JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

I. Other Presentations In Which Either The Date And / Or Sponsoring Organization Is Missing

1. Risk Management/Investment Related Topics

u. "Notes Real Estate Investment Trusts", no date

Index

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~~ $1 billion 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.

II. 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-dilusion. 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 thrgugh 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 advisor's 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 therfore the problem of selling new shares. Increasing public interest has been met with a flood of issues and in 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-dilution 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 dilution.

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, righ 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.