

REIT dividend cuts should be viewed on case-by case basis

Joseph Betlej, CFA
Vice President and Lead Portfolio Manager
Real Estate Securities

As real estate investment trusts (REITs) have expressed concerns about weakening fundamentals over the past few months, a trend became evident: REITs are cutting, suspending or reconstituting their dividends.

Dividends and the underlying value of hard assets provide the “double-backstop” that makes REITs attractive. Even as stock prices decline, a higher dividend yield can soften the losses. Dividend cuts, however, sap investor confidence for any company, and it’s particularly noteworthy for REITs. But a closer analysis shows that recent headlines about REIT dividends do not necessarily signal bad news. Each company is reacting to their own situation; some are better positioning themselves, while others are really struggling.

Dividend rules and strategies for REITs

This is a good time for a refresher on REIT dividends and strategies that might be employed in the near future. A REIT must make annual distributions of 90 percent of the company’s taxable income to its shareholders and may retain the remaining 10 percent (as well as earnings above their taxable income). With the current results and forecasted earnings drop, certain REITs are cutting the dividend to a lower level more consistent with expected cash flow.

Recently, many REITs have elected to pay up to 90 percent of the required dividend in the form of stock. In today’s climate, this could allow a REIT to delever its balance sheet (using cash that would have been used to pay the dividend to pay down debt) without diluting shareholder value. This is similar to

a “stock split,” which gives all share holders the same economic interest in the company after the distribution of shares.

According to a recent Bank of America/Merrill Lynch research paper, “The sector could save over \$8 billion a year in cash by paying 80 percent of their dividends in stock, with the balance paid in cash.”*

The bottom line

It’s no secret that the commercial real estate industry is facing a reduction in the availability of capital. This is ominous, considering the large amounts of commercial mortgage debt coming due in the next few years. The recent action on dividends might be well-managed REITs attempting to manage their cash and balance sheet for more uncertain times, or it may be signs of bigger trouble— dramatically weakening fundamentals or a shrinking financing market for commercial real estate.

To determine which is correct, we believe you have to look at each REIT on a case-by-case basis. In addition, investors may have to review their own needs. For example, paying part of the dividend in stock would be viewed positively by bond holders, implying that debt will be paid down and credit spreads would tighten.

Stockholders may be split on their opinion of the dividend activity. One camp could view dividend cutting as evidence that management teams are making the tough decision to fortify their balance sheets by retaining cash. The opposite camp may

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suggest that this is a sign of weakness, with market pressures impacting a company's cash flow for a longer time. We believe that for some REITs, the former is true; for others, it's the latter.

The best situation is a company that grows their dividend on a constant basis over time. Companies reducing dividends are under some duress. For many of these, it's a result of decisions made to operate companies with debt levels that are too high for the cyclicity inherent in their business.

In recent years, many REITs used more aggressive business plans and higher levels of debt to become more growth-oriented. However, REITs are, by nature, the "turtle" of investments—they are typically slow and steady growers of cash flow. It is this fundamental nature that will require the real estate industry to delever. We anticipate that many REITs will return to their more modest roots with lower growth parameters, reduced balance sheet leverage and higher cash flow coverage of dividends. At the same time, we expect REIT prices will eventually show less volatile price performance and a higher degree of correlation to returns of the underlying real estate.

**Source: Merrill Lynch REITweekly, Feb. 2, 2009.*

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