

REAL ESTATE INVESTMENT TRUSTS (REITs)

A REIT is an investment trust that owns, and in most cases manages, a pool of income producing commercial properties, mortgages and other commercial real estate assets. The primary objective of the creation of REITs in 1960 by the US Congress was to make investments, in large scale income-producing real estate, accessible to smaller investors.

The shares of a REIT are freely traded and usually on one of the regulated major stock exchanges. This investment vehicle has now become a common and popular phenomenon around the globe where private real estate ownership is encouraged. The greater diversification through investing in a portfolio of properties rather than a single building and expert management by experienced real estate professionals, appeals to a wide spectrum of the investor community.

WHY INVEST IN REITs

- Attractive income stream
- Distribution growth that has consistently exceeded the rate of consumer inflation
- Liquidity – the shares of publicly traded REITs can be readily converted into cash
- REIT managers are skilled, experienced real estate professionals
- The portfolio diversification minimizes overall risk
- The performance of a REIT is monitored by:
 - Independent directors
 - Independent analysts
 - Independent auditors
 - The business & financial media
- REITs are highly regulated entities

TYPES OF REITs

EQUITY REITs

Equity REITs have increasingly become operating companies which engage in a wide range of real estate activities that include leasing, property development and tenant services. The major distinction between REITs and other real estate companies is that a REIT acquires and develops its properties primarily to operate them as part of its own portfolio rather than to resell them once they are developed.

MORTGAGE REITs

Mortgage REITs lend money directly to real estate owners and operators or extend credit indirectly through the acquisition of loans or mortgage backed securities. The lending is, in most cases, against existing properties.

HYBRID REITs

Hybrid REITs own properties and make loans to real estate owners and operators

REIT PERFORMANCE MEASUREMENT

Like the rest of the corporate environment, the REIT industry uses net income as defined under Generally Accepted Accounting Principles (GAAP) as the primary operating performance measure. In addition, the REIT industry uses Funds from Operations (FFO) as a supplemental measure of a REIT's operating performance. FFO is defined as net income excluding gains or losses from sales of property and depreciation of real estate.

Many real estate professionals as well as investors believe that commercial real estate maintains a residual value to a much greater extent than machinery, computers or other personal property. Therefore they view the depreciation measure used to arrive at GAAP net income as generally overstating the economic depreciation of REIT property assets and the actual cost to maintain and replace these assets over time, which may well be appreciating. Thus FFO excludes real estate depreciation charges from periodic operating performance.

INVESTMENT FUNDAMENTALS

The most critical factor influencing the value of a REIT's real estate holdings is how well balanced the supply of new buildings is with the demand for new space. When construction adds new space into a market more rapidly than it can be absorbed, building vacancy rates increase, rents weaken and property values decline, thereby depressing net asset values.

Growth in employment, capital investment and household spending in a strong economy increases the demand for new office buildings, apartments, industrial facilities and retail stores. Similarly, population growth stimulates demand for apartments.

However, economic growth does not have a consistent geographic spread thereby creating an uneven demand in the various property sectors. Thus investors should compare the locations of properties of different REITs with the relative strength or weakness of real estate in the respective locations.

TAXATION

A REIT is effectively a tax conduit where the distributions are taxed in the investor's hands. To maintain this status, most countries require a REIT to distribute at least 90% of its taxable income to avoid paying corporate taxes. The distributions are for tax purposes allocated as ordinary income, capital gains and return of capital, each of which may be taxed at a different rate.

Capital Gain

A capital gain is defined as the amount by which the selling price of an asset exceeds the purchase price. The gain is realized when the asset is sold and is subject to a Capital Gains Tax (CGT). Capital Gain receipts are attractive to investors so long as the appropriate capital gains tax rate is less than the investor's marginal ordinary tax rate (this is the position in most countries).

Return of Capital

A return of capital distribution is defined as that part of the distribution that exceeds the REIT's taxable income. This is not taxed as income but rather, the investor's cost basis in the stock is reduced by the amount of the distribution. A high return of capital distribution may be attractive to investors in high tax brackets.