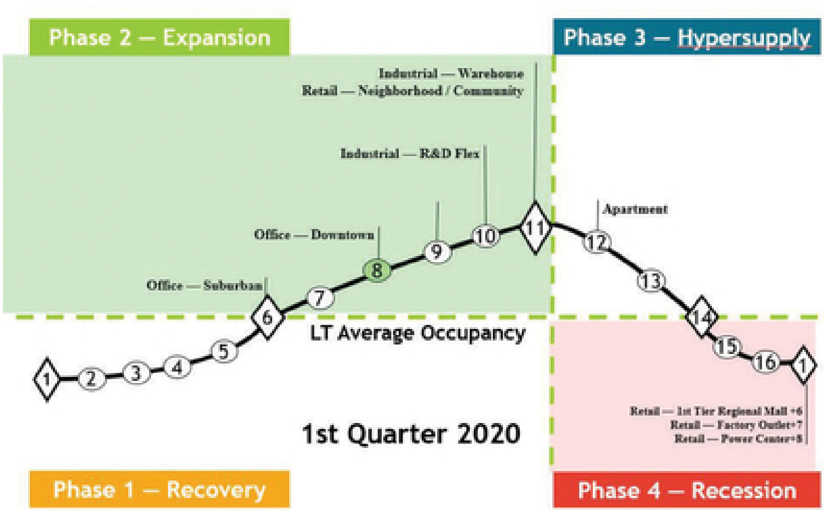
# Educated REIT Investing

## The Ultimate Guide to Understanding and Investing in Real Estate Investment Trusts


Stephanie Krewson-Kelly
Glenn R. Mueller
*with* Merrie S. Frankel and Calvin Schnure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*To my son, William, and my husband, Matthew. Thank you for indulging my passion for "The Three R's": reading, writing, and REITs!*

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*To Jan for loving and living with your type A husband these last 44 years.*

# Contents

# Foreword

Steven A. Wechsler
*Nareit President & CEO*

REITs were established by Congress in 1960 to make commercial real estate investment – once available only to the wealthy and large institutions – accessible to all investors. Today, more than 87 million Americans invest in REITs through their 401(k) or other retirement funds.

Even though REITs have grown to become an essential part of the investment universe with an equity market capitalization of approximately $1 trillion, there is room for greater understanding of all that REITs have to offer. Enter *Educated REIT Investing,* which makes the REIT approach to real estate investment easily understandable to investors of all sizes and experience levels.

Stephanie Krewson-Kelly, Glenn Mueller, and their contributors have written a book that delivers a comprehensive window into REIT investment, sharing their insights on everything from how REITs are formed to the fundamentals of REIT stock analysis.

*Educated REIT Investing* explains the benefits of investing in REITs, including the important roles REIT stocks can play in addressing volatility and boosting the performance of investment portfolios. Importantly, the book also introduces readers to the broad spectrum of REIT market segments, explains their business models, and sheds light on their performance in various market conditions.

I have known Stephanie and Glenn for many years, and they are both well equipped to make the case for REITs and REIT investment. Stephanie brings her experience heading investor relations at Corporate Office Properties Trust, a major NYSE-traded office REIT, coupled with her earlier roles as a well-regarded investment banker and REIT analyst.

Glenn is a longstanding member of Nareit's Real Estate Investment Advisory Council who has more than 40 years of real estate industry experience. He is internationally recognized for his Real Estate Market Cycle research and REIT research, his public and private market investment strategies, and his capital markets analysis.

I recommend this book to anyone looking to better understand REITs and real estate investment. Investors new to REITs can read it in its entirety and come away with a comprehensive introduction to REITs, while more experienced investors can also dive into the book for greater understanding of specific topics.

# Preface

Many investors are unfamiliar with equity REITs – the world's largest real estate companies that own income producing properties, such as office, industrial warehouse, retail, apartment or hotel buildings – or with mortgage REITs, which invest in real estate-based (mortgage) loans.

The legislation that created the REIT structure was enacted by the US Congress in 1960 to allow small investors access to large multi-million-dollar and now even billion-dollar properties. In 2016, Standard & Poor's Dow Jones Indices (S&P) and MSCI Inc. (MSCI) created a new Global Industry Classification Standard (GICS) sector called *Real Estate*. Historically, REITs were classified in the Financials sector, but S&P and MSCI determined that real estate should be regarded as a distinct asset class – one that is different from banks and financial institutions. (Note mortgage REITs remained in S&P's *Financials* sector.) The Real Estate GICS sector elevated investor awareness of REITs, broadening their appeal to individuals and institutions.

*Educated REIT Investing* provides the essential information about REITs in an easy-to-understand format, using graphs, illustrations, and examples to make complex or unique concepts comprehensible. Even novice investors can gain a thorough understanding of the REIT market by reading the relevant industry background and simple examples presented in these pages. Part I, An Introduction to REITs, presents basic information that will help investors quickly gain an understanding of what REITs are in order to have more informed conversations with their financial advisors. Part II, Investing in REITs, is more technical in nature, with content geared for individuals who want to analyze and evaluate specific REITs before investing in them. The content in *Educated REIT Investing* is distinctly different from other REIT books – and may still be read cover-to-cover in a day.

Here are a few industry background facts to get started:

- The REIT industry's aggregate equity market capitalization has increased exponentially from a mere $8.7 billion at the beginning of 1990 to $1.3 trillion at the end of 2019 (see Table 1.1).

- Innovations to the REIT structure that eliminated conflicts of interest between management and shareholders helped fuel the industry's growth. Equity REITs were added into the S&P 500 Index in 2001. Since then, REIT shares have attracted an increasingly broader array of investors, including general money managers, pension funds, hedge funds, and individual investors. As a result, the average monthly dollar trading volume for REITs increased from approximately $350 million in 2000 to roughly $8 billion in 2019, providing good liquidity for all investors.
- Along with higher trading volume, REIT stock price volatility also has increased dramatically. While the stock market is emotional in the short run, it is normally logical in the long run. Thus, greater volatility creates greater risk short term, but also greater potential returns long term. Applying good fundamental analysis is very valuable and should be rewarded.
- Despite REITs' historical long-term outperformance over other stocks, most investor portfolios are underallocated to real estate securities. Institutional Investor Allocations to real estate range from 5% to 20% with an average close to 10% – even though the Real Estate asset class is 20% of their investible universe. Also know that home ownership is *not* income producing real estate; people live *in* their homes but must retire and live *on* their investments.

With REITs now in their 60th year and having grown rapidly over the past 30 years, it is surprising that basic information about REITs is not easy to find. Nareit® is a Washington, DC-based organization that represents and advocates for REITs globally. They provide a wealth of information on their website (www.reit.com) that is free, including the ability to receive daily emails and industry event information. They also show quarterly performance information with the Nareit T-Tracker, https://www.reit.com/data-research/reit-market-data/nareit-t-tracker-quarterly-operating-performance-series.

However, if investors don't know about Nareit and its online resources, information on individual REITs and the industry is difficult to obtain. If investors consult their financial advisors, they will still have incomplete information, as each brokerage firm typically has access only to information about the REITs actively covered by their research department. To remedy this information gap, the appendices of this book list the 219 REITs that comprise the FTSE Nareit All REITs Index at the end of 2019, as well as some basic information about each company. The following chapters present information in a progressive manner. Read as much or as little as you require, and welcome to the world of REITs.

*Note: Unless noted otherwise, all prices, total returns, and data used in this book are as of December 31, 2019.*

# Acknowledgments

The following chapters reflect the experience and technical expertise of dozens of REIT industry professionals, whose contributions make this book a unique and invaluable resource for understanding and investing in real estate investment trusts.

Sincere thanks to the following individuals and organizations for their permission to reproduce select material and for the time they invested in editing this book's more technical content:

- John D. Worth, Ph.D., Calvin Schnure, John Barwick, and Christopher T. Drula at Nareit
- Keven Lindemann at S&P Global Market Intelligence
- Kevin T. Gannon and Nancy T. Schabel at Robert A. Stanger & Company, Inc.
- Green Street Advisors
- Michael Lewis, CFA, and Ki Bin Kim, CFA, at SunTrust Robinson Humphrey equity research

At the risk of omitting someone, we would like to thank numerous colleagues at Corporate Office Properties Trust (NYSE: OFC), especially Jack Lopez and Greg Thor for their technical edits to Chapters 8 and 11, respectively, and Michelle Layne, for her general edits to the entire manuscript and her mastery of PowerPoint. Sincere thanks also to the REIT equity research team at BTIG for their edits to Chapter 6. Kudos to Will Azar, Denver University Graduate Assistant, for his edits as "fresh eyes" while learning about REITs for the first time.

Special thanks to David M. Fick, CPA, for providing technical edits and guidance on the evolution, benefits, and risks of operating partnership units (Chapter 8).

Thank you to our family and friends for their love, patience, and support during the months it took to compose this work.

Last but never least, sincere thanks to Nareit's Calvin Schnure (Chapter 7) and Merrie Frankel (Chapter 9), not only for contributing content, but also for their generosity in providing comments and advice on the entire manuscript. It has been an absolute pleasure working with you both.

# About the Authors

**Stephanie Krewson-Kelly's** 26 years of experience in the REIT industry began in 1994 and includes work in investment banking (1994–97) and as an equity research analyst (1997–2009) Since 2011, Ms. Krewson-Kelly has served as vice president of investor relations at Corporate Office Properties Trust (NYSE: OFC), a publicly traded office REIT. Prior to her career in REITs, Ms. Krewson-Kelly worked as an internal auditor for a global corporation headquartered in Paris, France.

Ms. Krewson-Kelly is on the Board of Advisors at the University of Wisconsin's James A. Graaskamp Center for Real Estate (Applied REIT program) and teaches as an adjunct professor of real estate at Franklin L. Burns School of Real Estate & Construction Management at Denver University.

In between retiring from Wall Street and joining her current firm, Ms. Krewson-Kelly wrote *REIT Roadmap: An Insiders Guide to Successful Investing in Real Estate Investment Trusts* (second edition published in 2012 under her maiden name, Krewson; now out of print). In 2016, Ms. Krewson-Kelly wrote *The Intelligent REIT Investor: How to Build Wealth with Real Estate Investment Trusts* (Wiley, 2016).

In 1992, Ms. Krewson-Kelly graduated from the University of Pennsylvania's College of Arts & Sciences and Wharton School of Business, where she earned her respective B.A. in English and B.S. in Economics.

**Glenn R. Mueller, Ph.D.** has 44 years of real estate industry experience, including 37 years of research. Mueller is internationally known for his market cycle research on income producing real estate, his real estate securities (REITs) research, and his public and private market investment strategies and capital markets analysis. Glenn is a professor at the University of Denver's F.L. Burns School of Real Estate & Construction Management, teaching and doing research in development, feasibility, investments, and real estate capital markets. DU's program started in 1938 and offers undergraduate (BS) and graduate (MS, MBA, & PhD) degrees in business RE&CM. He has published 100+ research articles and 110+ quarterly issues of his Real Estate

Market Cycle Reports. He held research positions at Legg Mason Inc., Price-WaterhouseCoopers, ABKB/ Jones Lange LaSalle Real Estate Investors, and Prudential Real Estate Investors.

He is also the Real Estate Investment Strategist at Black Creek Group, Advisory board member at Arden Group, former chairman of the board for European Investor's REIT fund, and a 20-year visiting professor at Harvard. He holds a B.S.B.A. from University of Denver, M.B.A. from Babson College, and Ph.D. in Real Estate from Georgia State University.

PART I

# AN INTRODUCTION TO REITs

Part I of this book begins with very basic information that will be helpful to individuals who have little or no prior knowledge of REITs. Chapter 1 addresses industry size, the different ways REITs are classified, and online resources for learning more about the industry and individual companies. Chapter 2 provides an overview of the benefits of investing in REITs, followed by a discussion of real estate fundamentals in Chapter 3. Chapter 4 discusses REIT dividends in great detail, including how to calculate the current yield and the yield on cost, ways to quickly assess if a dividend is safe, and how dividends generally are taxed at the investor level. Chapter 5 provides an overview of different lease structures associated with various property types that REITs own, followed by a discussion in Chapter 6 of the property sectors and subsectors REITs own and that Nareit® tracks. Chapter 7 discusses mortgage REITs in detail.

These first seven chapters are designed to provide foundational information about real estate as an investment asset, REITs that own different types of real estate, and REIT dividends. The chapters that compose Part II of the book build upon this fundamental knowledge and address the more technical aspects of analyzing and investing in the common shares and fixed income securities that REITs issue.

# CHAPTER 1

# What Is a REIT?

A real estate investment trust (REIT, pronounced "reet") is an entity that receives revenue through owning or financing income-producing property. Similar to other industries, REITs can be private organizations, public but non-traded, or they can be publicly traded on a stock exchange. (Chapter 8 compares the benefits of publicly traded REITs versus private and public non-traded REITs.) By being publicly traded, REITs are similar to mutual funds that are accessible to all investors, who can benefit from receiving real estate income without purchasing, managing, or financing property directly.

Publicly traded REITs are bought and sold like the stock of any other public company. Unique to REITs, however, is their tax status. The *Real Estate Investment Trust Act of 1960* legislation that created the REIT structure exempts companies that qualify as REITs from paying corporate income tax (just like mutual funds), provided they distribute their taxable income as dividends. To qualify as a REIT in the eyes of the Internal Revenue Service (IRS), a company must meet many specific criteria. The most widely known provision is that a REIT must pay shareholders a dividend equal to at least 90% of what would otherwise be taxed as ordinary income. (Chapter 8 highlights the fundamental technical hurdles companies must clear to qualify for REIT tax status.)

Nareit® (formerly known as the National Association of Real Estate Investment Trusts) is the worldwide representative voice for REITs and publicly traded and non-traded real estate companies with an interest in US real estate and capital markets. Nareit's website, www.reit.com, provides investors with educational resources, research, and data and index information, as well as news and information about the industry.

## SIZE OF THE REIT INDUSTRY

As of December 31, 2019, Nareit tracked information on 226 publicly traded REITs with a combined public equity market capitalization (or size) of $1.3 trillion. Table 1.1 presents year-end data on the REIT industry's capitalization going back to 1971. The market capitalization shown excludes operating partnership (OP) units, which are similar to shares of common stock in the REIT, but which are not publicly traded. (OP units are discussed in detail in Chapter 8.) The FTSE Nareit All REITs Index includes 219 of the total 226 REITs tracked; 184 REITs were listed on the New York Stock Exchange (NYSE) and the remaining 35 were listed on either the National Association of Securities Dealers Automated Quotation System (NASDAQ) or the NYSE American (NYSE MKT, and formerly known as the American Stock Exchange [AMEX]). Before delving into the benefits of investing in REITs, investors will find it instructive to understand a few more basics about how these companies are categorized and where information on each can be found.

## CATEGORIES OF REITS

The two broadest categories for REITs – equity and mortgage – are based on the types of investments they make and the nature of their revenues. Equity REITs were included in S&P's *Real Estate* Global Industry Classifications Standart (GICS®) Sector Index when it was created in 2016; mortgage REITs (mREITs) remained in the *Financials* sector. REITs are also classified by the type of property they own, such as office or apartment buildings, and by other means discussed in the following pages. Before buying or selling any stock, investors should know whether the REIT is an equity REIT or a mortgage REIT, and what type(s) of property it owns. Nareit tracks equity REITs according to property type and mortgage REITs according to whether their investments are backed by residential or commercial real estate. Chapters 6 and 7 provide additional information to help investors identify REITs that fit their portfolio objectives.

### Equity REITs

Equity REITs derive the majority of their revenue from rents paid by tenants according to the terms of leases that exist between the REIT (the landlord or lessor) and its tenants (the lessees). These REITs usually have *fee simple*

**TABLE 1.1** Historical REIT Industry Market Capitalization and Total Returns*

| | All REITs | | | All Equity REITs | | | All Mortgage REITs | | | Hybrid REITs | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Year Ended | # of REITs | EMC[a] ($MMs) | Total Return[b] | # of REITs | EMC[a] ($MMs) | Total Return[b] | # of REITs | EMC[a] ($MMs) | Total Return[b] | # of REITs | EMC[a] ($MMs) | Total Return |
| 1971 | 34 | $1,494 | – | 12 | $332 | – | 12 | $571 | – | 10 | $592 | – |
| 1972 | 46 | $1,881 | 11.2% | 17 | $377 | 8.0% | 18 | $775 | 12.2% | 11 | $729 | 11.4% |
| 1973 | 53 | $1,394 | −27.2% | 20 | $336 | −15.5% | 22 | $517 | −36.3% | 11 | $540 | −23.4% |
| 1974 | 53 | $712 | −42.2% | 19 | $242 | −21.4% | 22 | $239 | −45.3% | 12 | $232 | −52.2% |
| 1975 | 46 | $900 | 36.3% | 12 | $276 | 19.3% | 22 | $312 | 40.8% | 12 | $312 | 49.9% |
| 1976 | 62 | $1,308 | 49.0% | 27 | $410 | 47.6% | 22 | $416 | 51.7% | 13 | $483 | 48.2% |
| 1977 | 69 | $1,528 | 19.1% | 32 | $538 | 22.4% | 19 | $398 | 17.8% | 18 | $592 | 17.4% |
| 1978 | 71 | $1,412 | −1.6% | 33 | $576 | 10.3% | 19 | $340 | −10.0% | 19 | $496 | −7.3% |
| 1979 | 71 | $1,754 | 30.5% | 32 | $744 | 35.9% | 19 | $377 | 16.6% | 20 | $633 | 33.8% |
| 1980 | 75 | $2,299 | 28.0% | 35 | $942 | 24.4% | 21 | $510 | 16.8% | 19 | $847 | 42.5% |
| 1981 | 76 | $2,439 | 8.6% | 36 | $978 | 6.0% | 21 | $541 | 7.1% | 19 | $920 | 12.2% |
| 1982 | 66 | $3,299 | 31.6% | 30 | $1,071 | 21.6% | 20 | $1,133 | 48.6% | 16 | $1,094 | 29.6% |
| 1983 | 59 | $4,257 | 25.5% | 26 | $1,469 | 30.6% | 19 | $1,460 | 16.9% | 14 | $1,329 | 29.9% |
| 1984 | 59 | $5,085 | 14.8% | 25 | $1,795 | 20.9% | 20 | $1,801 | 7.3% | 14 | $1,489 | 17.3% |
| 1985 | 82 | $7,674 | 5.9% | 37 | $3,270 | 19.1% | 32 | $3,162 | −5.2% | 13 | $1,241 | 4.3% |

*(Continued)*

**TABLE 1.1** (*continued*)

| | All REITs | | | All Equity REITs | | | All Mortgage REITs | | | Hybrid REITs | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Year Ended | # of REITs | EMC[a] ($MMs) | Total Return[b] | # of REITs | EMC[a] ($MMs) | Total Return[b] | # of REITs | EMC[a] ($MMs) | Total Return[b] | # of REITs | EMC[a] ($MMs) | Total Return |
| 1986 | 96 | $9,924 | 19.2% | 45 | $4,336 | 19.2% | 35 | $3,626 | 19.2% | 16 | $1,962 | 18.8% |
| 1987 | 110 | $9,702 | −10.7% | 53 | $4,759 | −3.6% | 38 | $3,161 | −15.7% | 19 | $1,782 | −17.6% |
| 1988 | 117 | $11,435 | 11.4% | 56 | $6,142 | 13.5% | 40 | $3,621 | 7.3% | 21 | $1,673 | 6.6% |
| 1989 | 120 | $11,662 | −1.8% | 56 | $6,770 | 8.8% | 43 | $3,536 | −15.9% | 21 | $1,356 | −12.1% |
| 1990 | 119 | $8,737 | −17.4% | 58 | $5,552 | −15.4% | 43 | $2,549 | −18.4% | 18 | $636 | −28.2% |
| 1991 | 138 | $12,968 | 35.7% | 86 | $8,786 | 35.7% | 28 | $2,586 | 31.8% | 24 | $1,596 | 39.2% |
| 1992 | 142 | $15,912 | 12.2% | 89 | $11,171 | 14.6% | 30 | $2,773 | 1.9% | 23 | $1,968 | 16.6% |
| 1993 | 189 | $32,159 | 18.6% | 135 | $26,082 | 19.7% | 32 | $3,399 | 14.6% | 22 | $2,678 | 21.2% |
| 1994 | 226 | $44,306 | 0.8% | 175 | $38,812 | 3.2% | 29 | $2,503 | −24.3% | 22 | $2,991 | 4.0% |
| 1995 | 219 | $57,541 | 18.3% | 178 | $49,913 | 15.3% | 24 | $3,395 | 63.4% | 17 | $4,233 | 23.0% |
| 1996 | 199 | $88,776 | 35.8% | 166 | $78,302 | 35.3% | 20 | $4,779 | 50.9% | 13 | $5,696 | 29.4% |
| 1997 | 211 | $140,534 | 18.9% | 176 | $127,825 | 20.3% | 26 | $7,370 | 3.8% | 9 | $5,338 | 10.8% |
| 1998 | 210 | $138,301 | −18.8% | 173 | $126,905 | −17.5% | 28 | $6,481 | −29.2% | 9 | $4,916 | −34.0% |
| 1999 | 203 | $124,262 | −6.5% | 167 | $118,233 | −4.6% | 26 | $4,442 | −33.2% | 10 | $1,588 | −35.9% |
| 2000 | 189 | $138,715 | 25.9% | 158 | $134,431 | 26.4% | 22 | $1,632 | 16.0% | 9 | $2,652 | 11.6% |
| 2001 | 182 | $154,899 | 15.5% | 151 | $147,092 | 13.9% | 22 | $3,991 | 77.3% | 9 | $3,816 | 50.8% |
| 2002 | 176 | $161,937 | 5.2% | 149 | $151,272 | 3.8% | 20 | $7,146 | 31.1% | 7 | $3,519 | 23.3% |

| | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 2003 | 171 | $224,212 | 38.5% | 144 | $204,800 | 37.1% | 20 | $14,187 | 57.4% | 7 | $5,225 | 56.2% |
| 2004 | 193 | $307,895 | 30.4% | 153 | $275,291 | 31.6% | 33 | $25,964 | 18.4% | 7 | $6,639 | 23.9% |
| 2005 | 197 | $330,691 | 8.3% | 152 | $301,491 | 12.2% | 37 | $23,394 | −23.2% | 8 | $5,807 | −10.8% |
| 2006 | 183 | $438,071 | 34.4% | 138 | $400,741 | 35.1% | 38 | $29,195 | 19.3% | 7 | $8,134 | 40.9% |
| 2007 | 152 | $312,009 | −17.8% | 118 | $288,695 | −15.7% | 29 | $19,054 | −42.3% | 5 | $4,260 | −34.8% |
| 2008 | 136 | $191,651 | −37.3% | 113 | $176,238 | −37.7% | 20 | $14,281 | −31.3% | 3 | $1,133 | −75.5% |
| 2009 | 142 | $271,199 | 27.5% | 115 | $248,355 | 28.0% | 23 | $22,103 | 24.6% | 4 | $741 | 41.3% |
| 2010 | 153 | $389,295 | 27.6% | 126 | $358,908 | 28.0% | 27 | $30,387 | 22.6% | § | – | – |
| 2011 | 160 | $450,501 | 7.3% | 130 | $407,529 | 8.3% | 30 | $42,972 | −2.4% | § | – | – |
| 2012 | 172 | $603,415 | 20.1% | 139 | $544,415 | 19.7% | 33 | $59,000 | 19.9% | § | – | – |
| 2013 | 202 | $670,334 | 3.2% | 161 | $608,277 | 2.9% | 41 | $62,057 | −2.0% | § | – | – |
| 2014 | 216 | $970,428 | 27.2% | 177 | $846,410 | 28.0% | 39 | $61,017 | 17.9% | § | – | – |
| 2015 | 223 | $938,852 | 2.3% | 182 | $886,488 | 2.8% | 41 | $52,365 | −8.9% | § | – | – |
| 2016 | 224 | $1,018,730 | 9.3% | 184 | $960,193 | 8.6% | 40 | $58,537 | 22.9% | § | – | – |
| 2017 | 222 | $1,133,698 | 9.3% | 181 | $1,065,948 | 8.7% | 41 | $67,750 | 19.8% | § | – | – |
| 2018 | 226 | $1,047,641 | −4.1% | 186 | $980,315 | −4.0% | 40 | $67,326 | −2.5% | § | – | – |
| 2019 | 226 | $1,328,806 | 28.1% | 186 | $1,245,878 | 28.7% | 40 | $82,928 | 21.3% | § | – | – |

*Information prior to 1971 is not available.

§Nareit discontinued its FTSE Nareit Hybrid REIT Index in 2010.

[a]The equity market capitalization (EMC) numbers shown are based on year-end share prices and do not include operating partnership units (OP units), which are not publicly traded and which are discussed in Chapter 8.

[b]Total returns are from the FTSE Nareit All REITs Index, the FTSE Nareit All Equity REITs Index, and the FTSE Nareit Mortgage REITs Index. As of December 31, 2019, the FTSE Nareit All REITs and All Equity REITs indices excluded seven small cap equity REITs that trade less frequently.

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*interest* in their properties and use debt to finance a percentage of the purchase price. This investment approach is similar to how individuals purchase homes in that the REIT generally uses some amount of debt and pays the remainder in cash (equity). Fee simple interest in real estate means the buyer receives title to the land and improvements, which include the building and any structures that exist on the land. The debt a REIT uses to finance a portion of a property ranges from a simple mortgage (which is also called *property-level* debt) to publicly traded, corporate-level bonds (also called *senior* or *unsecured* debt). Chapter 9 discusses real estate fixed income securities in greater detail.

Sometimes equity REITs own properties according to a leasehold interest, which is also called a *ground lease*. In this case, the REIT does not own the land on which the building(s) sits. The REIT pays the landowner (or *lessor*) a monthly fee for an agreed-upon time period – usually several decades – in exchange for the right to use the land as needed to support the building's operations.

REITs originally were externally advised like mutual funds, but later *The Tax Reform Act of 1986* allowed them to internalize management. Particularly since the *REIT Modernization Act of 1999*, equity REITs increasingly have operated as fully integrated real estate companies that also derive income from a range of real estate-related business activities. (See Chapter 10 for more information about legislative improvements to the REIT structure.) At December 31, 2019, Nareit tracked 186 equity REITs, 179 of which were included in the FTSE Nareit All REITs Index. These companies had an aggregate equity market capitalization of $1.2 trillion (excluding OP units), constituting the largest category of REITs in the United States. Chapter 6 provides more detail on equity REITs according to the different types of commercial properties they own.

## Mortgage REITs

Mortgage REITs (mREITs) lend money to real estate owners directly by issuing mortgages, or indirectly by acquiring existing loans or mortgage-backed securities. mREITs derive the majority of their revenues from interest received on commercial mortgage loans or from investments in residential- or commercial-based real estate instruments.

mREITs are analogous to banks that lend almost exclusively to commercial real estate developers and landlords, except mREITs do not have customer deposits from which to lend. Instead, they raise capital by issuing debt and equity in private or public capital markets. Their revenue consists of the principal and interest payments received from their investments.

As of December 31, 2019, FTSE Nareit All REITs Index listed 40 mREITs with a combined equity market capitalization of $82.9 billion (excluding OP units). Since the *Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010* (the Dodd–Frank Act) was signed into law in July 2010, the number of publicly traded mREITs tracked by Nareit has increased 48%, from 27 companies at the end of 2010 to 40 at the end of 2019; during the same time period, mREITs' equity market capitalization has more than doubled, from $30.4 billion to $83.0 billion. This renewed growth in mREITs is due in part to the tighter regulations the Dodd–Frank Act imposed on traditional banks and lenders. mREITs essentially stepped in to fill the credit void created by this and other legislation. Calvin Schnure, Nareit's Senior Vice President of Research & Economic Analysis, authored Chapter 7, which discusses mREITs in great detail and includes a list of mREITs that were publicly traded at the end of 2019.

### Hybrid REITs

Prior to 2011, there was a third category of REITs, then called *hybrid REITs*. These companies combined the ownership strategies of equity and mREITs, depending on the investment opportunities available. Historically, hybrid REITs represented the smallest class of REITs in the industry and, in December 2010, Nareit reclassified the four remaining companies as mREITs.

## Classification by Property Type

Most often, investors refer to REITs by the type of commercial property in which they invest, such as offices, apartments, retail, hotel, or warehouse buildings. A few years after the Great Recession of 2008–09, the IRS ruled that rental income from less traditional property types could also qualify as *good income* for REITs. (Chapter 8 addresses the concept of good or bad REIT income.) As a result, the industry now includes REITs that own billboards, cell phone towers – even gas and electric transmission lines – and other highly specialized real estate. Nareit classifies these new companies as *specialty* REITs. Many REITs used to own multiple property types, but have evolved to own only one property type; this change occurred largely because investors can diversify their portfolios by buying REITs that own different property types, and generally prefer management teams that have a clear investment focus and expertise. In addition to the information provided in Chapters 6 and 7, Appendix C provides additional summary information on all 219 REITs that were included in the FTSE Nareit All REITs Index at the end of 2019.

## Size and Index Inclusion

In describing each classification of REIT, size is one important investment criterion, because companies that are large (as measured by their equity market capitalization) trade differently than small companies. Chapter 11 details how to calculate a REIT's equity market capitalization (also referred to as *equity market cap* or *EMC*) and other important metrics.

An important detail to keep in mind when looking at REIT data is that, in addition to the shares of common stock held by public shareholders, most REITs also have private, non-traded ownership units called *operating partnership (OP) units* outstanding. Specific to REITs, OP units are similar to shares of common stock in that they represent a percent ownership in a REIT (see Chapter 8). Generally, OP units can be exchanged on a one-for-one basis into common stock of the REIT and receive the same dividend. The main difference between OP units and common stock is that OP units are not publicly traded (also referred to as not being *liquid*). Unless expressly noted otherwise, market capitalizations for REITs that are available on financial service outlets, such as *Yahoo*! *Finance,* or Bloomberg, exclude OP units.

One of the reasons why large- and small-cap REITs trade differently is that larger REITs simply have a greater supply of common shares available to buy or sell on stock exchanges; the number of common shares outstanding is also referred to as a company's *float*. Larger-cap REITs with greater float tend to have higher average daily trading volumes, and institutional investors tend to prefer larger-cap REITs so that they do not have ownership concentration issues (see Chapter 8 for ownership limitations).

At the end of 2019, 118 REITs, or about 50% of public REITs, have market capitalizations and daily average trading volume levels that have qualified them for inclusion in major stock indexes. The 30 larger-cap REITs included in the S&P 500 Index at the end of 2019 are listed in Table 1.2.; REITs included in the S&P 400 Mid Cap and 600 Small Cap Indexes, respectively, are listed in Tables 1.3 and 1.4. Index inclusion is a significant factor in long-term REIT performance because money managers typically have to allocate money to invest in stocks that are part of the broader indexes against which they *benchmark*. Benchmarking is simply measuring the performance of an investment strategy against a standard, such as an index. Money managers who benchmark against the FTSE Nareit All Equity REITs Index,