

JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS
II. CLASSES AT THE UNIVERSITY OF WISCONSIN--MADISON
I. Business 760: Real Estate Equity Investment
2. Lecture and Discussion Notes: Undated

760 Notes on Real Estate Investment Trusts

I. Origins

Financial institutions evolve on old frameworks which may or may not cramp their style. Savings and loans are an interesting anachronism of mutual or coop home organization. The real estate investment trust has a most interesting geneology.

- A. Old Massachusetts law prohibited a corporation from owning real estate other than what is incidental to its business. Thus the Massachusetts Investment Trust was used by 1886 to permit small investors to participate in real estate growth in frontier America.
- B. When corporate income taxes were introduced by constitutional amendment in 1917 the real estate trust was considered exempt but in 1936 a federal court removed the exemption.
- C. When corporate taxes became significant during World War II the REIT's began a long fight to have the same tax position as mutual funds under the investment company acts of 1938 and 1940.
- D. The public scandals which upset broad ownership syndication SIRE and others dramatized the need for a conduit with pooled investors but the IRS would not relent until the REIT's gave up the rights to pass through a accrued losses or the right to be active in the development process.
- E. In 1960 the Real Estate Investment Trust Act was passed in between 1961 and 1967 about \$350,000,000 of REIT securities were sold to the public, more than half in 1961 and 1962. The great majority of these trusts were conversions of some that have survived from earlier days of real estate corporations and took ownership positions.
- F. These trusts have a very slow growth in terms of assets, earnings per share, and share pricing for a variety of reasons:
 1. The public did not understand real estate operations with hidden appreciation in book value and understated earnings.
 2. Many trusts had older properties within inadequate depreciation. Law required payout of 90% of taxable earnings so that it was difficult to amortize mortgages without tax shelter and thus trust did not enjoy full leverage.
- G. In 1961 a little trust was formed called Continental Mortgage Investor and unlike their cousins, CMI invested in mortgages and construction loans which it financed with low rate long term debt. It showed an earnings growth rate per share of 20% a year through 1971 while its assets grew from \$25,000,000 in 1962 to over \$400,000,000 in 1971.
- H. The tight money of 1966 and 1969 as well as the investment notice which CMI had attracted suddenly caused a revolution in REIT growth so that total REIT assets grew from \$1,000,000,000 at the start of 1969 to almost \$5 billion to the end of 1970. During easy money of 1971 trust assets increased by \$3 billion more.

11. Strategic and tactical operating strategy of the mortgage loan REIT reflects an interesting change in management concepts and the opportunities inherent in arbitraging between sectors of the capital market. The real estate market has to do with asset management while Wall Street is concerned with opportunities in liability management.

A. Asset management is concerned with the land, buildings, and loans involved in development. Construction and development loans were a bank specialty and mystery and thus enjoyed a high spread of five points or more above prime. By 1968 interest rates on C & D loans were higher than equity returns in new properties.

B. Liability management is concerned with the opportunity costs of money and the REIT's discovered they could borrow using long term debt, commercial paper, or bank lines depending on the trend and level of interest rates and maintain or increase their spread between their asset investment rate.

→ C. The equity trust could not leverage its assets nor realize its appreciation in assets without selling the property and if it sold it could not find another property that would do as well. Even if it could sell IRS ratio tests limited the earnings that could come on resale and the frequency with which it could turn over assets. Thus equity trusts sell on a yield basis of cash throwoff and almost always sell at a discount from book value as a closed end trust.

→ D. However, a mortgage investment trust could invest in long term mortgages in '69 and '70 which were yielding 9% and use these mortgages to secure credit lines for additional money to be lent as construction and development loans at 14 or 15% effective yield. Since mostly construction loans would be self liquidating due to a permanent financing commitment these loans would be funded with short term debt. A big C & D loan may be on the books for several years but:

1. On a J shaped interest curve the trust could refinance its commercial paper as the interest fell increasing its spread on existing commitments. Toward the bottom of the trough it would convert to long term debt. If commercial paper went too high it would switch to bank loans. The use of short term paper to move from one interest level to another is called "bridging".

2. As earnings would rise with falling interest rates or increasing leverage, the market became valuing trust shares as growth stock. This made possible equity leveraging or a strategy called contra-dilution. A trust could sell a \$10 share which would earn \$1. If it borrowed another \$10 for 50¢ the yield on the share would go up to \$1.50 and if it borrowed \$20 the yield would go to \$2 and a price of \$20 a share. A second sale of stock at \$20 would increase book value to \$15 and increase the borrowing power of the trust which would further increase earnings.

E. Thus the successful mortgage trust requires two capabilities: the ability to increase the supply of mortgage opportunities on demand and the ability to operate successfully in the commercial paper market.

III. The incentives to organize and manage an REIT are diverse and subtle and a good example of a profit center viewpoint in the approach to real estate.

- A. Ownership of REIT stock could convert interest income through a capital gain but most REIT advisors own very few shares of the trust they manage.
- B. The advisory management fee is a percentage of assets ranging between 1.2 and 1.5%. Since a trust is closed end the only way it can lose assets is through write-downs or reduction in leverage and so the basic fee is a steady source of income. There can be incentive fees such as 10% of all capital gains or 10% of all income in excess of some minimum dividend rate for investors. Operating expenses generally amount to less than .75% so the advisor should have a profitable contract unless some serious management oversight occurs.
- C. To establish a trust a management firm takes the risk that its organization expense will not be covered because the sale of shares is rejected by the market. Once the shares have been sold the organization expenses are charged to the trust. Thus the advisor gains a handsome stable return on a negligible investment once the underwriting hurdle has been passed.
- D. A trust usually complements an advisors existing operation although it may compete to some extent for example:
 - 1. It provides a captive correspondent for the mortgage banker
 - 2. It provides a spread of fixed costs for insurance company staff when the insurance company is not making loans.
 - 3. It permits institutions to make loans for which it lacks capacity or regulatory authority.
 - 4. It provides a captive source of credit such as hotel investor REIT which was started by Hilton and Marriott.
 - 5. It expands the services which can be offered by a bank, etc.
- E. A constraint of this money machine is therefore the problem of selling new shares. Increasing public interest has been met with a flood of issues and a November 1971 one of the best CMI announced it was about to announce its first earnings decline. Uninformed investors are skitish investors and trust share prices fell drastically. Since recovered investors nevertheless foresee a slow rate of growth and more marginal opportunities to make loans. Indeed the traditional spread on construction loans has fallen drastically. Thus the ability to issue shares today largely depends on the name and reputation of the sponsor.

IV. What are the risks to the investor in REIT shares and to the trust industry in its present growth patterN?

- A. The theory of contra-dilusion will work only as new money is willing to invest in trusts so that supply is short of demand and prices will rise because the PE ratio is rising. New issues have tended to cause supply to at least keep even with demand and since many convertible trust issues have been sold or warrants attached to private lines of credit there is real opportunity for dilusion.

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- B. The earnings curve may flatten out for a variety of reasons:
1. A declining spread on specialty loans because of the supply of money available.
 2. A declining spread should the trust be caught bridging in a rising interest market as was prudent real estate investment trust.
 3. Loss of earnings due to a cumulative reduction of cash flow as a result of a frozen asset in default or a reduction in paper outlets and increasing dependency on bank loans.
 4. Failure of a stock issue required to refund debt necessitating discount sale of a loan interest.
- C. Disqualification of the trust for tax exemption due to breach of the IRS ratios, redefinition of "passive investors" or lack of 100 independent shareholders, etc.
- D. The interrelationship of advisory firms, insurance companies and banks leave open numerous opportunities for conflict of interest.
1. Variety of provisions such as first right of refusal, 50% participation, right of non-affiliated directors to make contracts etc. reduce chance of direct adverse selection of mortgages.
 2. The conflict of interest is more subtle in terms of how fast the advisor expands the trust in pursuit of equity leveraging when it will compete more and more with the original sponsors market opportunities.

Real Estate Equity Trusts

I. Origins

- A. Massachusetts Investment Trust
 - 1. Real Estate Investment Trust of America 1884
- B. Mutual Investment Fund Act
- C. Failure of large public syndicate
- D. 1960 REIT Act to provide conduit status

II. Structural flaws created by IRS fear of conduits

- A. 90% of earnings must be paid out
 - 1. Principal payments on mortgages must be less than depreciation so that older buildings enjoy little leverage
 - 2. No opportunity to build loss reserves
 - 3. Little opportunity to generate internal financing of new projects
- B. Passive investment role
 - 1. No profit centers from management or development
 - 2. Real profits go to outside management firm
 - 3. IRS even questions participating loans, stock participation with tenants, or percentage leases if they are not customary for type of property involved
 - 4. Earnings insensitive to inflation for long term investments or unstable from short term leases
- C. Investors buy dividends not growth as slow turnover of assets leads to significant understatement of book value. Indeed, depreciation leads to declines in book value.
- D. Decline in book value increased where part of cash dividend is depreciation in excess of principal payment.
- E. IRS limits sale of assets and annual percentage contribution of capital gain so that submerged assets cannot be converted quickly; indeed, capital gains must also be distributed under 90% rule
- F. Growth requires future sales of stock without dilution of current shares - encourages managers to overstate earnings or pay dividends out of capital in order to support new security floatations
- G. Management fees provided negative incentive
 - 1. Were based on total assets rather than change in net worth or bottom line earnings
 - 2. Conflicts of interest between sponsors who were developers, banks, insurance companies, mortgage bankers, etc. and trust investors

III. Mortgage trust designed to take advantage of arbitrage between commercial paper and bond markets and mortgage market

- A. Original trusts used historical spread between insured home mortgages and bond market

1. Money managers became greedy and saw construction loans had greater spread and more rapid turnover
 2. Short term construction loans justified more reliance on short term commercial paper
 3. Loans did not require write-down of book value for depreciation and interest only financing meant all earnings were available for distribution
- B. Growth for the mortgage trust and advisor management fee came through theory of contra-dilution
1. Book value of existing shares leveraged by selling a reduced number of shares for the same price
 2. Lenders required a ratio of debt to equity so that every new dollar from sale of stock created four dollars in assets
 3. Many trust sponsors were banks so that new debt was issued under conditions and terms that would not be true in an open market
 4. Accounting and appraisal rules for trusts were unrealistic and lax
- IV. Accounting and appraisal rules for trusts were unrealistic and lax
- A. Appraisal on basis of as developed, marketed and highest quality
 - B. Absence of loss reserves
 - C. Accrue of income
 - D. Restructuring of loans in default by incorporating past due payments into new balances
 - E. Sale of distressed property to captive buyers with recation of loan terms
 - F. Regulators then flip-flop to require a write down in assets to represent not only current present value but in addition the present value of future holding costs. Capital surplus was wiped out overnight and operating losses could not be carried back to share holders.
 - G. Shareholders have opportunity to refile income taxes for previous three years to the degree that dividends were paid from capital rather than earnings, once earnings have been redefined .
- V. Current investment strategy for real estate trusts
- A. During period of inflation you should control tangible assets with as much leverage as possible. Tremendous discounts on understated book values of equity shares makes them good investments for some purposes.
 - B. Trust shares are priced both on dividend and in part like a commodity, rising and falling in the market without regard to quality differentials. Therefore, many quality shares are under priced.
 - C. In mortgage trusts, those with less than 35% of their portfolio in distress have more chance of surviving. In addition to bank loans, many of the bank sponsored trusts have subordinate bond issues which still receive their interest payments but uncertainty as to value recoveries and willingness of banks to fund the trust have depressed bond prices to a fraction of par. In the long run many of these bonds will be sound and bankruptcy courts will be reluctant to cram down on the subordinated debt to favor the bank loans when bank sponsors cause the problem and bank loans are 1% of interest plus all earnings for the next ten years.

- The Real Estate Trust

1. Real estate subscription - half price, Real Estate Review and Real Estate Law Journal
2. Introduction, Real estate trust
 - A. Stock market values on conservative PE ratio
 - B. The equity trust trap - principle repayment must be covered with depreciation tax shelter since 90% of earnings must be paid out after deduction for interest and depreciation - nothing left for expansion of asset base.
 - C. Equity trust sold for sharp discount on book value so it was difficult to sell more shares without diluting previous shares
 - D. CIL and FMI develop theory of contradilution for the mortgage trust
 1. Borrow wholesale - lend retail
 2. Arbitrage between short-intermediate-mortgage rates
 3. Use short term loans which liquidate to provide liquidity coverage on commercial papers
 4. Use construction loans which tie interest rate to a spread over prime (problem: prime is now political rather than economical so many were caught by introverting money market in '73 - a condition which has occurred in only 16 months in the past 22 years
 - E. Leverage increases earnings while speculation on money market increases PE ratio so market price a share rises permitting second issue of stock at higher price per share which favors average book value for previous owners - hence the term contradilution.
- II. The essential differences between equity and mortgage trusts are liquidity and growth strategy.
 - A. Equity trusts reduce leverage and play for inflationary long term gains. Low breakeven point but growth held in check by available depreciation cover.
 - B. Mortgage trusts maintain solvency with short term loans offsetting short term commercial papers and play for time lags between wholesale and retail money market to provide capital gain appreciation in market price of shares as well as cash income.
 - C. The mortgage trust theory is now having difficulty raising new money. Guardian Mortgage Investment 600,000 new shares to the public on August 16. New share holders were to receive the same dividend as the old share holders after one week of investment. On a \$50 investment they would receive an estimated \$4.90 dividend during the first year. In addition, there was a 6% sales commission paid the underwriters so that the new money costs the trust 16-17% for the first year.
 - D. Paybacks for short term construction and development loans are slowing down while commercial paper is starting to sell. The shortage of cash may cause some to default on funding commitments for a new loan.

E. Since the mortgage trust is speculating in the money market it is fashionable in some areas to speculate in convertible bonds or warrants. Warrants presently would be interested in some of the bigger trusts. The presence of convertible bonds and warrants makes comparisons among trusts a tricky business.

1. Basic practice dilutes earnings assuming fully converted debentures since funds from debentures are at work in the trust.
2. Shares outstanding is not adjusted for conversion or exercise of warrants as these funds are not actually in use and the key measure is primary cash flows.
3. For mortgage trust primary earnings are annualized by multiplying the latest quarter by 4 without seasonal adjustment and assuming conversion of all convertible debts.
4. For equity trusts primary earnings are regarded as net cash flow (earnings plus depreciation and non-cash charges minus mortgage principle payment) and these are adjusted for any known seasonal factor

F. On this basis 4 standard comparison are provided by the services

1. Last price and price change since the last issue
2. Price earnings ratio and estimated dividend for next 12 months
3. Market price as a % of book value
4. Return on book value to measure management performance with available funds

Real Estate Investment Trusts

- I. Real estate investment trust act of 1960 made it possible to develop investment funds for real estate similar to the tax conduits of closed-end investment funds for the stock market. These funds were subject to a great many technical constraints as they were a compromise by the Internal Revenue Service between unstable limited partnerships called syndicates which enjoyed a single tax status and standard corporations which faced a double tax status but could provide legally for continuity, marketability, limited liability, and centralized management.
 - A. Some of the significant constraints would include:
 1. The trust avoids income or capital gains taxes if it pays out 90% of taxable income.
 2. Beneficiaries are taxed on distributions of ordinary income and capital gains taxes on capital gains.
 3. Ownership must be distributed among a minimum of 100 persons and no 5 persons can control more than 50% of the ownership.
 4. 75% of total assets must be represented by real estate assets including mortgages, cash, and government securities.
 5. No more than 30% of annual income can be from short term trading in stock or real estate.
 6. The trust is prohibited from active ownership or operation of a trade or business which rules out profit sharing, property management, sale of services to tenants, or ownership of more than 10% of stocks, assets, or net profits of a lessee.
- II. While there were a number of large Massachusetts style trusts specializing in real estate prior to the Act of 1960 and a number of local REIT's formed in the early 60's, they did not do very well with the public. Losses could not be carried back and depreciation had to exceed principle payments on the mortgages or the trust would be unable to pay out 90% of taxable income to share holders and make its mortgage payments, too.
 - A. It was difficult to buy properties at a price and on financing terms that would support dividend expectations.
 - B. Market prices for shares generally reflected book value rather than appreciated value of the property so that shares often failed to recognize inflation value.
- III. In 1968 & 1969 however, the real estate trust came into its own, not as equity investors but as mortgage investors - particularly construction loans. These trusts, called MIT's provided 2 billion dollars of new construction money in 1969.
 - A. By the end of 1969 there were 38 MIT's in operation, 30 more than at the beginning of the year, and Wall Street had sold \$750 million of new shares in a period of tight money. In addition 24 new MIT's have been registered for sale in 1970.

- B. In 1969 commercial banks greatly restricted their origination of interim loans; in fact long term permanent lenders were rejecting applications unless the developer had a take-out commitment for construction money!
- C. Many MIT's have a mortgage banking company as a management company which gives the MIT the advantage of established relationships with builders, developers, brokers, title insurance companies, etc. While the mortgage bankers can then offer a complete package of financing services.
- D. MIT's can take risks and make contracts that are not available to the bank and at the same time are in short term loans rather than trading in equities. Short term construction interest rates are higher in profit than long term ownership and there is no squeeze between mortgage principal payments and depreciation cover.