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The REIT Craze

By Peter Lynch

I wish I had a few dollars for every time I've been asked in the past year, "Hey, should I buy a REIT?" I'd take that money and buy...well, maybe shares in a real-estate investment trust. A REIT.

But not just any REIT. I'd need to do some looking around and some reading, and I'd want to talk with people who know more than I do. In other words, I'd expect to put in a reasonable amount of work before I could find a REIT or two that I'd want to invest in. The question, however--"Should I buy a REIT?"--too often assumes that this work isn't necessary, apparently because each REIT is more miraculous than the next. I have a feeling the REIT is the most recent example of a recurring phenomenon: the investment that people think will make money for them whether or not they really understand it.

I wish that were true. I could go down the hall right now and tell a lot of people to stop working so hard. But investing doesn't have much to do with miracles. Real estate is a cyclical business, and most REITs are enjoying a very profitable part of the cycle. Eventually the wheel will turn, and then we'll see which REITs actually have the best holdings, the best management, and the best honest-to-goodness long-term prospects. The happiest investors then will be those who didn't buy just any old REIT in 1997.

Much of the fogginess that surrounds REITs is owed to the fact that the category is relatively new and surprisingly small. The legislation that produced the REIT industry was signed in 1960, but it was 30 years before REITs could be called respectable, mainstream investment vehicles. Even now, there are only about 195 publicly traded REITs. The market capitalization of these 195 is about \$94 billion, which means the entire publicly traded component of the industry is only about two-thirds the size of Microsoft. What do REITs own? Real estate, of course. But real estate in different forms, in different places, with different relations to economic cycles. The most traditional kind of REIT is one that owns office buildings or apartments or hotels. The newest kind--I kid you not--is one that holds prisons.

Here is a much-simplified version of how the most common kind of REIT, called an equity REIT, is set up and operates. The process begins with an initial public offering--let's say the management group of a new REIT sells ten million shares for \$10 each. Then it borrows, to pick a conservative number, another \$25 million. With that \$125 million it builds or (more likely) buys income-producing property. The source of the income is rent--paid by families in apartments, companies in office towers, or stores in malls.

What actually defines a REIT is its lack of choice regarding the money it earns: Tax law requires that a REIT distribute at least 95 percent of its net income to shareholders as dividends. That sharply limits the REIT's options. But tax law giveth, too: REITs pay no federal income tax.

Equity REITs constitute about 89 percent of the REIT industry in terms of market capitalization. About half the remaining market cap is in mortgage REITs, which don't buy property but instead invest in mortgages taken out by builders and property owners--a demanding business that succeeds only if borrowers don't default and interest rates don't go sharply up or sharply down. The remaining REIT money is in so-called hybrids, which own property and also loan money.

By and large, individual investors are best off with equity REITs. If you're a shareholder in an equity REIT, you're a landlord. If you own shares in a mortgage REIT, you're a money lender who lives and dies with interest rates.

Within the equity sector, there are ten or so subsectors. The largest, with 43 REITs and about \$21 billion in market capitalization, is retail: REITs that own shopping complexes of various sorts. Next, with 36 REITs, is residential: apartment buildings and complexes. Then industrial/ office: industrial parks and office buildings. There's also a lot of money invested in self-storage and health-care facilities (these REITs tend to own not hospitals and clinics but the ground beneath them).

Any subsector might very well have its own subsectors--in the retail subsector, for example, there are five REITs that own nothing but outlet centers. All this breaks down even further along geographic lines.

The National Association of Real Estate Investment Trusts (800-3-NAREIT or www.nareit.com) is the source for data on the REIT industry. NAREIT's industry-wide index showed a total return of 35.75 percent in 1996--12.79 percentage points better than the Standard and Poor's 500 Stock Index. The big winner, at 51.98 percent, was mortgage-backed securities, which isn't surprising given the relatively strong economy and steady interest rates. The best performer on the equity side was the office group, with a total return of 51.82 percent. Hotels did almost as well: 49.19 percent. Regional malls returned 44.63 percent.

This is the stuff that caught so many investors' eyes. Yet look at the return on those outlet-center REITs: just 3.51 percent. That's how it was possible to do badly in REITs even in a deliriously good year. And as so often happens, the REIT industry is coming down to earth just as attention on it is intensifying--through the first four months of 1997 the NAREIT index was down by a couple percentage points. How does an investor go about evaluating a REIT? The first step is to learn about the properties it holds. Visit them if you can. If the properties are apartment buildings, are they well maintained, do they command good prices, and are the vacancy rates low? If the properties are shopping centers, are the parking lots full and the retail spaces leased? Will the malls still be attractive to shoppers five or ten years down the line? Most important, what's the likelihood that competition will crop up?

That's the first level of examination. Here are additional points of focus:

LEASES. The key here is the relationship between a REIT's leases and local economic conditions. The best combination for a REIT is a market that is turning up and leases that are turning over. In that environment, a new lease is an opportunity to raise prices. You can get some information about a REIT's leases by calling the investor-relations office. But the more important side of the equation is the local markets, and that doesn't require any special knowledge or access. Let's say I'm considering an office-building REIT with a lot of properties here in Boston. I know the local office market is strong--I can read that in the paper. And if I look out my window I can see that there's nothing coming out of the ground. It would take years for a developer to put up new buildings to take advantage of the conditions my imaginary REIT is already enjoying. No one's going to sneak a 50-story office building past me.

The flip side of this happy scenario is one in which the local economy is headed south. If leases are turning over, they're going to be renewed at lower rates. There go your earnings. Even if the terms of the leases are relatively long, investors will see trouble coming and punish the stocks here and now.

GROWTH STRATEGIES. The best REITs don't want to just pay dividends. They want to grow--buy more properties, collect more rent, drive their stock prices up. That's not simple, given the requirement that REITs distribute 95 percent of net income. A REIT can't hold its dividend down for a few quarters while it accumulates cash to buy more property.

So how does a REIT grow? At least four ways: It borrows money; it pays the smallest dividend allowable by the law and acceptable to shareholders (and thereby retains a maximum of earnings); it sells property from its portfolio at a profit; and it issues more stock. An investor should learn which of these strategies a REIT is employing and to what extent.

Leverage is a basic fact of real-estate investing. So is cyclicality. And, given the combination of these two, so is volatility. Right now, aggressive REITs are using leverage to their advantage. That's fine, but they're going to have to be pretty quick on their feet to avoid being hoisted on that leverage when the cycle moves along. Conservative REIT analysts don't like to see debt that totals more than 40 percent of a REIT's estimated asset value.

Selling property can give earnings a kick if, first, the price is right and, second, the money is used to buy another property with a better upside. Stock issues can be good news, too, but only if the sale doesn't dilute the value of existing shares. In other words, any proceeds from the sale of new stock should be invested in property in a way that raises, or at least doesn't reduce, the REIT's overall rate of return. The worst kind of stock issue is one used to support faltering operations or prop up the dividend.

MULTIPLES. The stock tables in the newspaper show a price-to-earnings ratio for every listed REIT. People in the industry tend to ignore it-- for good reason. Different REITs figure earnings differently, so p/e ratio isn't much use for REIT-to-REIT comparison.

NAREIT has pushed its members to adopt a more meaningful measure called funds from operation. It may be a while before all REITs report FFO the same way, but price-to-FFO ratio is a reasonable measure of valuation and means of comparison. The average equity REIT now sells at about 11.3 times FFO.

Much as you might like the income, don't get too hung up on dividend yield. Some REITs distribute money well in excess of 100 percent of their net income (they do this by distributing a portion of the tax break for depreciation on their properties). That may attract investors, but the best REITs look for ways to use their cash for growth. In this environment, if you see a dividend above 8 percent, do some more research. You may be looking at a company that doesn't have a viable strategy. Or you may have found one that has been overlooked and undervalued.

Finally, examine the rate of growth for net income and FFO. The top companies show steady, sustainable growth.

INSIDE OWNERSHIP. I always feel better about a company when the managers have a financial stake in it. NAREIT suggests that management should own a minimum of 10 percent of the shares in any REIT. Sounds good to me.

The REIT craze is far from over. Last year produced six REIT initial public offerings. This year, there will probably be twice as many, including the largest ever, Boston Properties, started by publishing magnate Mortimer Zuckerman and scheduled to go public soon. REIT mutual funds are proliferating, too: There are now 58, and 19 of them are sold without front-end loads. If you believe in the idea of REIT investing

but aren't sure that you have an edge, or the time to take up another kind of investment research, consider letting the professionals do it for you.

Of course, picking a fund will take some research as well. REIT funds are no more alike than REITs are and no less subject to the basic rules of investing: Buy only what you understand, believe in, and intend to stick with--even when others are chasing the next miracle.

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