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REIT Basics



Definitions

Adjusted Funds From Operations (AFFO)—In part to cope with the limitations associated with the calculation of FFO, many portfolio managers and analysts calculate adjusted funds from operations, or AFFO. Some analysts, companies, and portfolio managers prefer the terms cash available for distribution (CAD), or funds available (FAD) to AFFO. More important than which acronym you adopt is how you get from FFO to AFFO. Though there is some debate, most industry veterans derive AFFO by adjusting FFO for the straightlining of rents, as well as after establishing a reserve for costs (i.e., capitalized expenditures) which, though necessary and routine, aren't costs that can be recovered from tenants. This includes certain maintenance costs and leasing costs.

Adjusted Funds From Operations (AFFO) Multiple—A company's AFFO yield and its AFFO multiple are reciprocals of one another. So, both are valuation measures. For a variety of reasons—including P/AFFO multiples are roughly equivalent to P/E ratios—AFFO multiples are more often cited as a valuation measure than AFFO yields. Some portfolio managers contend that comparing AFFO multiples to growth rates is a useful valuation screen. If a company's growth rate is equal to or exceeds its AFFO multiple, the company isn't overpriced. Most portfolio managers modify this screen by factoring into the equation an appropriate "discount rate."

Adjusted Funds From Operations (AFFO) Payout Ratio—This is the single best measure of a company's dividend paying ability. It is calculated by dividing a company's per-share annual dividend by the current year's per-share AFFO estimate.

Adjusted Funds From Operations (AFFO) Yield—In addition to being one measure of valuation, AFFO yield is often used as a proxy for a company's nominal cost of capital. It is calculated by dividing a company's per-share AFFO estimate by its stock price. If a company with an AFFO yield of 6.5% buys a property at a going-in stabilized return of 7.5%, it has acquired the property at a 100 basis point (or one percentage point) positive spread to its nominal cost of capital.

Capitalization Rate—A "cap rate" is determined by dividing the property's net operating income by its purchase price.

Cost of Capital—Variously defined as the weighted average of the cost of equity and debt capital employed by a REIT. Unfortunately, an incorrect definition of this term is often commonly used, which equates the cost of equity capital to the REIT's current dividend yield or FFO yield. A company's "true" cost of capital is the investor's expected rate of return on his/her investment.

Dividend Reinvestment Program (DRIP)—Most, though not all, REITs offer these.

downREIT—A side benefit of the UPREIT structure is that operating partnership units can be used as currency to acquire properties from owners who would like to defer taxes that would come due if the property(ies) were sold or swapped for stock. In response to this advantage of the UPREIT structure, a number of non-UPREITs have created so-called downREITs. This makes it possible for them to buy properties using downREIT partnership units. The effect is the same, however; the downREIT is subordinate to the REIT itself, hence the name.

EBITDA—Earnings before interest, taxes, depreciation, and amortization.

Fixed-Charge Coverage Ratio—This ratio is EBITDA divided by total interest expense (including capitalized interest and debt premium amortization, but excluding finance cost amortization) plus preferred dividends and distributions.

Funds From Operations (FFO)—Equal to a REIT's net income after the addback of real estate depreciation. This is the measure of REIT operating performance most commonly accepted and reported by REITs, conceptually analogous to net income of non-real estate companies.

Implicit 12-Month Total Return—This is calculated by adding the company's year-over-year growth rate and its current stated annual dividend. This is a "guesstimate" of total return potential that is widely used. Some industry veterans criticize this guesstimate of total return because, among other things, it fails to take into account potential changes in multiples. As long as investors recognize its potential shortcomings, implicit 12-month total returns can serve as a useful screening tool when putting together a REIT portfolio.

Implied Cap Rate—Net operating income (NOI) divided by a REIT's total market capitalization (the sum of its equity market capitalization and its total outstanding debt).

Interest Coverage Ratio—Simply referred to as the company's coverage ratio, it's the ratio of EBITDA to interest expense.



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Net Asset Value (NAV)—When evaluating public companies, investors generally focus on price-to-book ratios as one valuation measure. Unfortunately, price-to-book ratios are inappropriate for REITs insofar as a company's book value, which is based on historic cost figures, may not accurately reflect the earnings capacity of otherwise well-maintained assets. Also, the balance sheet consolidations accompanying IPOs were often pursued using different accounting conventions, resulting in an apples-to-oranges comparison between companies. Thus, many analysts prefer to use net asset value as a surrogate for book value, which is appropriate insofar as book value is meant to represent an entity's liquidation value.

Positive Spread Investing—Defined as when a REIT buys a property that has a higher initial yield than the current yield on the REIT's capital. For example, a REIT buys a property yielding 11% (property net operating income divided by the all-in cost of the property) at a time that its debt is borrowed at 8% interest and its equity is trading at an FFO yield (inverse of its FFO multiple) of 10%. If the REIT is funded half with equity and half with debt, it realizes a 200 basis point (11% minus 9%) positive spread.

Real Estate Investment Trust (REIT)—A real estate investment trust is a private or public corporation (or trust) that enjoys a special status under the U.S. tax code that allows it to pay no corporate income tax so long as its activities meet statutory tests that restrict its business to certain commercial real estate activities. Most states honor this federal treatment and do not require REITs to pay state income tax. By law, REITs must pay out 90% of their taxable income.

Return of Capital—The portion of a REIT's dividend in excess of taxable income. Because REIT dividends are often higher than taxable income, principally due to depreciation, the amount by which the dividend exceeds taxable income is a return of capital to a shareholder, meaning that—for a taxpaying shareholder—it does not create currently taxable ordinary income, but instead reduces the shareholder's tax basis. At the final sale of the shares, the difference between tax basis and final net sales price is recognizable as a capital gain. To the extent the final capital gains rate is lower than interim ordinary income tax rates, REITs provide a tax shelter function for certain taxpaying investors, by allowing the deferral of tax on current cash received as dividends and taxing it at a lower rate upon disposition of the shares.

Straightlining—REITs straightline rents because generally accepted accounting principles, or GAAP, require it. Typically, a tenant's monthly rent will increase over the life of a lease; this applies to commercial properties, not usually residential properties. Straightlining averages the tenant's rent payments over the lease's life. In other words, rental revenues are overestimated in the early years and underestimated in the later years.

Total Debt and Total Market Capitalization—Together, these measures have been used to provide an assessment of leverage. Debt-to-Total Market Cap was the most often cited measure of leverage early on in the current REIT underwriting cycle (circa 1993). There are a number of problems associated with using it for that purpose, however. Chief among those is that it doesn't provide meaningful information regarding a company's ability to service its debt.

Umbrella Partnership REIT (UPREIT)—A REIT structure in which the REIT does not own a direct interest in properties, but rather in an umbrella partnership that owns interests in properties. For this reason, this umbrella partnership is generally referred to as the operating partnership. It is also common for an operating partnership in an UPREIT structure to own interests in joint ventures in addition to properties. The UPREIT has been the structure of choice in most REIT initial public offerings over the past several years, owing to the tax deferral benefits this structure offers to the company's principals.

In a nutshell, the UPREIT structure allows the principals, who are transferring their properties from private ownership to public ownership via an IPO, to maintain their historical cost basis by transferring the properties to the operating partnership rather than directly to the REIT.

The REIT, in turn, is the general partner of, and owns a majority interest in, the operating partnership. If the properties were transferred directly to the REIT, it would result in a stepped-up cost basis in the properties for the new public entity and trigger a taxable event for the transferring principals. By transferring the properties to the operating partnership in exchange for operating partnership (OP) units, the principal's historical cost basis is maintained.

The OP units are exchangeable on a one-for-one basis into REIT common shares and, over time, the principals can convert OP units to REIT common shares (triggering a taxable event), giving the principals the option to incur their tax liability in smaller increments.

In compiling our definitions, we relied on a variety of sources, notably material produced by Green Street Advisors, NAREIT, Merrill Lynch & Co., and Prudential's Bernard Winograd.

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