Have REITs Helped Tame Texas Real Estate?

Texas is known for its turbulent real estate cycles. More than once, a run-up in the sector has suddenly reversed course, stranding investors with massive amounts of overvalued but underoccupied real estate. Newfound wealth has often vanished nearly as fast as it appeared. However, despite Texas' propensity for cyclical extremes, evidence suggests its real estate markets may now be less volatile than in the past.

The Texas real estate landscape has changed considerably in the last two decades. Some changes have been unmistakable. For example, gone are the days of misguided tax policy, which granted investors large tax breaks for developing real estate. Gone also are the days when unbridled savings and loans could throw money at virtually any project. Such notable changes have added stability to Texas real estate markets.

Other changes have been more subtle but not without effect. Of particular interest has been the shift of ownership from private hands to publicly held real estate investment trusts (REITs). REITs are real estate companies that own and manage properties and whose shares are traded on a public stock exchange. In general, REITs can enhance market discipline by improving efficiency, increasing liquidity and discouraging unjustified lending. They do this, in part, by facilitating improved information gathering and sharing. While the proportion of total real estate owned by REITs is still modest, economic intuition suggests that the increased number of REITs might help moderate market volatility.

This article discusses REIT activity and trends at the national level. It then explores the growth of REITs in Texas and analyzes Texas REIT performance against the overall equity market. Finally, it enumerates some of the differences between the current Texas real estate environment and that of the 1980s and examines REITs' effect on the state's real estate markets.

REITs in the United States

A REIT engages in some combination of buying, selling, operating or financing income-producing properties. Such properties can include apartments, retail establishments, office buildings, hotels and warehouses.

REITs differ from traditional real estate companies—which are often private partnerships—because their shares are publicly traded. Additionally, REITs are required by law to pay at least 90 percent of taxable income to shareholders in the form of dividends.[1] In return, REITs can deduct dividends from their corporate tax bill. As a result, most REITs distribute all of their taxable income as dividends, avoiding corporate income taxation. (They are still required to pay property tax.)

Congress established REITs in 1960 to enable a wider segment of the investing public to own income-producing real estate. In effect, REITs make real estate ownership more accessible by breaking large fixed assets into bite-size shares and lowering other barriers to investment. With the advent of REITs, shareholders are able to extract the benefits of owning professionally managed real estate without being subject to the risks of just a single property. REITs also provide liquidity to their investors. In contrast to private partnerships, REIT investors can quickly dump real estate holdings by selling their shares in the market.

REITs fall into three functional categories. Equity REITs acquire and operate income-producing properties. Mortgage REITs lend money to real estate operators. And hybrid REITs do some of both. In theory, a management team carries out the REIT's daily operations, and a board of directors makes investment decisions.[2] However, in practice, directors often just sign off on investment decisions already made by management.

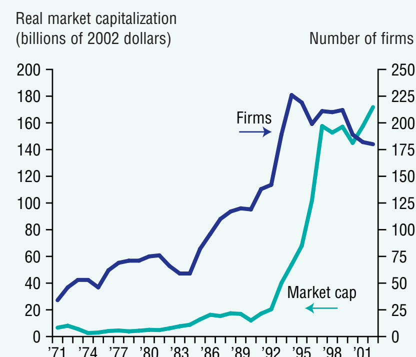
Even though REITs emerged over 40 years ago, it was some time before the industry picked up steam. Early growth was limited because REITs were only allowed to own real estate, not manage it. This arrangement curtailed growth because investors were reluctant to entrust property operations to a third party with possibly misaligned incentives. Also, interest in REITs stumbled initially because private real estate investors could exploit a tax shelter not available to REITs; consequently, REITs were less able to compete for capital.

With passage of the Tax Reform Act of 1986, the picture changed. The legislation boasted a two-pronged adjustment to real estate investment, opening up the sector to brisk growth. First, it curtailed opportunities for tax shelters in private real estate investment. Second, it expanded REITs' autonomy by permitting them to manage and operate properties, not just own them. When the fallout from the 1980s real estate depression and the savings and loan crisis finally began to clear, REITs were poised for rapid growth.[3]

Starting in the mid-1980s, the number of REITs trading on the New York, American and Nasdaq exchanges began a steady upward trend, peaking at 226 in 1994, then scaling back to 180 by 2002.[4] The increase in REITs was followed by a dramatic upsurge in the sector's overall market capitalization. Between 1992 and 2002, total REIT market capitalization increased more than eightfold (*Chart 1*).[5] Growth was so dramatic that by 2001, REITs controlled roughly 15 percent of the $2 trillion worth of investment-grade

Chart 1

REIT Growth over Three Decades



SOURCE: National Association of Real Estate Investment Trusts.

Table 1

U.S. Real Estate, Then and Now

	1981–90	1991–2000
Inventory added (million square feet)	1,319.7	406.7
Increase in inventory	98%	15%
Absorption (million square feet)	887.3	647.9
Inventory added/absorbed	149%	63%
Rental rate increase in nominal dollars	7%	51%
Occupancy change	–13%	11%

SOURCES: Torto Wheaton Research; Crescent Real Estate Co.

Historically, real estate supply and demand have often marched to their own drummer.

commercial properties in the United States.[6] In fact, by 2001 REITs controlled 40 percent of the equity portion (as opposed to debt) of institutional real estate, up from around 1 percent in 1993.[7]

The REIT Modernization Act of 1999 gave REITs new opportunities to increase earnings. The act enabled REITs to offer more sophisticated services, thus helping them maintain a competitive stance in the marketplace. The progression of legislation since REITs' inception in 1960 has helped the industry flourish.

Coincident with REIT growth was a more controlled real estate environment throughout the 1990s. New inventory relative to absorption was more measured in the 1990s than the 1980s, and rent growth was more robust (*Table 1*).

Some observers have argued that during the 2001–02 downturn, REITs helped prevent a return to the overcapacity problems that plagued the 1980s.[8] As the industry matured, improved information flow and transparency helped discourage inordinate construction. Despite stratospheric stock market hype during the 1990s, new office construction never reached the excesses of the '80s. In fact, during the recent weakness in national real estate markets, new completions dropped off before vacancy rates even started edging upward. During the '80s, vacancy rates shot up over 20 percent before completions ever began to decline (*Chart 2*).

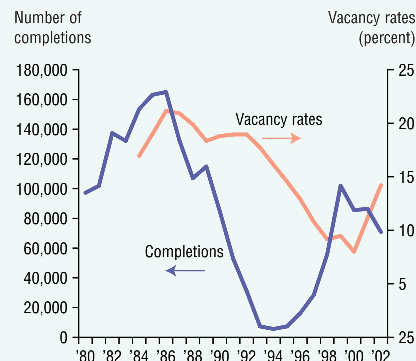
Sharp corrections are still possible, however. Real spending on U.S. nonresidential building has already declined 26.8 percent since peaking in 2001 (and will likely decline more before bottoming out), just below the total decline of 33.3 percent during the 1990–91 recession.[9] While this reversal has damaged the real estate sector, it is also a sign of increased market nimbleness and improved ability to react to changing conditions. Much of the run-up in spending in the late '90s was driven by stock market hype. That the industry has been able to retrench so quickly helped avert a more severe overbuilding problem.

Historically, real estate supply and demand have often marched to their own drummer. However, as REITs own and manage more real estate, there is likely to be a tighter alignment between supply and demand. REITs raise much of their capital through equity markets, making it more difficult for them to pursue irrational investment plans. In addition, REITs must always act to preserve stock value and eschew activities that might undermine it. Analyst and investor

Chart 2

Office Vacancy Rates and Completions

Sum of U.S. metropolitan markets



SOURCE: Torto Wheaton Research.

Table 2

Top 10 REIT Markets

		Total market cap (millions of dollars)	Number of REITs	Total employment	Average annual dividend per share (dollars)	Average dividend yield (percent)
1	Illinois	27,676	11	15,083	1.65	6.5
2	California	24,197	29	9,375	1.51	6.6
3	New York	24,158	25	5,975	1.29	7.1
4	Maryland	9,831	13	7,913	.87	4.2
5	Texas	8,413	10	3,067	1.86	8.4
6	Massachusetts	7,939	5	925	1.46	6.3
7	Pennsylvania	5,559	10	1,881	1.46	7.7
8	Tennessee	4,178	7	15,834	1.60	7.5
9	Georgia	4,077	7	3,123	1.38	7.4
10	Florida	3,843	8	1,129	1.09	6.0

NOTE: Tennessee's unusually high REIT employment is attributable to a single company, National Health Reality, which owns 23 health care facilities.

SOURCE: Bloomberg.

scrutiny of REITs has given the market the ability to quickly punish firms with investment agendas that aren't justified by the fundamentals. While REITs won't erase the sector's cyclical makeup, their presence may be contributing to increased market solidity.

REITs in Texas

REITs are playing an increasingly important role in Texas real estate as well. The state is ranked fifth in the nation in total number of operating REITs, fifth in combined REIT market capitalization and seventh in total REIT employment. The biggest REIT markets are Illinois, California and New York (*Table 2*).

Texas-based REITs are all headquartered in either the Dallas/Fort Worth or Houston metropolitan areas, though their real estate holdings may be located anywhere in the country. Some REITs with operations and headquarters in Texas are actually incorporated in Maryland because of its more favorable tax and regulatory environment for REITs. Most Texas REITs own and operate various types of real estate, including office, retail, multifamily, restaurant and hotel properties. One Texas REIT, Capstead Mortgage Corp., is a mortgage REIT that loans money to real estate owners and operators. (See the box titled "Some Large Texas REITs.")

The effect of growing REIT numbers in Texas has not been trivial. For one, the sector has made efficiency gains. Because shares are traded on public exchanges, investors receive real-time feedback on the sector's relative well-being. Any negative information, such as oversupply risks, gets factored into equity prices, helping safeguard against unrealistic zeal and lessening the chance of the kind of market blindsiding that has afflicted Texas real estate in the past.

The growing incidence and size of REITs have also helped the Texas real estate sector capture economies of scale. Such economies occur when the average cost of a firm's product declines as the firm expands the size of its operations.

Some Large Texas REITs

The following list provides a snapshot of some prominent REITs based in Texas. Size and core business strategy were the basis for selection to the list.

Name	Location	Employees	Investment strategy	Market cap (October 2002)
Camden Property Trust	Houston	1,750	Mid- to upper-market multifamily properties in nine Sunbelt and Midwestern states.	$1.26 billion
Capstead Mortgage Corp.	Dallas	16	Real estate-related assets such as single-family residential mortgage-backed securities issued by government-sponsored entities. Does not have a core geographic focus.	$290 million
Crescent Real Estate Equities Co.	Fort Worth	794	Office, resort/hotel, residential development and temperature-controlled warehouses. Holdings concentrated in Dallas/Fort Worth and Houston.	$1.62 billion
FelCor Lodging Trust	Irving	61	Hotel properties in the United States, mainly Texas, California, Florida and Georgia, and in Canada.	$582 million
Prentiss Properties Trust	Dallas	650	Office and industrial properties in the Midwest, Southwest, Northern Virginia, Northern and Southern California.	$1.04 billion
U.S. Restaurant Properties	Dallas	181	Operates 811 restaurant and service station properties in 48 states.	$257 million
Weingarten Realty Investors	Houston	265	Retail properties and, secondarily, industrial holdings in the southern half of the United States.	$1.95 billion

NOTES: Technically, La Quinta Corp. of Irving and Wyndham International of Dallas are REITs because their primary Standardized Industrial Code is 6798-01, or "real estate investment trust." However, these two companies were excluded because their operations differ substantially from the REITs mentioned. The REITs above have holdings in one or more of the office, industrial, retail, multifamily or hotel market segments. In contrast, La Quinta and Wyndham focus exclusively on hotel ownership and management, effectively operating as large national and international hotel chains. As such, they fall outside the scope of this article. Relatively small REITs were also excluded, including Transcontinental Realty Investors, Dallas; PMC Commercial Trust, Dallas; Income Opportunity Realty Investors, Dallas; FFP Real Estate Trust, Fort Worth; Liberté Investors, Dallas; Texas Pacific Land Trust, Dallas; and AMRESCO Capital Trust, Dallas.

SOURCES: Bloomberg; Yahoo! Finance; Multex.com, Inc. Market Guide.

REIT stocks in 1998 when real estate markets weakened (*Chart 3*).

Finally, the requirement that REITs distribute 90 percent of income through dividends builds in an added measure of discipline because they can only accumulate a limited amount of income to fund future growth. The result is that REITs must appeal to capital markets whenever they want to raise more debt or equity funding. They can't fund their future investments with internal sources.[13]

Over the last few years, stock prices of Texas REITs have fared relatively well compared with the overall market (*Chart 4*). From January 2000 to June 2002, stock price appreciation of the largest Texas REITs easily outperformed the Standard & Poor's 500. However, extending the horizon back to January 1997, only Camden Property Trust, Weingarten Realty and Prentiss Properties Trust outperformed the S&P index. Texas REITs outperformed the market during the tech bust but underperformed it in the boom years.

Total returns to REIT shareholders are a combination of stock price appreciation or depreciation and dividends paid out. Table 3 shows a variety of variables used to measure REIT performance. Dividend yields for the largest Texas REITs have been strong in the past year. Total returns for Texas REITs have been mixed but trending downward.

REITs capture economies of scale through brand imaging, access to lower-cost capital, management productivity and increased bargaining power with customers and suppliers.[10] For example, Texas REITs can spread out insurance costs by purchasing umbrella insurance for multiple properties. Such risk mitigation isn't generally feasible for firms with relatively small numbers of properties.[11]

Another effect of higher REIT numbers in Texas has been added discipline through improved monitoring of capital flows to real estate. Historically, lending institutions such as savings and loans, insurance companies and banks committed a pool of money to real estate at the beginning of each year, regardless of any changes that might take place in overall real estate conditions. Such dedicated lending was unresponsive to swings in the marketplace and often led to overinvestment. Real estate companies still get loan commitments that can be insensitive to changing real estate conditions; however, this kind of lending is less prevalent than it used to be.[12]

With REITs, when real estate indicators signal weakness in the fundamentals, equity markets adjust and capital shifts away from the industry. Thus, money is free to flow to the most promising opportunity, not some predetermined investment. This phenomenon has helped fill the long-standing demand for liquidity in what has otherwise been an illiquid industry. Texas REITs have helped improve market sensitivity to changing conditions, as shown by capital flight from

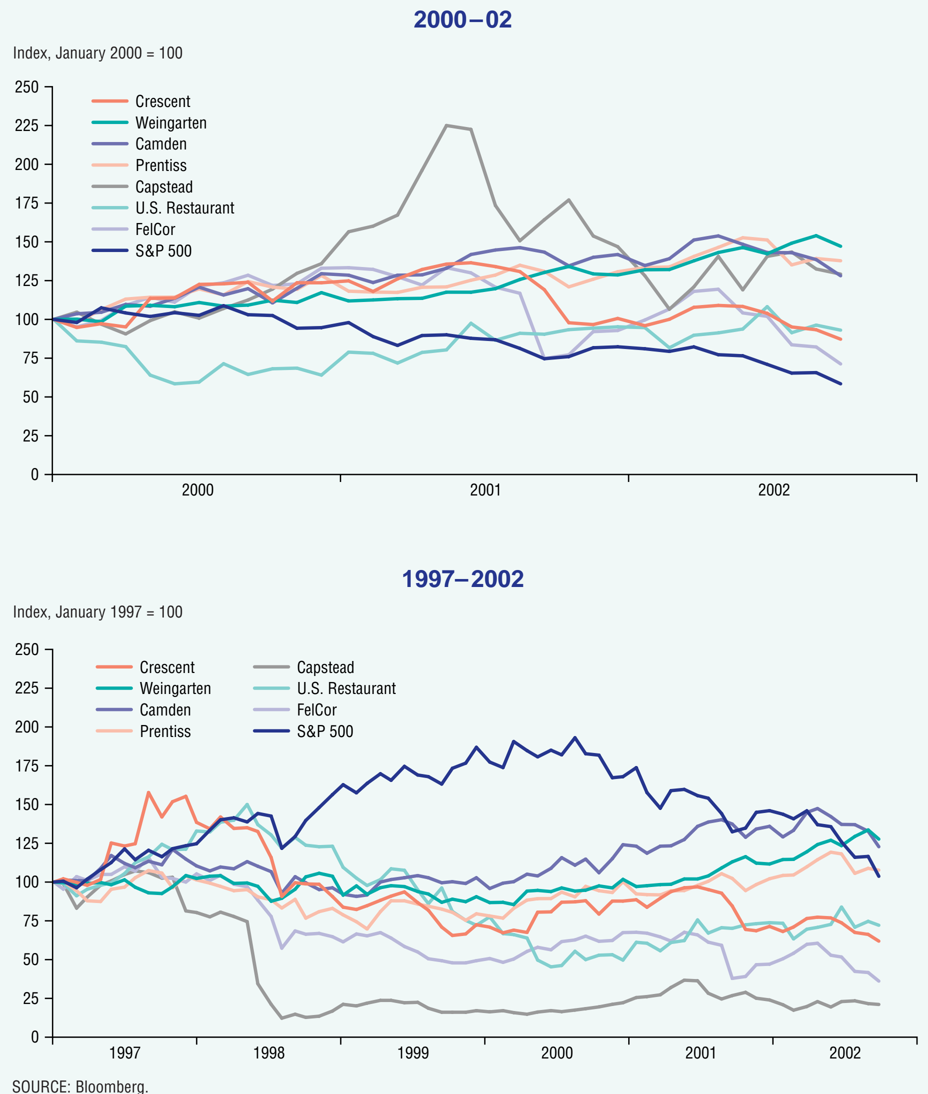


Table 3

Texas REIT Performance

Name	Ticker	Stock price*	Total return (year-to-date, percent)	Dividend yield (percent)	Funds from operations (2002E) ($/share)	Multiple (stock price/FFO)	Net asset value 2002:2 ($/share)	Prem/(Disc) to NAV (percent)
Camden Property Trust	CPT	31.3	–9.5	8.0	3.4	9.2	33.3	–5.9
Capstead Mortgage Corp.	CMO	20.5	—	25.3	5.3	4.0	—	—
Crescent Real Estate Equities Co.	CEI	15.6	–7.8	9.6	2.0	7.8	20.8	–25.1
FelCor Lodging Trust	FCH	11.1	–31.1	5.4	2.1	5.2	18.4	–40.0
Prentiss Properties Trust	PP	26.6	2.8	8.4	3.4	7.9	32.4	–17.9
U.S. Restaurant Properties	USV	12.9	–4.7	10.2	1.4	9.2	13.3	–2.9
Weingarten Realty Investors	WRI	37.2	21.5	6.0	3.2	11.5	30.9	20.4

* As of October 25, 2002.

NOTES: Total return includes stock price appreciation and reinvested dividends. Dividend yield is annualized, year-to-date dividends divided by stock price; this variable effectively gives an interest rate yield on a stock purchase. Funds from operations (FFO) is analogous to corporate earnings but excludes gains or losses from sales of property or debt restructuring and adds back depreciation of real estate. Multiple is analogous to corporate price/earnings ratio, or what the market is paying for $1 of earnings. Net asset value (NAV) is a per share measure of the market value of a REIT's net assets. Prem/(Disc) to NAV [(stock price/NAV–1) × 100] is the premium or discount of the current share price associated with the net asset value of the company.

SOURCES: Salomon Smith Barney; Yahoo! Finance.

During an economic downturn, high-dividend stocks are generally favorable for a portfolio. However, the current data point to a rather weak REIT market going forward. Fundamental real estate conditions in Texas have grown increasingly tenuous in recent quarters. Vacancy rates are up everywhere in Texas since last year, and rental rates have fallen. Until job growth returns, signaling an increase in demand for space, excess capacity will continue to exert downward pressure on Texas REIT returns.

This Time It Really Is Different

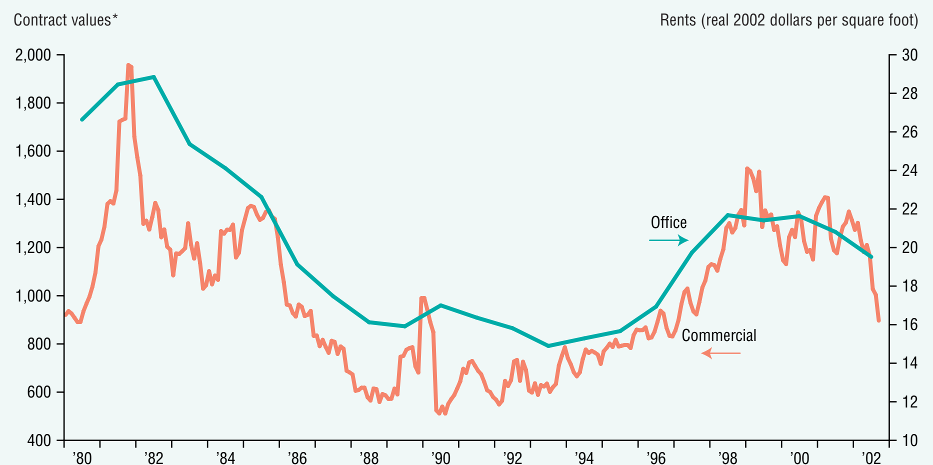
Still, the current weakness in Texas real estate is relatively benign by historical measures. Even though commercial and residential markets have both taken hits in the past 18 months, the situation is less extreme than the 1980s increase and subsequent derailment (*Chart 5*). During those years, investors watched in dismay as bloated commercial contract values collapsed, office rents gave back half their peak value and residential markets took on a burdensome two-year inventory of homes.[14]

The environment is less severe now. Present weakness, while keenly felt in some sectors, isn't nearly as encompassing as the pall that settled on Texas two decades ago. Much of this is due to the fact that Texas real estate markets haven't had as far to fall this time. In the 1970s, a run-up in oil prices cast a rosy hue on the energy-dependent state economy, and many assumed—unrealistically—that robust energy markets were here to stay. The optimism spilled over to real estate markets, and construction crews kicked into gear.

Later, in the 1980s, federal policy gave tax advantages to investors willing to finance real estate projects, feeding the building frenzy. At the same time, deregulation freed savings and loans to invest in service corporations, disregard geographical considerations in loan decisions and lend up to 40 percent of assets in commercial real estate. But the new legislation failed to implement higher deposit insurance premiums for savings and loans with precarious loan portfolios.[15] Exacerbating the problem was the failure of federal and state regulators to shut down insolvent thrifts, which were financing real estate projects that would have otherwise gone unfunded.

Chart 5

Real Texas Construction Contract Values and Real Rents



* Seasonally adjusted, real five-month moving average.

SOURCES: McGraw Hill Construction/F.W. Dodge; Torto Wheaton Research.

The combination of these forces rocketed Texas real estate markets to dizzying heights. But the fundamentals were never in place to support the rapid growth. Eventually the party ended (helped by the Tax Reform Act of 1986), leaving in its place a huge disequilibrium between supply and demand. The consequent imbalance sent property values and rents to damaging lows and dealt massive losses to real estate institutions.[16]

In contrast to the overhyped '80s, a speculative building free-for-all didn't occur in the late '90s, and the current downturn has been far less pronounced. Recent jumps in subleasing and vacancy rates, along with liberal rent concessions, have been somewhat isolated, materializing in tech-laden areas—such as Austin, the Dallas suburb of Richardson and Irving's Los Colinas business center—and not as much in the overall marketplace.

Even though excessive growth expectations seduced equity markets in the late 1990s and an office glut resulted, the memory of the '80s real estate meltdown helped curb Texas builders. What's more, significant changes in the way real estate gets funded helped control the recent buildup. During the 1980s, Texas lending institutions loaned money to practically anyone with a hammer and saw. This time, regulatory fixes prompted tighter scrutiny of capital flows, increased discipline and more transparency. Also, in reaction to 1980s abuses, banks now require a higher equity stake from potential loan recipients. Such hurdles have curbed frivolous lending.

In addition to these changes, the increased prominence of REITs in Texas may have helped contribute to a less frenetic buildup. Markets can punish REITs for ill-advised investment strategies by shunning REIT stocks. This dynamic was not available in the 1980s because REITs had not yet become a material part of the real estate market; they didn't really take off until the early 1990s. The gradual shift of real estate assets from private partnerships to public REITs has increased the sector's transparency, discipline and sensitivity to market conditions.

Still, the extent to which REITs foster increased discipline is contingent on whether markets function correctly in the first place. Accurate information (not corporate book cooking), rule of law (not executive malfeasance) and transparency (not covert and obscure business dealings) are essential to well-functioning markets. Without these, any positive effects from REITs would be negligible.

REITs' Continuing Influence

That the recent boom and bust in technology markets has not yielded a 1980s-like crash in real estate markets suggests some things have changed in Texas in the last two decades. The '90s boom never matched the skyscraping '80s, and it is unlikely the current downturn will be as protracted as the one that gripped the state from 1985 through the early 1990s. Rolling back perverse tax incentives and fixing the savings and loan problem were largely responsible for the improvement. Additionally, the increased incidence of REITs owning and managing real estate in Texas and the subsequent availability of more timely information may be having a positive effect.

REITs are not a fail-safe mechanism to avert irrational run-ups in real estate markets. If nothing else, the 1990s tech boom illustrated that investors still get caught up in bubble markets. It's too early to tell what ultimate effect REITs will have on the marketplace. Evidence in their favor is insufficient, and more research is needed; plus, they still make up a relatively small part of the overall market. But REITs have the potential to enhance the role of market discipline in real estate finance. They can also help improve funding and investment controls and add efficiencies and liquidity to the market.

Historical examples of misalignment between fundamental real estate conditions and investor decision-making abound. Significant improvements in real estate markets over the past 20 years have contributed discipline to the real estate sector, however. As part of these changes, restraint imposed on REITs through the threat of punishment in the equity market has likely contributed to increased discipline in the industry.

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Notes

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1. Shareholders still have to pay taxes on dividends at the individual level.
2. National Association of Real Estate Investment Trusts (2002), "Frequently Asked Questions about REITs," www.nareit.org.
3. National Association of Real Estate Investment Trusts (2002), "The REIT Story," www.nareit.org.
4. Only two-thirds of REITs trade on major exchanges, according to NAREIT; others trade on smaller exchanges. The drop-off in REIT numbers starting in 1994 is partially attributable to merger activity.
5. Despite strong growth among REITs, the sector's $172 billion market capitalization amounts to only 2.1 percent of the S&P 500's $8.2 trillion.
6. Elizabeth Stanton (2001), "REITs Rewarding Investors," *Chicago Sun-Times*, Aug. 5.
7. Rosen Consulting Group, Lend Lease Real Estate Investments.
8. Christine Perez (2001), "September 11 Effect on Insurance to Benefit REITs," *Dallas Business Journal*, Dec. 14, and Samuel Zell (2001), "Focus on the Economy: This Time It's Different," *Real Estate Issues*, July 1.
9. U.S. Census Bureau.
10. Shiawee X. Yang (2001), "Is Bigger Better? A Re-examination of the Scale Economies of REITs," *Journal of Real Estate Portfolio Management*, Vol. 7, no. 1, pp. 67–77.
11. Perez (2001). The ability of REITs to continue to capture economies of scale will likely get better. Average REIT size has trended up in recent years, and there has been growing pressure for consolidation. National mergers and acquisitions in 2001 were almost as numerous as in the previous three years combined. Some analysts predict that a third of REITs will disappear or be acquired before the sector reaches equilibrium. See Robert Burgess (2001), "Size Lends Weight," *Chicago Sun-Times*, May 20.
12. Zell (2001).
13. Mike Grupe, National Association of Real Estate Investment Trusts, personal communication.
14. Steve Brown (2002), "Report: Area Home Prices May Fall," *Dallas Morning News*, April 23.
15. An upward adjustment in such premiums would have likely curbed unjustified lending.
16. See Robert A. Eisenbeis, Paul M. Horvitz and Rebel A. Cole (2002), "Commercial Banks and Real Estate Lending: The Texas Experience," *Journal of Regulatory Economics* (forthcoming). See also Bert Ely, "Savings and Loan Crisis," *The Concise Encyclopedia of Economics*, www.econlib.org/library/Enc/SavingsandLoanCrisis.html.