The REIT Way

In today's economy, investors set their sights on real estate


Mez Birdie, CPM®

by Nancy Pekala

Real estate investment trusts (REITs) remain the darling of today's investors. Thanks to the liquidity, transparency and stability they bring to commercial real estate and three successive years of outperforming the S&P 500 and Nasdaq, investors are increasingly turning to REITs.

Mez R. Birdie, CPM®, CCIM, SCSM, senior vice president of portfolio development for Commercial Net Lease Realty, Inc., a REIT specializing in net leased properties and traded on the New York Stock Exchange, recently shared with the *Journal of Property Management* his insights into today's investment market.

JPM®: REITs have enjoyed strong performance in the recent past. How will they perform through this downturn?

Mez Birdie: REIT stocks have outperformed the U.S. stock market for three consecutive years now, as real estate offers a safer capital haven than equities. Since 2000, REIT returns have beaten the S&P index and provided average returns of 25.6 percent in 2000, 15.5 percent in 2001 and 5.4 percent in 2002. As we know, S&P, Dow Jones and other stock market indexes have posted substantial negative returns during the same three-year period. Since REITs are basically "income" stocks versus "growth" stocks, they are less volatile and considered "defensive" stocks.

JPM®: Will the REIT market continue to consolidate? If so, to what degree?

Birdie: The market capitalization of REITs has increased from approximately $9 billion in 1990 to $162 billion in 2002. While consolidation has recently taken place, there are still more than 250 REITs in the marketplace today. Consolidation may make the industry more efficient, but a REIT buying another REIT has to have access to capital and buy at a discount to net asset value in order to gain real advantage.

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JPM®: Are today's REITs looking to outsource property management?

Birdie: While REITs generally "self manage," some property management functions are outsourced to top qualified service providers who are "relationship-oriented" as opposed to "transaction-oriented."

State-of-the-art accounting and software systems, excellent service, professional designations and leasing agents are all a given, as REITs are looking for service providers who can understand and solve their challenging real estate management needs.

JPM®: Will investors who have jumped into real estate continue to include real estate in their portfolios once the economy recovers?

Birdie: While some investors may reduce their REIT exposure when the equities market rebounds, REITs will still be part of most investors' portfolios because real estate, in general, will continue to perform well as an asset class in 2003 and beyond.

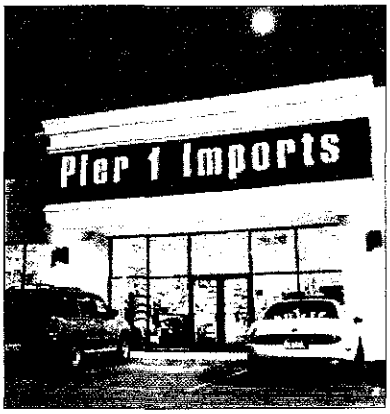
REITs do not pay taxes like a corporation, thus the only taxation is at the investor level. In some ways, the recent downturn had a positive effect on real estate, as non-real estate investors now have tasted the positive benefits of directly or indirectly investing in real estate. REITs have established credibility as many large pension and retirement funds offer REIT stocks as core options in their portfolio.

JPM®: The 1031 Exchange market would seem to offer some opportunities today. What is your view of this market?

Birdie: The motivating factor for a 1031 real estate investor is to defer payment of taxes on gain of sale. Hence, the investor is willing to pay more for a purchase of replacement property as the investor considers "paying himself" instead of paying Uncle Sam. A credit tenant leased (CTL), quality "net leased" 1031 property is the hottest product in the exchange market today. This type of property is the safest real estate investment, for which investors are willing to pay premium prices.

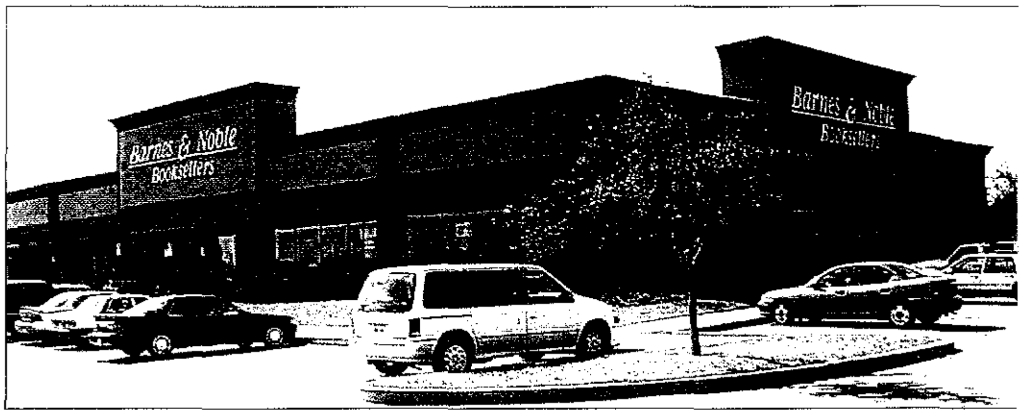
JPM®: Where are cap rates right now and how are they affecting the 1031 Exchange market?

Birdie: Cap rates are 100-150 basis points below "normal market conditions" and the demand for quality 1031 properties far exceeds the supply available for sale. Unless a current low interest rate is locked-in for a certain period, in the long run, investors run the risk of rates rising, thereby affecting spreads and yields on the property in a negative way. Today's environment of low cap rates and appetite by 1031 buyers is allowing sellers to dispose marginal real estate that would be difficult to sell under normal circumstances. Thus, buyer beware.



Photos courtesy of Mez Birdie, CPM

Real estate, as an asset class, is outperforming the U.S. stock market.



Investors are paying premium prices for credit tenant leased 1031 properties, the hottest product in today's exchange market.

JPM®: How has the tenant-in-common (TIC) ruling affected the 1031 market?

Birdie: Although the TIC structure has been around for sometime, the IRS ruling in March 2002 has affected its growth in a positive manner. Specifically, IRS Revenue Procedure 2002-22 has clarified circumstances under which the TIC structure is a viable 1031 Exchange option. A TIC interest represents co-ownership between investors in a property and is especially suited to the 1031 market because properties can be identified and closed in accordance with strict 1031 time limits. TIC investors receive separate deeds to undivided interests and are able to own fractional interests in potentially higher-valued properties. The resulting advantages may include increased net cash flow, tax write-offs, appreciation and professional property management.

JPM®: What, if any, are the downsides of the TIC phenomenon?

Birdie: Financing is complex and complications in co-ownership can arise due to death, bankruptcy and estate/trust issues. The biggest downside occurs when a transaction falls through and prevents an investor from successfully completing a 1031 Exchange in the required time period. If an investor fails to close on the Exchange, he is forced to pay sizable capital gains tax on the original property sale. The IRS gives an Exchange investor 45 days to identify a Like-Kind Exchange property from the closing date on the sale of the original property (down leg), and 180 days to close on the purchase of the new property (up leg). The greater the number of TIC investors involved in a property, the greater the risk. Legally, the maximum number of TIC investors is 35. Additionally, investors may have difficulty selling out of a TIC, unless a prior arranged exit strategy is in place. ☐

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