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REIT's Are the Future of Real Estate Investment

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Back in 1989, when I moved to San Diego to get into the commercial real estate industry, local developers built and owned most of San Diego's commercial real estate. Names like Oliver McMillin, The Hahn Company and The Koll Company dominated the landscape. Then, the real estate recession of the early-mid 90's brought much of that to a close, with assets reverting back to lenders through foreclosure, or to the RTC (Resolution Trust Company) through the seizure of much of the Savings and Loan industry. There was no appetite for investors or lenders to put capital into commercial real estate thereafter for many years.

However, real estate entrepreneurs didn't sit idle during the 1990's, and the capital markets and investment bankers didn't either. While REIT's (Real Estate Investment Trusts) had been in existence for about three decades, the mid-1990's propelled REIT's into what they are now. Individual investors, pension funds and life insurance companies had all been badly stung by buying into individual properties in the 1990's. Those investors still wanted the real estate asset class in their portfolio, but didn't want the risk concentration of any one building or project, or the lack of liquidity inherent in commercial real estate assets. Meanwhile, there were billions of dollars of foreclosed and seized assets that could be bought for half off, or less. Thus, the supply of real estate capital converged with the demand for real estate capital, and the REIT sector took off. As reported by REIT.com in 1990, there were 58 equity REIT's in the U.S. with a combined market cap of $5.5B, and in 2010, there were 126 REIT's with a combined market cap of $360B.

A REIT is a public entity that raises capital from a stock offering, just like any other company would. However, while most public companies use that capital to fuel their R&D, sales and marketing and the expansion of their operating business, for a REIT, it's the underlying property asset portfolio that is being taken public. The capital raised is generally used to acquire even more real estate assets. The public is investing in the quality of the assets themselves, and most importantly, the cash flow from those assets. What is so attractive to investors in REIT's is that a REIT pays no corporate tax, so long as at least 90% of a REIT's taxable income is distributed to shareholders through dividends. Thus, investors get a cash dividend from the stock, and also enjoy the upside of capital gains from the growth of the stock.

To a REIT, it's all about amassing assets to drive income. This is why REIT's are generally best positioned to fund tenant improvements and building upgrades, as they will often trade capital investment in spades for the increased income they can derive through long term rents. REIT's have been incredibly stable through this recession of the last three years. With typically low debt and broad diversity of assets (both in number of assets and geography), a few empty buildings do not kill a REIT. Just to put it in perspective, Kilroy Realty, the second largest owner of property in San Diego County, has 141 buildings totaling 14M square feet from San Diego to Seattle. Alexandria Real Estate Trust, one of the largest players in biotech facility ownership, has 167 buildings totaling 13.7M square feet from San Diego to Boston. While property ownership structures of the past would have been wiped out during this recession, REIT's have continued to raise capital, have been aggressive in their leasing programs, and have generally seen their stock prices recover.

REIT's generally have a long haul view of their commercial real estate investments, and have the staying power to implement major campus remodels and building improvements that will last for many decades. Most of the remaining large tracts of quality buildable land in the central San Diego region are owned by REIT's, waiting for larger users to come along that might need a campus, or for a market recovery in which to build new spec buildings.

While I am not an investor in REIT's, to avoid any conflicts of interest with my business of representing corporate tenants in their leases, institutional real estate investors should be taking a close look at the opportunities in REIT stocks. I have seen billions of dollars of public pension fund money wiped out over the last 4 years due to pension funds directly investing in commercial real estate buildings and projects. Pension funds have less expertise in operating real estate, thinner local operating staffs (if any at all) and less market visibility to be making direct investments in commercial real estate. By owning or investing in single-asset buildings or projects, there is also significant market-timing risk related to when an investor might need to get out of the real estate. Pension funds have been net sellers of real estate over the last three years, as they have faced loans maturing and the need to rebalance their portfolios.

Investment in REIT's offers the ability to sell in an instant, as they are publicly traded stocks, and also offers a great way to diversify a portfolio. While one REIT in itself offers diversity due to the number of buildings it might own, a portfolio of REIT's can offer industry, geographic and product diversity. There are REIT's separately specializing in retail, industrial or office product. There are REIT's that operate separately on the west coast or east coast. There are REIT's like Alexandria, Biomed Realty and HCP that focus only on life science real estate. There are even REIT mutual funds if you don't have time to do the research on individual REIT's. REIT's are the future of real estate investment!

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