Special Issue: Real Estate Investment Trusts—Foreword from the Guest Editors

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This is the first of two special issues of Real Estate Economics dedicated to the study of Real Estate Investment Trusts or REITs. The goal of these special issues is modest. Rather than attempting to provide a comprehensive survey of current research on REITs,¹ our objective is instead to provide readers with a sampling of the various general directions of inquiry either about REITs or employing REITs. The volume of research on REITs has exploded in recent years. The objective of this introduction is to provide three non-mutually exclusive catalysts for this explosion, and to provide brief summaries of the studies contained herein.

Why Have REITs Become More Interesting?

Changes in the REIT Universe

The first and arguably most obvious factor has been the changing landscape of the REIT universe since their inception. Table 1 provides selected statistics that illustrate some of these changes over the past 30 years. The number of publicly traded REITs has increased from a mere 46 in 1972 to 176 as of December 2002, an annualized growth rate over the three decades of 4%. The largest growth rates in the number of REITs occurred between 1982 and 1992, when the compounded annual growth rate (CAGR) equaled 8%. The past 10 years have witnessed a smaller growth rate of 2.2%. Over the same three decades, there has been a dramatic shift in the “type” of REITs, with an increasing preference for Equity REITs. Equity REITs made up only 37% of the universe in 1972, but now represent 85%.

The most dramatic increase, however, can be found in the total market capitalization figures, which, as demonstrated in the seventh row, grew 86-fold over the 30 years, or an annualized rate of 16%. Since, by construction,

¹ See Corgel, McIntosh and Ott (1995) or Chan, Erickson and Wang (2003) for recent excellent surveys.
Table 1 ■ Selected historical data for Real Estate Investment Trusts.

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<tbody>
<tr>
<td>Number of total REITs</td>
<td>46</td>
<td>66</td>
<td>142</td>
<td>176</td>
<td></td>
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<tr>
<td>Number of equity REITs</td>
<td>17</td>
<td>30</td>
<td>89</td>
<td>149</td>
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<tr>
<td>Equity REITs/total REITs</td>
<td>37%</td>
<td>45%</td>
<td>63%</td>
<td>85%</td>
<td>4.6%</td>
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<tr>
<td>CAGR number of total REITs</td>
<td></td>
<td></td>
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<tr>
<td>Ave. market cap. (millions)</td>
<td>41</td>
<td>50</td>
<td>112</td>
<td>920</td>
<td>11%</td>
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<tr>
<td>CAGR ave. market cap.</td>
<td></td>
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<td>2.0%</td>
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<tr>
<td>Total market cap. (billions)</td>
<td>1.9</td>
<td>3.3</td>
<td>15.9</td>
<td>16.2</td>
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<tr>
<td>CAGR market cap.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>16%</td>
</tr>
<tr>
<td>NAREIT index level</td>
<td>111</td>
<td>266</td>
<td>593</td>
<td>1,573</td>
<td></td>
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<tr>
<td>CAGR index level</td>
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<td></td>
<td></td>
<td></td>
<td>9.2%</td>
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<td>Dividend yield</td>
<td></td>
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Source: www.nareit.org.
CAGR: Compound annual growth rate.

The NAREIT total return index has increased over 14-fold during this time period. Further, decadal CAGRs remained fairly constant, varying only from 8.4% to 10%. This total return index includes both capital gains and dividends. We report dividend yields annualized per decade; they vary from a low of 7.3% to a maximum of 9.0%. Although not reported, these data are available, however, at www.nareit.org/nareitindexes/monthlyd.xls.

2 To be exact, \((1 + \text{CAGR}\{\# \text{REITs}\}) \times (1 + \text{CAGR}\{\text{Ave. Mkt. Cap}\}) - 1 = \text{CAGR}\{\text{Aggregate Market Cap}\}\).
capital gains can be inferred by examining the difference between total returns and dividend yields. Although these differences have increased over time, over none of the three decades have these differences exceeded 3%. Obviously, this result should not surprise, since REITs have been regulated to pay out 90–95% of their income in the form of a dividend.

It is interesting to compare this conclusion (that increases in trust values due to capital gains are minimal) to the result above that the average trust grew by around 11% per year. Such a contrast suggests that growth in a typical REIT does not come from internally generated growth (i.e., “plowback”) but must be due to some combination of the revaluation of existing assets, mergers, IPOs of new large REITs, or growth in the asset base fueled by external financing.

Changes in the Regulatory Environment

In 1960, Congress passed the modern legislation enabling the creation of REITs. As mutual funds had encouraged individual investors to purchase stocks, so too REITs were designed to provide an opportunity for individuals to invest in real estate portfolios. In the original legislation, however, REITs were not permitted to actively manage the properties they owned. Therefore, outside managers had to be found. This led to an agency problem, that is, a misalignment of the interests of management and owners, making early REITs less attractive to investors.4 At the same time, real estate professionals had little incentive to join REITs, as they would be unable to fully utilize their expertise in developing and managing attractive properties. Another factor contributing to the slow initial growth of REITs was the preferential tax treatment provided to real estate limited partnerships over much of that time period. Owners of shares in a limited partnership were permitted to deduct from their taxes a share of the losses incurred by the partnership. This distorted the investment policy of many partnerships and often led to partnerships that were not economically viable, existing solely for the tax benefits they provided. With high debt levels and aggressive depreciation schedules making paper losses common, most public money coming into real estate was funneled into limited partnerships.

The Tax Reform Act of 1986 altered both the above factors. First, it removed many of the incentives that had made limited partnerships comparatively attractive. Specifically, passive owners were no longer permitted to take advantage of tax losses. Second, it allowed REITs to both own and actively manage properties. These changes led directly to a dramatic shift from limited partnerships to REITs and the surge in IPOs of public REITs.

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4 See Capozza and Seguin (2000) on agency issues arising when REITs are managed by external advisors.
Also contributing to the large number of conversions from private firms to REITs was the advent of the Umbrella Partnership REIT (UPREIT) organizational structure. Traditionally, REITs had direct ownership of their property portfolios. When a REIT was formed to purchase existing property on the open market, this organizational structure was sufficient. If an existing real estate partnership were to elect REIT status, however, the transfer of property ownership to the REIT would create a tax liability for the original owners. Depending on the tax basis of the property, this could form a significant obstacle to the creation of the REIT.

Since 1992, development of the UPREIT organizational structure has facilitated the transfer of property from existing real estate partnerships to REITs without necessarily triggering a tax liability. In an UPREIT, a publicly traded REIT enters an operating partnership (OP) with the owner of existing properties. In exchange for shares in the OP, the REIT contributes the cash raised in a public offering, while the property owner contributes the property. Because the property is transferred to a partnership, the property owner avoids the tax liability that would be incurred if the property were sold. Shares in the OP can subsequently be converted to REIT shares or cash under certain provisions. This conversion does trigger a tax liability.

Advantages of this procedure include the ability to spread the payment of taxes over several years or to time the conversion from OP units to REIT shares to take advantage of offsetting losses. The creation of a tax liability can be avoided if the OP shares are directly or indirectly part of an estate. An extra benefit of the UPREIT structure is that these OP shares do not generally count as REIT shares for the purpose of the 5/50 rule, which allows a property developer to maintain a significant ownership position in the OP without violating the REIT ownership restrictions. According to NAREIT, since the creation of the UPREIT form, more than 75% of new REITs have organized as UPREITs.

The DOWNREIT organizational structure is similar to an UPREIT, with the distinction that property contributed to the OP is held in a separate organizational unit. In an UPREIT, contributed property of all original owners is pooled within the OP, so that shares in the OP have a claim on all property. This pooling may, in fact, trigger a tax liability, as the IRS may view this as diversification of the portfolios of the original owners. A developer who wishes to control partnership shares linked to a specific property, whether for tax purposes or for other reasons, may prefer the DOWNREIT structure.

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5 REIT regulations restrict the largest five shareholders to less than a 50% ownership share.
The REIT Modernization Act of 1999 led to a number of additional changes when implemented in 2001. While many provisions of the act are technical clarifications and adjustments or specialized provisions for a limited segment of the industry, there are two changes that are likely to have wide impact. With certain restrictions, REITs are now permitted to own 100% of the stock of a taxable REIT subsidiary, which can, in turn, provide services that in the past would have resulted in disqualifying all rents from the leases involved. Existing third-party subsidiaries can continue as before or can convert tax free into a taxable REIT subsidiary.

Another significant change is to the distribution requirement that dropped from 95% of taxable income to 90%. This should enable existing REITs to undertake capital expenditures with less need to raise capital from the markets. This change is actually a return to the distribution levels in place from 1960 to 1980.

**REITs as an Experimental Laboratory**

A number of studies have used the unique features of REITs to make inferences about corporations in general. Perhaps the most interesting feature of REITs is that the underlying assets are tangible and trade, albeit infrequently, in a separate “Main Street” market. These two aspects combined allow researchers to compute replacement values, and hence relative values (like Tobin’s $q$s) with greater accuracy.

A second feature is the transparency of the income statement. In particular, there is little accounting “discretion” involved. For example, since there exists no “sales” expenses in REITs, a sales, general and administrative (SG&A) expense is replaced with a general and administrative (G&A) expense. This allows investigators to examine pure “overhead” with greater accuracy.

A third factor is attributable to the 90% rule, where trusts are required to distribute 90% (previously 95%) of earnings as a dividend. As a result, dividend yields typically exceed 7% of share price. Given that the dividend yield for S&P 500 stocks is below 2% and the median dividend yield on Nasdaq stocks is 0, REITs provide a particularly rich environment for studying aspects of dividend policy.

**Studies in This Issue**

The studies contained in this issue reflect many of the motivations outlined above. In the first article, Brown and Riddiough raise the question of why REITs, which have none of the tax advantages for issuing debt that accrue to C-corporation, issue debt at all. They provide a detailed examination of the
liability structure of REITs rather than simply focusing on total debt. They find that public unsecured debt is typically used to reconfigure the liability structure of a REIT. They outline the evidence that REITs issuing public debt constrain themselves by targeting total leverage ratios that meet the requirements for maintaining an investment grade credit rating.

As highlighted earlier, the 90% rule severely curtails internally financed growth, so growth in the asset base generally comes from acquisitions that are externally financed. This is the focus of Cambell, Petrova and Sirmans, who examine acquisitions of portfolios of properties and their financing. They find a positive overall announcement effect that increases based on the nature of the assets purchased (greater geographic focus) and the financing (project-specific private debt or privately placed equity).

Capozza and Seguin exploit the relatively clean measures of relative value (Tobin’s $q$) to examine the valuation impacts of ownership structure. They find that increased insider ownership is positively related to relative value. They find that REITs with greater inside ownership assume less property risk and less financial risk (leverage). There is little evidence of links between cash flow components, dividends and inside ownership. Instead, they find a negative relation between inside ownership and net required rates of return.

Ling and Naranjo also examine external financing. Using a VAR framework, they examine the interrelations between aggregate external financing (capital flows) and returns. Post-1992, they find no evidence of “return chasing”; that is, they find that returns do not affect subsequent capital flows. They find causation in the opposite direction, however, with capital flows affecting observed returns.

Kallberg, Liu and Srinivasan exploit the 95% dividend payout rule (in effect during their sample) to reexamine dividend-pricing models. In the finance literature, these models are rejected using only dividends but accepted when share repurchases are included. Using REIT data, where dividends are relatively more important than repurchases, they cannot reject rational dividend-pricing models.

Chui, Titman and Wei examine the determinants of REIT returns in a multifactor framework. They find that the regulatory changes in the early 1990s were associated with a regime shift in those factors associated with returns. Before 1990, returns were associated with four factors: momentum, size, turnover and analyst coverage. However, post-1990, only the first factor, momentum, is related to returns. This relation is greater for large trusts.

Finally, Bond, Karolyi and Sanders also examine the determinants of returns in a multifactor framework. However, their focus is on variations in cross-country
returns. They find the existence of a single worldwide real estate factor that affects returns in the majority of countries in their sample. However, additional explanatory power ensues when they add country-specific risk factors.

*We thank Carolyn Chase for assistance with the regulatory section.*

**References**

