GEEK-OUT TOPIC: Real Estate Investment Trusts (REITs)

Real Estate Investment Trusts are a popular way for investors of all types to gain exposure to real estate as an investment. Real estate investment was largely limited to wealthier investors and institutions and the Real Estate Investment Trust Act enacted as part of the Cigar Excise Tax Extension of 1960 opened the world of real estate investing to a broader base of investors. Since the REIT came into existence they have grown in popularity and today are a mainstay in many portfolios. Today, more than 80 million Americans invest in REITs, which own around $3 trillion in real estate assets.

What is a REIT?

A Real Estate Investment Trust is a company that invests in and operates income generating real estate and passes proceeds onto investors. A REIT, therefore enables an investor to invest in a portfolio of real estate and benefit from the rent income generated by the properties as if they owned the property themselves. REITs come in several different forms and have to meet strict guidelines in order to receive the tax status afforded them in the 1960 Act.

REIT Qualifications

As part of the REIT Act, companies that qualify as a REIT are not directly taxed but rather the investors are taxed on investment income and capital gains. This is somewhat different from a public company that is taxed on its income in addition to its investors who are also taxed on any dividends and capital gains received from the purchase or sale of the stock. In order to qualify as a REIT, a company must have the following characteristics:

- Invest at least 75% of its total assets in real estate
- Derive at least 75% of its gross income from rents on real property (a legal term for real estate), interest on mortgage financing for real property, or the sale of real property
- Pay out at least 90% of its taxable income to shareholders in the form of a dividend every year
- Be an entity that is taxable as a corporation
- Be managed by a board of directors or trustees
- Have a minimum of 100 shareholders after a year
- Have no more than 50% of its shares held by five or fewer shareholders

Based on the REIT's \ requirements one can see that, if managed properly, a REIT is a vehicle which can effectively provide an investor exposure to diversified, income generating real estate without having direct ownership.

Categories of REITs

REITs come in several different categories as follows:

Equity REIT

This is the most typical REIT which buys, owns, and operates income generating real estate and passes income along to investors.

Mortgage REIT

Also known as an mREIT, mortgage REITS invest by lending capital to real estate owners either through direct lending or through the purchase of mortgage-backed securities. mREITS earn income primarily through the spread between short term borrowing costs and longer term loan returns, similar to a bank. This is referred to as net interest margin. Because mREITS rely on short term borrowing, increases in short term interest rates can diminish net interest margin making this category of REIT interest rate sensitive.

Publicly Traded REIT

These are REITs that trade on security exchanges and are regulated by the Securities Exchange Commission. Because they trade on exchanges, these are generally highly liquid and can be bought and sold like any other exchange traded instrument.

Public non-Traded REIT

These REITs are registered with the SEC but they do not trade on securities exchanges. Investors typically invest in these through an investment advisor or broker. Though they are less liquid and typically come with many fees, the value of these REITs can be more stable as they are less susceptible to public market vagrancies.

Private REIT

These REITs are not registered with the SEC, and though they operate in similar fashion to the others, they are provided as private placements to investors.

How to invest in REITs

Most investors invest in publicly traded REITS which make up some 2/3 of REIT assets. Investors can invest directly in public REITS (stock), in Mutual Funds, or Exchange Traded Funds (ETFs). All of these return income produced from real estate ownership in the form of

dividends. There are over 225 publicly traded REITs and 31 of them are members of the S&P500 Index. Most REITs specialize in certain areas such as apartment complexes, single family homes, office buildings, warehouses, data centers, hotels, health care facilities, infrastructure (cell towers, pipelines, etc.), retail centers, self-storage facilities, and timberland.

With so many options to chose from, investors need to do their homework in selecting ones that will perform well and deliver stable returns. When assessing REITs some critical areas of consideration include:

1. *A track record of success*. REITs that have demonstrated an ability to achieve stable growth in earning thus enabling them to have stable and growing returns to investors
2. *Solid management*. Investors should look for management teams with proven track records in their specific field of focus. Additionally, it is important to seek out REITs which employ strong corporate governance thus assuring the safety of the investment.
3. *Ability to pay dividends*. As dividends are the primary reason for an investor to make an allocation to a REIT, its ability to pay them should be a critical consideration

It is important to note that there are many other factors to include in the assessment of REITS such as expenses, risk type, net asset value relative to price, geographic focus, and taxation. One should consult professionals for help in analyzing options.

Payout Ratio

A REIT's payout ratio is a good way to asses and compare its ability to pay dividends. Unlike a typical dividend paying stock in which we would use earnings per share, we would use Funds From Operations, which is a REIT specific metric which can be attained through a REIT's disclosures. Funds From Operations (FFO) can be thought of as cash flow received from investments. We use this method because net income contains depreciation expense which is not a real cash outflow. A company may lose money due to high depreciation from a net income standpoint but still have positive cash flow, so FFO is the preferred metric in real estate. The payout ratio is calculated as follows:

$$P = \frac{D}{FFOps}$$

Where:

P = Payout ratio
D = Dividends per share
FFOps = Funds from operations per share

A higher Payout ratio may seem good to investors who would like to secure as much of the income as possible, but the downside of a high payout ratio might mean that a REIT will be unable to sustain the current dividend if it hits any bumps in the road.

Tax considerations

REITs provide income to investors in the form of dividends. REIT dividends are taxed in two specific ways. On the portion of the dividend that comes directly from rent income, investors will be treated as ordinary income. Dividends may also contain return of capital or capital gains. A return of capital distribution is any payment made that exceeds the REIT's taxable income. In that case the investor's cost basis is reduced which would be taxed as a capital gain when the REIT is sold. This information is supplied by the REIT in year-end tax documents, specifically, the IRS form 1099-DIV.

Conclusion

Real Estate Investment Trusts are a good way for investors to invest in income generating real estate portfolios without directly owning the property. REITs, if selected carefully are a great source of stable income and are a good way to add diversity to a portfolio. Historically, the National Association of REITs (Nareit) FSTE REIT index has returned an annualized total return of 9.9% over the past 25 years making it worth considering as an allocation in any diversified portfolio. As with all investments, risks vary broadly across different REITs, so investment as well as tax experts should be consulted when selecting investments.

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