

For those who wondered, what are REITs, and why I am so confident in putting REITs in my portfolio to grow my assets.

Introduction to Real Estate Investment Trusts (REITs)

What are REITs?

A Real Estate Investment Trust (“REIT”) is a publicly listed company that raises capital (from shareholders) to purchase and operate real estate assets (i.e. shopping centres, office buildings apartments etc...). Over 90% of the rental income generated from these properties is then distributed back to the shareholders as dividends (DPU: distributions per unit) at regular intervals. And these DPU are regulated by mandate, which put me more at ease.

Benefits of Investing in REITs

REITs allow small, individual investors to invest in and share the benefits reaped from real estate investing. (Very Important when you start to grow your assets.)

Investing in real estate not only provides the opportunity for capital appreciation, but also generates regular cash flow from rental income. Unlike stocks, properties are ‘real assets’ that do not have the risky possibility of going bankrupt and becoming worthless.

Here are the additional advantages REITS provide for real estate investors:

a) Portfolio Diversification

REITs usually own multi-property portfolios with diversified tenant pools, thus reducing the risks of reliance on a single property and tenant in the case of directly owning a real estate asset.

Honestly speaking, it’s very difficult to afford a various class of real estate asset if you were to buy them separately on your own, unless you are a multi-millionaire. 😊

b) Professional Management

REITs allow investors the opportunity to buy into properties managed by professional property management companies. It takes out the hassle of having to find your own tenants and maintaining your own property. When you are renting out your own property, you would have to worry about tenants calling you in the middle of the night complaining about pipe burst, or flushing system not working. This can be the downside of renting out your own unit, as I've discovered.

Potential Returns of REITs

Real estate appreciates at an annual compounding growth rate of about 6.8% over the long term (> 20 years). Rental yield ranges from 5%-8% in Asia.

Total returns from REITS can thus range from 11.8%-14.8% annually. Returns vary for different REITs. A REIT typically distributes dividends regularly based on income generated by the properties in its portfolio.

Most REITs have annual managers' fees, property management fees, trustees' fees and other expenses that will be deducted from their cash yields before distributions are made.

Risk from Investing in REITs

Investing in REITs carry similar risks as investing directly in real estate. Here are the factors that can affect your returns (or losses) from REITs.

1) The Rise or fall in rental income and property prices arising from a change in market conditions. A decline in the level of property prices could adversely affect the value of your REIT and the dividends received.

=> Hence, it is important to invest in REITs during the right time in an economic cycle. Invest during economic downturns or during early recovery when real estate prices are low, dividend yields are high and sell/avoid buying when property prices are high (during an economic boom). Eg, in March 09, CDL H Trust was at \$0.45. In September 07, it hit \$2.51. Currently, with the recovery, in Oct 09, it's \$1.51.

2) Substantial increase/fall in interest rates, making listed REITs less/more attractive as an investment instrument.

=> When interest rates are high, REITs financing costs increase, resulting in lower earnings and dividends to shareholders. When interest rates are low, the cost of financing property purchases are lower, resulting in higher returns to shareholders.

3) The quality of property assets owned by the REITs affects the sustainability and stability of rental income from tenants.

=> REITs that own high quality properties in prime locations with strong tenant pools will be able to deliver consistently increasing dividends to shareholders. Some REITs hold very prime office space and industrial areas, which also provides good returns. Some REITs buy over hospitals, and rent it out to doctors who run their own private practice.

Key REIT Terminologies

Here are some common terms you must understand in REIT investing.

a. Distributions Per Unit (DPU)

DPU is the dividends per unit (share) that is distributed to shareholders. DPU is normally announced and distributed quarterly (every 3 months) or half yearly (every 6 months).

b. Net Asset Value (NAV)

The net NAV of a REIT is the "market value" of all its assets, including but not limited to its properties, after subtracting all its liabilities and obligations. In other words, $NAV = Total\ Assets - Total\ Liabilities$. NAV is a one of the measures of a REIT's intrinsic value. When a REIT's share price is below NAV, it can be considered undervalued.

c. Gearing Ratio

The Gearing of a REIT refers to how much debt it is taking on, relative to the value of the assets it owns. $Gearing\ ratio = Total\ Debt / Total\ Assets$.

REITs are required to have a gearing of no more than 60%. However, most REITs listed in Singapore have gearings of less than 40%. The more a company borrows, the higher the gearing, the more risky the investment is. When a REIT is highly geared, it will be more adversely affected when it comes time to refinance their loans at higher interest rates.

d. Funds From Operations (FFO)

FFO is the most commonly accepted measure of REIT operating performance.

$FFO = \text{Net Income} + \text{Depreciation} - \text{Gains/Losses from Sale of Property}$.
It is similar to the 'Net Cash from Operations' we look at when valuing stocks.

e. Adjusted Funds From Operations (AFFO)

AFFO is used to measure a REIT's free cash flow generated by operations.

$AFFO = FFO - \text{Capital Expenditures used to maintain operations}$
AFFO is also called Cash Available for Distribution (CAD) or Funds Available for Distribution (FAD).

Criteria that I use for Selecting REITs

Here are 5 Fundamental Screens in selecting a winning REIT.

Criteria #1: High Current Dividend Yield (> 5%)

The main reason for buying REITs is for their high dividend payouts. So, the first screen is to select REITs with the highest dividend yields. Dividend Yield should be more than 5%. $\text{Dividend Yield} = \frac{\text{Annual DPU}}{\text{Current Price}} \times 100\%$.

Criteria #2: History of Consistent Growth in AFFO & Dividends

Select REITs that have a track record of achieving consistent growth in AFFO and dividends for the last 5-10 years.

When a REIT is able to consistently grow its AFFO and dividends, you will get consistently higher dividend payouts and capital appreciation from the stock price increase.

Note: Adjusted Funds from Operations (AFFO) = Net Income + Depreciation – gain/loss from sale of property – capital expenditure

Criteria #3: High Expected FFO & Dividend Growth

Select REITs that are expected to deliver higher future AFFO and dividend growth over the next 1-5 years.

What drives growth in AFFO and dividends?

- a. Quality of properties in portfolio and quality of tenants
- b. Expected increase in property prices
- c. Expected increase in rental
- d. Acquisition of new properties

You can find the expected FFO/ AFFO growth forecast from REIT analyst reports. To see these reports, go to <http://sreit.blogspot.com>. Ensure long-term growth forecasts are above 5% and analyst reports are rating hold/buy.

It is also important to exercise common sense and actually visit the properties (i.e. shopping malls, industrial estate, office buildings, apartments etc...) held in the portfolio of the REIT you intend to buy. Are the properties in prime locations? Are they very popular with tenants? Is there high traffic? Are the tenants of high quality? Are the tenants likely to stay for long? Think like a property investor!

Criteria #4: Low Gearing Ratio (< 50%)

Check the Gearing Ratio of the REIT. Gearing Ratio = Total Debt/ Total Assets x 100%. Ensure Gearing ratio < 50%.

Criteria #5: Valuation of Stock Price

There are two ways analyst value REITS:

- a) Net Asset Value (NAV)
- b) Discounted Value of Future Cash Flows.

a) Net Asset Value (NAV). NAV = Total Assets

When REIT price is < NAV, the REIT is **UNDERVALUED**

- b) To calculate Intrinsic Value of the REIT using Discounted Cash Flow,

use your 'Intrinsic Value Calculator'. Enter the following variables:

- Current Cash Flow from Ops (Get from Sharesinvestor.com or Annual Report)
- Total no. of shares: See shareinvestor.com or business times.
- Expected growth rate: See analyst reports. If not available, you can use a conservative 3-4% growth rate.
- Risk free rate (US 3-year Bonds) and Beta: See Bloomberg.com/markets/rates and reuters.com/finance/stocks

Besides using Fundamental Analysis (FA) to decide which REIT to choose, I will also sometimes combine Technical Analysis (TA) , which is not my strength. This is the reason why I choose to work with a number of stock brokers and technical analysts, who has been instrumental in me choosing my REITs with greater efficiency?

In my personal opinion, Technical Analysis is a self fulfilling prophecy, and if we just use FA or TA, we may not have the most efficient outcome. But I also understand some are just comfortable using either of FA or TA.

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