

WHAT ABOUT EQUITY REITS?

We have discussed why all-equity capital structures are more efficient for leased property than debt-encumbered capital structures. In the case of commercial real estate, equity REITs constitute an easy investment alternative to direct property ownership. This raises an obvious question: should real estate investors take the easy approach and invest in commercial real estate indirectly through equity REITs?

There is a short answer to the question and a long answer. The short answer is that equity REIT shares do not represent investment interests in all-equity capital structures for leased property. Virtually all equity REITs use debt liberally (see [10]): mortgage debt at the property level and unsecured debt at the corporate level. Accordingly, REIT investment portfolios are capitalized inefficiently.

The long answer involves financial reporting. GAAP is designed for conventional operating companies, not investment/operating company hybrids. For companies that make a business of investing in leased property, GAAP leaves accounting loopholes that allow the companies to withhold critical investment information from investors. Exploitation of such loopholes has been a standard industry practice since the REIT industry began, see [2].

Valuation of REIT shares begins with valuation of the investments held by REITs. Award-winning research has shown that REIT managers have both tendencies and incentives to overpay for property, see [2]. This implies that REIT investors should not rely on book value as a measure of asset value. However, prospective REIT investors do not have any viable alternative.

As discussed, leased property has a prominent fixed-income component based on the leases. Accurate property valuation depends on accurate valuation of the component. For most types of leased property, accurate valuation of the component requires access to information about the leases and lessee creditworthiness.

REITs only disclose information that is required by regulators for financial reporting purposes. The SEC and GAAP require publicly traded companies to report book value and income, but not information about leases or lessees of company property. Book value reflects total asset acquisition cost and income reflects total current rent. These disclosures imply nothing about leases and not much about future rent. Accordingly, neither investment analysts nor public investors have the information needed to value the fixed-income component of REIT investment portfolios.

The quality of financial reporting by publicly traded American companies emerged as a major economic issue in 2002. The list of companies that violated the letter of GAAP financial reporting requirements is significant but short. The litany of companies that tested the letter of the requirements and violated their spirit is longer and includes numerous well known energy, hi-tech and financial corporations, see [5], [6], [7], [11].

GAAP loopholes allow investment companies in leased property to violate the spirit of the reporting requirements. The REIT industry has taken advantage of the opportunity for 40 years. Accordingly, public REIT shareholders are investing in the proverbial pig in a poke. Until the financial reporting loopholes for REITs are closed and REITs comply with the spirit of financial disclosure requirements, prospective investors in leased property have more prudent investment alternatives.