

REIT CASH AND DISTRIBUTION MANAGEMENT

Many South African investors who are used to investing in listed Property Unit Trusts (PUTs) and Property Loan Stocks (PLSs) and contemplating investing in the foreign equivalents Real Estate Investment Trusts (REITs) are intrigued as to how managers can make sustainable distributions which can include capital gains & returns of capital. This practice is common in the US & Canada but is not as widespread in other REIT jurisdictions and is not a facet of the draft REIT legislation set for SA.

Like PUTs and PLSs, REITs are tax conduits with the respective distributions being taxed in the recipient or investors hands. However, REIT managers can & do make cash distributions over and above net income earned. This manifests into an annual year end recharacterisation exercise where REITs reclassify the distributions made during the course of the year to the advantage of the investor.

The REIT manager effectively searches for tax saving measures that can be passed through the conduit & on to the investor. One such example is capital gains incurred on properties sold during the course of the year under review which is then apportioned amongst shareholders on a pro-rata basis. The benefit is that capital gains attract a lower rate of tax than the standard income tax rate.

The start to gaining an understanding of these phenomena is to appreciate that historical cost accounting for real estate assets implicitly assumes that the value of real estate assets diminishes predictably over time. Historically real estate values instead have risen or fallen with market conditions. Accordingly, many industry investors have considered presentations of operating results for real estate companies that use historical cost accounting to be insufficient by themselves. In particular, historical cost depreciation of real estate assets is generally not correlated with changes in the value of those assets, whose value does not diminish predictably over time, as historical cost depreciation implies.

Most real estate professionals as well as investors believe that commercial real estate maintains residual value to a greater extent than machinery, computers or other personal property. Therefore, they view the depreciation measure used to arrive at Generally Accepted Accounting Practice (GAAP) net income as generally overstating the economic depreciation of REIT property assets over time, which may be appreciating. Thus, Funds from Operations (FFO) excludes real estate depreciation charges from periodic operating performance. Many securities analysts judge a REITs performance according to its adjusted FFO (AFFO), thereby deducting certain recurring capital costs from FFO.

The term FFO was adopted in the belief that it would be useful if consolidated income plus future income taxes, depreciation and amortization was used as a supplemental measure of operating performance. In particular, it was hoped that prices of various REITs could be compared with each other and in terms of the relationship between stock prices and FFO. Thus, the original intent was that FFO be used for the sake of determining a supplemental capitalization multiple similar to a Price Earnings ratio.

However, most REIT managers & analysts, in an attempt to define or evaluate a REITs distribution policy make a variety of adjustments to FFO, with the desire to adjust it so that it would be a better measure of cash generated or distribution capacity. These calculations generally are referred to by their authors as Funds Available for Distribution (FAD), Cash Available for Distribution (CAD) or Adjusted FFO (AFFO).

To conclude REITs have historically made distributions that have effectively included a mix of income, capital gains & even returns of capital without impairing the growth of the respective entities. It is the nature of the asset (commercial real estate) and an adherence to AFFO guidelines that enables well managed REITs to produce income & capital growth that exceeds inflation on a sustained basis.

Extracts from white paper on Funds from Operations - Real Property Association of Canada (REALPAC)