A Reprint from *Tierra Grande*, the Real Estate Center Journal

Are REITs Paying Too Much?

By Wayne E. Etter

As noted in a previous Instructor's Notebook, evidence supports the general conclusion that real estate investment trusts (REITs) have made sound acquisitions since their early 1990s revival. Some concern remains, however, that their growth cannot continue. There is further concern that the desire to maintain growth has caused some REITs to pay too much for properties.

Because REITs must pay dividends equal to or greater than 95 percent of their taxable income to retain tax-exempt status, they have a limited ability to retain funds for growth and must continually raise new funds from investors to grow. If new equity is not obtained, REITs must either use debt to make acquisitions or cease to acquire property.

Investors have supplied REITs with additional equity at a rapid pace because they expect continuing high annual total returns. As reported in the table, however, the annual total return for all equity REITs was negative during the first half of 1998 compared to an average annual total return of 23.6 percent for 1995, 1996 and 1997. Because the annual dividend yield for the first half of 1998 was 6.13 percent, the negative total return indicates that REIT share prices decreased during that time.

Despite the negative return during the first half of 1998, REIT initial and secondary equity offerings totaled $15.8 billion during the first six months of this year. This total equaled approximately 48.5 percent of 1997's record offerings of $32.7 billion. Nevertheless, the question remains whether investors will continue supplying additional equity capital to REITs unless there is a significant increase in total returns.

Potential for Growth

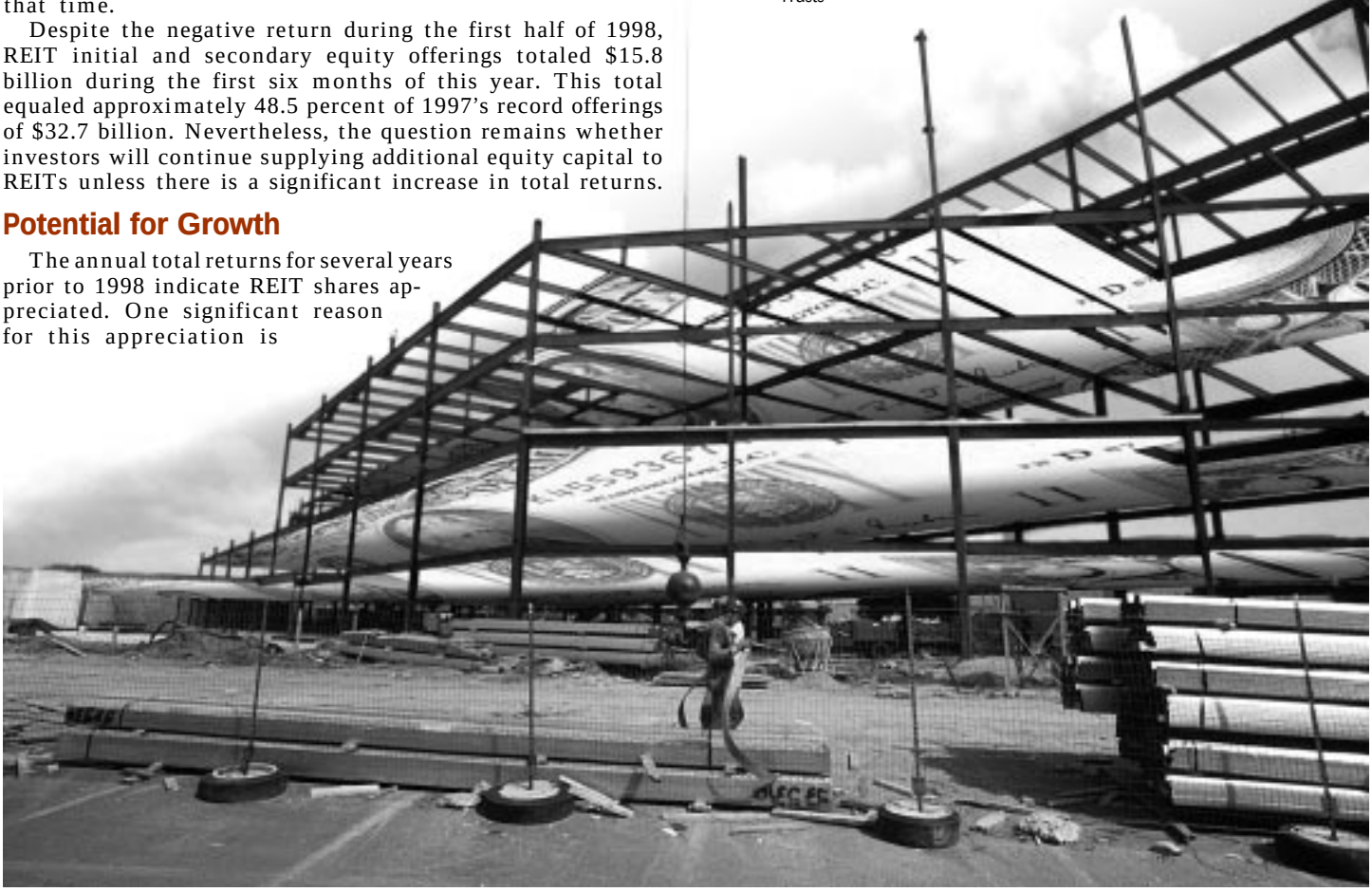
The annual total returns for several years prior to 1998 indicate REIT shares appreciated. One significant reason for this appreciation is that investors anticipated that properties previously acquired at prices less than their replacement cost would appreciate as the operating profits from those properties increased. Now,

Total Return for Equity Real Estate Investment Trusts 1990 to 1998

Year	Total Percent Return
1990	-15.35
1991	35.70
1992	14.59
1993	19.65
1994	3.17
1995	15.27
1996	35.27
1997	20.26
1998 (Jan 1 - June 30)	-5.03

Annual total return represents price appreciation, plus actual dividends paid and monthly dividend reinvestment.

Source: NAREIT ONLINE, National Association of Real Estate Investment Trusts



however, there are fewer properties suitable for REIT investment that can be purchased at prices less than their replacement cost and that have the potential for rapid income increases. As REITs pay prices closer to their replacement cost for their current acquisitions, there is less opportunity for rapid appreciation. And, while REITs have increased rents and achieved operating economies in the properties that they own, increasing the productivity and value of properties in this way cannot continue indefinitely.

Because REITs have been aggressive buyers in many large markets, there is concern that, in some cases, REIT owners might be paying too much for properties. This would, of course, limit short-term appreciation potential, reduce the growth rate of taxable income and funds from operations and would ultimately be reflected in lower share prices.

This raises an interesting question about the *investment value* of income-producing real estate: can a property's investment value vary for different buyers or is there a **correct** investment value for a property? Of course, investment value is not the same thing as market value.

There are several reasons REITs might have a lower cost of capital which allow them to outbid private investors.

Investment Value and Cost of Capital

The investment value of income property can be estimated by discounting a property's expected net operating income (NOI) and resale proceeds at a discount rate equal to the cost of capital. If a property's calculated investment value exceeds its purchase price, the property will provide a return in excess of the cost of capital. Obviously, because the cost of capital is the minimum acceptable rate of return, property market investors must expect to earn a rate of return greater than or equal to their cost of capital. Thus, the lower the cost of capital, the greater the price an investor can offer for a property and earn the minimum acceptable return.

If REITs have a lower cost of capital than other real estate investors, REITs can justify a lower required rate of return, a lower discount rate and can, therefore, pay a higher price for a property than other investors, all other things being equal.

Equity REITs' cost of capital is dependent primarily on the return required by shareholders to compensate them for risk. Thus, there are several reasons why REITs might have a lower cost of capital which allow them to outbid private investors. First, the liquidity of REIT shares allows investors to get in and out of the investment much more easily than direct ownership. Second, the reduced risk associated with the *pro rata* ownership of the portfolio properties gives the owner the benefits of diversification. Third, professional management of the portfolio properties provides a larger and more predictable cash flow from the portfolio. Experienced professional portfolio managers may achieve this result because they benefit from economies of scale in purchasing such things as electric power and property insurance and because they can spread property managers' responsibilities over several properties.

For these reasons, REIT share ownership is considered less risky than direct property ownership. REIT shareholders, therefore, require a lower return from REIT shares than from direct investment in real estate.

Why might REITs acquire a property with an expected return that is less than their cost of capital? Because they are under pressure to grow. REITs that do not continue adding properties to their portfolios often will have little opportunity for future growth and may be viewed as poor investments. To avoid this market perception, REITs have a voracious appetite for raising additional equity and investing it in more real estate. Of course, the investment menu could include operating properties or more speculative investments, including developing properties. Furthermore, if REITs were to stop making acquisitions, their principal role would revert to managing their existing property portfolios for their shareholders' benefit. This would eliminate the role of REITs as property acquisition and development specialists—a role they would reluctantly surrender.

Is Paying Too Much a Problem?

If a REIT pays too much for a property, the actual return from the acquired property may be less than the REIT's capital cost and required rate of return. This reduces the total returns that shareholders receive. Should a REIT persist in paying too much, the value of its shares will decline because the market's total return expectations will not be met. Shares will decline in value until the relationship between the stock's reduced price and the expected return makes the shares attractive investments once again. Thus, the loss of wealth by those stockholders who initially owned the stock is offset by the increased attractiveness of the shares to other investors.

Many REITs purchase properties using little or no debt. Consequently, REIT defaults or bankruptcies as a result of paying too much for the properties is unlikely. If REITs finance new property development, however, it is

REITs Then and Now

The recent and dramatic growth of real estate investment trusts (REITs) of the 1990s is quite different than the initial growth first experienced in the 1970s. First, in the 1970s, REITs primarily grew by financing speculative development but in the 1990s, they have grown by acquiring operating properties—many of them at prices below the replacement cost.

Second, in the 1970s, REITs borrowed funds in the short-term market to make construction and development loans but currently, their acquisitions are financed primarily with equity.

For more information, see "REITs: Overheated or Just Red Hot?" This article was in the July issue of *Tierra Grande*. Correction: In this article, the term "portfolio income" was mistakenly used in lieu of the more appropriate term "taxable income."

possible that certain markets could be over supplied with certain types of property. If a significant over supply develops, market rents will decline and non-REIT properties financed with debt could default.

REITs have sold new shares at dividend yields that are less than those required by investors who make direct investments in income properties. In recent years, REIT investors also have enjoyed significant share price appreciation in addition to their dividend yield which composes the investor's total return. If the dividend yield is maintained but the total return is significantly less than in 1995, 1996 and 1997, will investors continue to supply additional equity? If they do, then REITs will continue aggressive acquisition of real estate. REITs are under intense pressure to seek out investments that have significant potential for rents and value growth.

Thus, the question of whether REITs are paying too much for properties is one that the market will answer. REITs need to attract capital to grow; investors will supply capital if they expect to receive a return that compensates them for risk.

The challenge for REIT professionals will be to continue acquiring properties with attractive future appreciation potential in the major markets where new construction is beginning to offer a competing supply for tenants.

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REAL ESTATE CENTER

Tierra Grande (ISSN 1070-0234), formerly *Real Estate Center Journal*, is published quarterly by the Real Estate Center at Texas A&M University, College Station, Texas 77843-2115.

Subscriptions are free to Texas real estate licensees. Other subscribers, $30 per year, including 12 issues of *Trends*.