Kahr Notes

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Introduction - Welcome to Kahr Notes

Welcome to the first issue of Kahr Notes, a newsletter on commercial real estate where I aim to inform with original research, news, and interviews.

In future issues, I will interview at least one fascinating real estate professional about what they do and how they do it. If you have someone you'd like to suggest that I interview, please contact me.

As I have not completed my first interview, this issue contains a small piece that I wrote on Mortgage REITs recently. I hope to work it into a larger paper for one of the academic journals. Don't worry; it's still fit for mass consumption and hasn't been drowned in footnotes (yet). Please enjoy it and let me know what you think.

To kick off the first issue, I'm using my Palm Pilot to build the subscriber list. If for any reason you're not interested in receiving this newsletter, simply respond and include "cancel" in the "Subject" field and I'll take you off the mailing list.

Good luck in all your endeavors and expect the second issue in a month. Regards, Joshua Kahr Mortgage REITs - a work in progress Mortgage REITs have been treated as the black sheep of the REIT business for years, and I personally think it's about time that they started getting some respect. Am I crazy for thinking so? Are Mortgage REITs really as risky as everyone seems to think?

When the investing public thinks of REITs, they do not have an accurate picture of the diversity of the REIT universe. They typically envision Equity REITs; An Equity REIT owns and manages real property. There are two other major classes of REITs. There are Mortgage REITs that invest only in real estate mortgages and Hybrid REITs that invest in a mix of both. It is reasonable that the public has not heard of Mortgage or Hybrid REITs. This lack of knowledge also extends to the academic world; in any class of graduate students studying real estate, there will be at least a few that are genuinely surprised that a REIT could invest exclusively in mortgages. In fact, when the REIT structure came into being in 1960 with the

enactment by Congress of the REIT Investment Act, many of the early REITs that were formed were Mortgage REITs.

According to statistics from NAREIT (National Association of Real Estate Investment Trusts), in 1971 there were 12 Equity REITs, 12 Mortgage REITs, and 10 Hybrid REITs with Equity Market Capitalizations of $332.0 million, $570.8 million and $591.6 million respectively. The REIT investor in 1971 owned for the most part either Mortgage REITs or Hybrid REITs. Thirty years later at the end of 2001, the REIT universe's focus had reversed. There were 151 Equity REITs, 22 Mortgage REITs, and 9 Hybrid REITs with Equity Market Capitalizations of $147,092.1 million, $3,990.5 million, and $3,816.0 million respectively. Why did Mortgage and Hybrid REITs languish to such an extent that they comprised only 5% of the total REIT market in 2001?

In the late 1960's and early 1970's, Mortgage REITs were perceived to be the REIT class that would have the most growth. The REIT Investment Act of 1960 discouraged the growth of Equity REITs by putting limits on a REIT's ability to self-manage. REITs could not directly operate the properties they owned and were required to hire outside managers. They were, in the parlance of the industry, "externally advised". While the goal of this requirement was to limit potential for abuse on the part of management, it resulted in hampering the growth of Equity REITs. Most investors were not attracted to investing in a company that had regulatory restrictions on its ability to manage its own assets. Mortgage REITs were less hampered by this rule. It was a lot easier to convince investors in a Mortgage REIT that outsourcing management was not a bad idea. The assets of a Mortgage REIT are not physical and therefore investors could get comfortable with the idea of hiring a "fund manager".

In 1973 and 1974, rising interest rates caused many REITs to have severe problems in 1974 and 1975. At the time, many Mortgage REITs provided short-term construction and development loans. As developers that were unable to pay the higher interest payments defaulted on these loans, and the higher interest rates and a weakening economy cut back on the REITs' ability to make new loans, Mortgage REITs were squeezed by both declining revenues and property foreclosures. The only Mortgage REITs that came out of this period in good shape were those that had focused on long term permanent mortgages.

As a result of this extremely rough period in the 1970's, investors have shunned Mortgage REITs to this day. Wall Street made a concerted effort to convince investors that not all REITs were bad and presented Equity REITs as a viable option. Regardless of their attempts to promote REITs, the REIT industry was relatively sleepy throughout the late 1970's and early 1980's. Limited partnerships were the main form of investing in real estate for the small investor during this period. Even though it was difficult for investors to trade partnership units, the promoters earned high fees, and the tax accounting was more complex than REITs, limited partnerships proved popular because they provided an effective tax shelter. REITs could not, as a matter of tax law, pass through losses to investors whereas limited partnerships could.

The Tax Reform Act of 1986, in addition to helping trigger a real estate depression, helped REITs. By severely limiting the ability of limited partnerships to pass through losses, they helped REITs by leveling the playing field. They also helped REITs by allowing them to manage their own assets by removing the requirement that they had to hire outside managers. Regardless of these changes in the REIT's favor, Mortgage REITs remained ignored by investors. The risk still remained that they could be squeezed by a shift in interest rates.

In the 1990's, the explosive growth of Equity REITs did not carry over to Mortgage REITs. Additionally, in 1994, a rapid succession of rises in interest rates raised the borrowing costs of Mortgage REITs to such a point that their profits and dividends were put under pressure and their stock prices suffered for it. Thankfully, the Mortgage REIT industry did not have a repeat of the 1970's as the real estate market was on an upswing and the rise in interest rates was not as severe as in 1973 and 1974. After 1994, Mortgage REITs changed their business practices to limit the chances of being negatively impacted by a change in interest rates. Some Mortgage REITs have expanded into writing and servicing mortgages instead of just holding a portfolio of securities. Additionally, most Mortgage REITs now use derivatives to protect themselves from rate fluctuations. The modern Mortgage REIT is not immune from being hurt by a shift in interest rates, but the chance of them declaring bankruptcy is remote.

Furthermore, Mortgage REITs are inherently safer than Equity REITs as an asset class. The Mortgage REIT does not have to worry about a change in the value of real estate unless the cash flows from the property decline to a point where the mortgage will not be paid. In the event of a deflation in real estate asset values, which seems likely as we are probably in a real estate bubble, the Equity REIT will suffer far more than the Mortgage REIT. If there is widespread deflation in commercial real estate asset values, Mortgage REITs that invest in commercial mortgages should be in a strong position because the strength of the cash flows should remain solid. As for Mortgage REITs that invest in residential mortgages, the primary risk would be if owners choose bankruptcy to get out of mortgages that have greater balances than the value of their properties. When one considers that personal bankruptcy rates are at an all time high, perhaps this risk is greater than it once was. Bankruptcy has lost much of its social stigma and is treated by many as simply another financial planning tool.

In conclusion, Mortgage REITs are not without risks but many of them are viable businesses that investors have ignored. It would appear that in today's market they offer a reasonable alternative to investing in Equity REITs. Wall Street has shown us time and again that if one invests in the most ignored and unloved sector, one can often expect above average returns with below average risk.

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