

Quick Study

Q&A with William Hardin, Florida International University by Brad Case



Quick Bio: William Hardin is professor of finance and real estate and director of real estate programs at Florida International University, and a member of the board of directors of the American Real Estate Society. He has authored or co-authored some 40 papers on varied topics in commercial real estate investment, including REIT governance and financial structure.

Portfolio: In one of your most recent papers you found that REIT-owned apartment properties generated higher effective rents than otherwise similar properties owned by non-REITs, at least in the Atlanta area. What accounts for the superior operating performance by REITs?

Hardin: There are several potential advantages including local market knowledge gained from ownership of multiple

properties, longer-term property and portfolio strategies and the ability to attract and maintain competent management. Most REITs have direct, real-time property knowledge that they generate through their direct participation in the space market. REITs and other larger operators get this information more quickly than most other market participants.

Because REITs are generally owner-managers as opposed to passive managers with third-party property management, they are more likely to push effective rents as opposed to simple occupancy as the performance metric. REITs also tend to have long-hold strategies so that property maintenance is more likely, which leads to higher rents. While we did not have access to data to test this idea, it is logical to assume that a REIT or other long-term investor will better maintain a property that generates higher cash flows through higher relative rents.

Portfolio: Before the liquidity crisis you published a study in which you concluded with respect to publicly traded REITs that “the firm, equity sources, and debt providers support actions that create greater transparency and set the foundation for a virtuous capital acquisition

cycle.” That sounds prescient in light of the REIT industry’s success in raising both equity and debt capital during 2009. Will you summarize the “virtuous cycle”?

Hardin: The cycle is related to the use of short-term debt to augment residual cash flow from operations to make investments. The use of a line of credit in and of itself requires more transparency and monitoring. Banks providing these funds monitor firm performance and generally know management well and are well aware of what investments these firms are making. Banks also look at lines as short-term funding and evaluate repayment risk. A bank’s first concern is simply debt service capacity, meaning that interest on a line or revolver can be paid. The primary concern, however, is the repayment of debt.

While a REIT could get a mortgage at the property level, integration of REITs into the financial markets allows for the use of public market debt and equity. Access to the public market on a consistent and recurrent basis requires transparency. Investors providing these additional funds want to monitor how they are used and overall firm performance.

The cycle has to do with the continual use of private bank line and public capital as well

as some internal capital to fund REIT investments. The use of short-term debt reduces agency costs, which makes public capital more available, while the need for additional public capital reinforces the requirement for transparency. The use of multiple monitors, banks, public debt and equity holders reduces agency costs, which reduces overall capital costs.

In today's market, transparency is critical. It reduces uncertainty and limits agency costs between managers, debt holders and equity holders. These players know a REIT's portfolio, its management and its organizational structure. This makes it easier to assess risk and provide additional capital.

This is not to say that some REITs have not mismanaged their capital structure. But, in the case of REITs, information is available to better evaluate which REITs these are. I think that REITs with reasonable leverage, known portfolio properties and known tenant exposure have the potential to be winners in today's market.

Portfolio: In a related paper you found that "the agency conflict caused by holding too much cash is effectively controlled within the REIT industry." Can you explain the advantage to investors of having companies that choose not to hold excess cash?

Hardin: Excess cash provides managers with an opportunity to make investments that may not generate sufficient returns to reward shareholders. This cash can also be used to buy perquisites.

Investors are better off when managers have sufficient cash to manage the firm's operations, but do not accumulate excess cash that then might be

misapplied. While REITs have a mandatory dividend requirement by statute, REITs typically pay out more in dividends than is required. This reduces potential agency costs between management and shareholders.

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In another working paper, my co-authors and I quantify the value of excess dividends and show that the market values the reduction of potential agency costs. The value of returning cash to shareholders is reflected in the firm's stock price.

Portfolio: Investors and investment consultants often ask why at least three academic studies have shown that REIT returns exceed institutional core property returns even after controlling for property type mix and the use of leverage. Might your findings provide part of the answer?

Hardin: There may be at least four related issues. One, there should be a value to transparency. While it is possible to get information on direct investment in real estate and other forms of real estate ownership, the transparency and review of this information can be more limited when compared to REITs. Investors, external analysts, rating agencies and others review the largely public REIT data and make recommendations. There should be value related to a reduction in information uncertainty. There may also be a related value associated with

property operations and fees associated with management which are generally known.

The second issue is related to liquidity. There is a value associated with being able to enter and exit an investment quickly.

Investment in REITs does not require extensive documentation, does not require an explicit long-term commitment and does not require substantial intermediation. There are differences in liquidity across REITs, but in a typical situation there is a market for REIT stock.

The third issue is the measurement of returns. REITs are continuously priced on the public market while other forms of investment have greater ambiguity in asset pricing. The implications for these differing yardsticks are beyond the scope of this interview, but they are substantial. In some cases, the benefit accrues to REITs and in other cases it accrues to other ownership structures. At least with REITs, I know the price or value of my position, while in other forms of ownership the value is more ambiguous.

Finally, REITs provide access to scale and a diversified property portfolio. There are few non-REIT funds that have a similar breadth of portfolio within a single fund. ♦

Brad Case is NAREIT's vice president of research and industry information.