That's the downside scenario in recession times. The good-times' argument favoring equity REITs is that property owners, not lenders, enjoy all the upside benefits.

OTHER CONSIDERATIONS

Major issues to examine are:

- Diversity of geography and/or business type of holdings;
- Tenant quality; and
- Financial leverage.

Like a securities portfolio, a REIT property list involves lower risk if it is not heavily concentrated. California, the realty rocket of the 1970s and 1980s, saw its success fizzle early this decade as unemployment rose, property prices fell, and foreclosures mounted. In a shocking historical reversal, families and even businesses left there "for better opportunities elsewhere." A REIT concentrated in a single state or region (remember the "Rust Belt" days and the troubles in "energy alley"?) has above-average vulnerability.

Property-type diversification is also desirable. REITs holding a mix of apartments, shopping centers, medical centers, office buildings, and hotels are at lower risk than those specializing in one type of realty.

Tenant quality bears examination. Depending on the phase of an economic cycle, a trailer park might represent more, or less, vacancy risk than a luxury-end apartment complex. A shopping complex whose anchor tenant is Sears or Wal-Mart (national corporations with credit ratings to protect even if that means covering a lease for one abandoned store) is at lower risk than a strip mall with all local, small-business tenants. As was feared about two years ago when K-Mart was falsely rumored as planning a deliberate bankruptcy, a single major tenant or debtor can represent a risk large enough to sink its related-party REIT.

Overly aggressive financing carries problems all its own. Another counterintuitive observation holds here. Seeds of future losses are usually sown when risk *seems* low: In businesses that have been successful, and late in expansion cycles when prosperity is greatest. Thus positioned, corporate leaders and their lenders become confident; memories of past cycles' difficulties are overshadowed by visions of greater profits to be gained in seemingly unending good times.

REITs can undertake two major types of financial risk, both easily detected in quarterly financials. The first is simple over-leveraging.

Examine historical ratios in search of recent upside deviation. Look at peers' ratios. Compare today to 1992–1993 when money was cheap and easy. Over-leveraging occurs when a REIT manager adds debt to gain a higher net return on the assets owned by shareholders. This trap is most appealing late in an expansion, since few have the courage to add leverage near periodic bottoms. The press release or annual report speaks of "taking advantage of new and expanded opportunities" via added borrowings; the latest debt/equity ratio will be higher than in recent years. No trustees will be clairvoyant enough to be able to forecast exactly what the next calamity will be, or they would resist taking on added debt risk. Just because the coast looks clear now does not mean it will actually provide smooth sailing. If your REIT is one of the later ones among several in its peer type to add leverage, odds are heightened that the cycle is already aging and that a downturn may come soon. Heady collective capacity expansion reduces rents, pinching margins. The late-1999 situation, fortunately, provides a buffer against this trap. REITs today are very sensitive to being accused of over-leveraging. Most would prefer to expand via equity capital. However, the low prices of REIT shares (in many cases, below book value) preclude secondary offerings. Thus the present bargain-basement valuation phase also supplies insurance against overbuilding or excess buying at high property prices.

The other common financing folly to ensnare REITs is the age-old trap of borrow-short/invest-long. Temptations to borrow short term are usually very alluring. Short-term interest rates are usually lower than long-term ones, a difference that widens the spread between gross income (rent to be received) and carrying costs. When one borrows short, the unspoken risk is that when permanent financing is eventually accomplished, rates will have moved higher—or in a worst-case scenario (tight money), financing might be unavailable at any economic cost. Variable-rate short-term financing has raised the stakes, as future levels are tied to prime or London interbank offered rate (LIBOR). Did your neighbors extend themselves in the low-interest-rate days of 1993 with an adjustable-rate mortgage, only to suffer rate and payment shock a couple of years later on their large debts? REITs are prone to making the same error when short-term rates are appealingly low. Prudent investors will impose on their REIT choices the same standards of caution that they use personally.

Finding the relevant evidence is easy: databases and multi-year balance sheets will disclose historical ratios of short- to long-term debt; footnotes must provide a table of annual loan maturities.

SIGNS OF GOOD HEALTH

In REITs, an acceptable payout ratio can exceed 100% of reported earnings because reported earnings are stated after a non-cash accounting entry for depreciation has already been subtracted. Therefore, cash available for repairs and for distributions to holders (known as FFO, or funds from operations) is actually more than reported earnings per share and is the yardstick against which to judge distribution rates. Avoid REITs consistently paying more than 100% of FFO, since that means they're neglecting maintenance and/or dipping into capital. Unfortunately, it's not possible to prescribe a single specific desirable percentage of distributions to FFO, since circumstances and growth plans vary considerably.

Instead, fall back on a simple but highly reliable test: dividend growth. Distribution rates are a conscious choice made by boards of informed trustees after due deliberation. Raising payment rates gradually each year is a good sign. Absence of growth, or a slowdown from earlier growth rates, is the equivalent of legal (negative) inside information that you should never ignore. Management may say dividend growth is being shelved temporarily in favor of other business priorities, but the bottom line is that the press of such other needs is now more serious than in past years when trustees did have confidence enough to raise the distribution rate. Translation: risk has risen. You should go elsewhere without delay before more serious problems might surface. Your best single sign of continued good REIT health is a *steadily rising* distribution rate.

INVESTING IN REITS

The current market situation provides an excellent opportunity for potential REIT investors. Other sectors of the market have acted so well, including telecom excitement in the utility arena, that REITs have been rejected and ignored. At the same time, fears of rising interest rates, not truly supported by global economic pressures implying higher inflation, have depressed most yield-oriented vehicles.

Properly chosen REITs can provide attractive current income, capital protection due to their yield cushions, and potential moderate capital growth over time as distributions rise.

Buy quality, monitor dividend growth assiduously, and be patient. You may not be immediately or dramatically rewarded, but your time will come. In the interim, you can sleep quite soundly. ✦