Securitization of real estate and global growth

**REITs rule in domestic and global real estate markets**

Glenn R. Mueller

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The growing popularity of REITs as a domestic and global investment strategy is due to consistently good returns and tax benefits, said Glenn Mueller in his address to the Global Executive Forum.

Formed by an act of Congress in 1960, REITs – Real Estate Investment Trusts – can be public or private. “Public REITs are traded on major exchanges and are subject to financial reporting and the same securities law that govern stocks and bonds. Private REITs operate under a less restrictive and less transparent set of requirements,” said Mueller.

Public REITs offer investors liquidity, the ability to get in and out of their investment with ease. Private REITs can be difficult to exit. Usually, new money has to come in before cash is available for a payout. Public REITs, said Mueller, “Are a much better vehicle from a liquidity standpoint and for balancing a portfolio.” Unless otherwise noted, Mueller’s comments focused on public REITs.

REITs are governed by a strict set of rules. “They must have a minimum of 75 percent of their income and assets in real estate and distribute 90 percent of dividend income every year.” In return, the IRS relieves them of having to pay corporate taxes on the federal level. “Most REITs not only pay a quarterly dividend but many of them have a special dividend at the end of the year to make sure they hit their 90 percent of taxable income numbers. Because of this, REITs have been increasing their dividends at a rate almost double that of inflation since 1991,” said Mueller.

Institutional investors can put big money into real estate directly but the small investor also has an opportunity to invest in high quality commercial real estate through REITs, which are essentially a mutual fund of diverse real estate holdings. “REIT stocks today average anywhere from $10 to $60 a share,” said Mueller. “A hundred shares is anywhere from $1000 to $6000. What this means is the little guy can get a piece of the action and that has changed the world.”

Unlike a direct investment in a property, “when you buy a REIT, you buy a package deal that includes the real estate, management and capital structure.” REITs invest in all the different property types and specialize in specific sectors. There are office REITs, residential REITs, industrial REITs, shopping center REITs, health care REITs, etc.

The size and value of REITs have been steadily growing. “Back in 1991, 100 of the biggest REITs were under $100 million in market capitalization,” said Mueller. “Today there are more than 60 REITs that boast a minimum of $1 billion in market capitalization. “The composition of return in any investment is made up of the income and the capital appreciation. Over the past 25 years, the income return for REITs has
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averaged 8.4 percent; the price appreciation has averaged 6.4 percent and the earnings growth has averaged 7.8 percent. There have been a couple of years when the price appreciation was down, but overall REITs have beaten stocks and bonds as an investment over a 25-year time frame.

Mueller asked, “Can you name any industry any place in the world where there has been positive earnings growth for 25 years in a row?” Not all years have seen stellar performance but “there is no other industry in the world that on average has had positive earnings growth every year.” It’s no wonder that more and more individuals and institutional investors are adding real estate to their portfolios. Capital is flowing into the US in search of solid properties and the competition is fierce. There is more money looking for real estate acquisitions than there are available properties.

“Right now, if a high quality office building in New York City were put up for sale, there would be 10 pension fund advisors, five international investors and five REITs all trying to buy the same property and bidding up the price in the process. It’s called the ‘wall of capital.’

“Capital, obviously, is a major component in the real estate market. Historically, it’s been from private sources. It wasn’t until the 1990s in the US that REITs began to enjoy access to public markets,” said Mueller. “Cross-border investing started to take off in 2000, and the size and health of different markets drive their future.”

**Global markets**

When investors can’t find what they’re looking for in the US, they turn to global markets. “All the major REIT managers in the US are starting to put together international real estate funds,” said Mueller. But it’s not that easy. Often, there’s a dearth of available stock and it can take weeks for shares to come on the market. So it’s a waiting game. Currency rates pose another problem. “You could make 20 percent on an investment and lose 20 percent just through the fluctuations in the currency exchange rate. So that is an additional variable that we have to worry about as we make investments internationally.”

But markets with high returns will continue to attract capital. According to Mueller . . .

- Real estate returns in the Americas, including Canada and Mexico, are totally dominated by US markets.
- In Europe the best returns are out of Ireland and Norway. Other major markets include Switzerland, Sweden, the UK, France, Germany and the Netherlands.
- In Asia, Hong Kong has mellowed out but is still viable.

“A lot of people are trying to go to Asia because they believe there is a strong potential in places like China and India. As these economies grow, the value of their real estate is going to explode,” said Mueller.

Although the global real estate market is an appealing buffet of investment opportunities, Mueller cautioned: “I believe real estate still is a very local market investment, and you need to be very careful. “Whether you’re making the investment directly or whether you’re investing in a securities form such as a REIT, you need to understand what that local market is about.”
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Things to know when investing in another country: “The size of that market and how much is being traded. Liquidity impacts return. The more liquidity, the better the return is going to be.” It’s essential to have a local partner when dealing in international real estate or even in an unfamiliar domestic market. “Every market is unique and you need to understand the characteristics that set it apart,” Mueller advised.

“We will never invest anywhere without having a local partner because we will lose. Real estate is so localized that you have to be a specialist in the area.” The success of the US REIT market has inspired other countries to set up similar vehicles, said Mueller. Not all of them will succeed at the same level. “If countries aren’t willing to adopt the tax laws and structures that make this work, they will never have a REIT market.”

Brief history of REITs

Now more than 45 years old, REITs—Real Estate Investment Trusts—“were ignored as an investment vehicle in the 1970s and 1980s because a limited partnership was the favored vehicle for real estate investments as they provided tax shelters,” said Glenn Mueller.

“Up until 1986, REITs were set up as passively managed trusts requiring an outside manager. The Tax Act of 1986 allowed REITs for the first time to be actively managed. Then you could have management inside of the REIT and managers could own stock in the company and be part of what was going on. I consider that to be the start of the new REIT era in the United States.

The Tax Act of 1986 also disallowed losses in one investment basket (active like real estate versus passive like stocks) from being used to offset gains in another investment basket. Thus, limited partnerships fell by the wayside.

“There are three types of REITs: equity REITs that invest in properties, mortgage REITs that make loans and hybrid REITs that do both. Today there are 172 REITs: 146 are equity and 26 are mortgage.

“In the 60s construction mortgage REITs proliferated. A bank or savings and loan institution that had reached its legal lending limit could form a REIT, gather capital from the public markets and then make more loans. So we had a lot of banks making indiscriminate loans to developers that got the buildings up but never filled them. This led to the real estate bubble and crash in the late 80s. And REITs got a bad name as a result.

“In the 1990s REITs become a major source of capital and securitization of debt became very popular through commercial mortgage backed securities (CMBS). “Today people are doing not only public REITs but private REITs because they fit so well into a stock and bond portfolio.”