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The Real Estate Institute of New York University

Many REITs report book values that are only fractions of their market values.

Why REIT Stocks Are Undervalued

John C. Edmunds

MOST REAL ESTATE PROFESSIONALS agree that the stock market undervalues real estate companies. The primary reason is that investors apparently look at earnings instead of cash flow. The stock market also values real estate investment trusts (REITs) incorrectly, and it is especially inaccurate in valuing the construction and development REITs. Unfortunately, current financial reporting practices have hampered rather than helped the market's valuation process. Just as financial reporting practices tended to conceal the trusts' potential vulnerability before 1974, they now err in the opposite direction by concealing the true extent of REIT recovery.

REIT shares, particularly shares of construction and development REITs, have recovered little from their subterranean lows of 1975, despite the marked improvement of REITs' fundamental financial positions. The NAREIT share index (1972 = 100), which fell to 15 in December 1975, had risen only to 33 by October 1981. And construction and development REIT shares, which fell lower than the composite, have recovered less than the composite.

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FINANCIAL REPORTING TECHNIQUES REINFORCE INVESTOR DISILLUSIONMENT

Investors have to be skeptical, suspicious, and cynical. The reason is that they are not insiders, and no amount of financial reporting can make them feel absolutely confident in their judgments. Unfortunately, the history of Wall Street is full of stories of investors who became skeptical too late. REIT shareholders in 1974-1975 are good examples of investors who did not become skeptical soon enough. In less than twenty-four months they collectively lost more than $2 billion. After such losses, it is no wonder that REIT stock values were depressed. But the fact that they have stayed so depressed for so long needs special explanation.

Current poor performance of REIT stocks may be largely the fault of financial reporting practices. This article makes the following assertions about financial reporting:

☐ During the period 1961-1973, investors placed their faith in real estate investment trusts. Financial reporting techniques encouraged investor optimism. Reporting practices gave no latitude to individual auditors who might have seen the potential risks.

☐ During the period 1974-1975, investors lost their faith in real estate investment trusts. Financial reporting reinforced the investor change of heart, by switching from optimistic valuations to a resolutely pessimistic treatment of REIT prospects.

☐ During the workout and recovery period which followed, financial reporting practices encouraged trust managers and auditors to set up large loss reserve provisions, offsets against mortgages or real estate held. Managers and auditors, trying to be rigidly conservative, often increased loss reserve provisions even when the market value of the trust's assets was clearly rising.

THE GOLDEN ERA AND THE GOING-CONCERN ASSUMPTION

The REIT boom was initiated in 1961 by a tax ruling which allowed the trusts to be set up as conduits for income. REIT shares were promoted as real property analogs to mutual funds. They permitted small investors to obtain the advantages of real estate investment.

The REITs rolled up an apparently solid record during the years 1961-1973, when construction was profitable, when mortgage financing was accessible, and when the yield curve was normal. The auditors who reported the financial condition of these trusts were aware of knotty financial reporting issues. The collateral was adequate, if undiversified, and the trusts' debt ratios were apparently within acceptable limits. True, after 1972 some of the construction and development REITs began to rely heavily on short-term borrowing, and some made risky or frankly speculative loans. There is evidence that investors did take note of these problems, and construction and development REIT shares began to decline in value well before equity REIT or long-term mortgage REIT shares started to fall.

The main reason that public investors had no forewarning of impending problems was that auditors treated REITs as going concerns and allowed management to report the value of their assets accordingly. Management and auditors both assumed that development properties would be completed and sold and that mortgages would be paid on schedule. There was no reason to assume that anything less desirable would happen, because nothing had ever gone wrong in the past.

AGONIZING REAPPRAISAL AND THE NULLIFICATION OF NET EQUITY

In 1974-1975, the REITs began to report staggering losses and devastating share price declines followed. The developments that brought about the collapse are already well chronicled. Builders, operating primarily on borrowed money, began to experience difficulty in selling their completed housing units. At the same time, their interest expenses were rising because many short-term loans were tied to the rising prime rate. Many builders began to default on the short-term REIT loans on which the lenders were receiving attractive markups over the prime rate.

Belatedly, the financial community discovered several weaknesses in REIT structures: their portfolios were inadequately diversified and their loan loss provisions were also inadequate.

It is standard practice to establish loan loss provisions using historical loan loss experience data. A key assumption underlying this technique is that the probability of one borrower defaulting is independent of the probability of any other borrower defaulting. An industrywide, nationwide downturn in real estate values had not occurred since 1929. The trusts were not prepared for a widespread downturn, leading to widespread defaults. Their loan loss reserves might have been adequate for some eventualities, but they were of little use in the circumstances that emerged.

In addition, the financial community realized too late that several serious problems had emerged:

- Some trusts had been lending primarily to highly leveraged borrowers, and for many properties, loan-to-value ratios were precariously high; and
- An unhealthy geographical concentration of lending violated basic principles of diversification.

Inadequate Capitalization

The majority of industry observers knew that many borrowers were inadequately capitalized. They knew that the most solidly capitalized borrowers could obtain their financing from conventional sources, and that the high-risk borrowers had to obtain funds from those REITs which were scrambling to gain clients and market share. Only high-risk borrowers would pay the rates which REITs were charging. REIT auditors should have known that REIT clients were not a random cross-section of all borrowers.

Absence of Diversification

Many construction and development REITs established their headquarters in northern Florida to be close to the projects they were financing. Others allowed their portfolios to become concentrated both by geographical area and by category of real estate financed (shopping centers, hotels, resort and vacation house properties, condominium development). Some pursued this concentration by intent, seeking to develop a specialization.

REVALUING REIT ASSETS

The downturn, when it came, was more severe than any previous cyclical setback since the Great Depression. Borrowers defaulted, loans went into nonearning status, and cash flow turned negative. The REITs (with the exception of some equity trusts) experienced operating losses, and fell behind on their payments to creditors. Their position as intermediaries meant they were hit from both sides, sued by borrowers and creditors alike. They could not bridge the cash-flow deficits; they could not take over the borrowers' duties, because they had neither the staff, nor the expertise, nor the market. They could not pay the banks, so they went into de facto receivership. Many ultimately filed for protection under Chapter 11 of the bankruptcy code.

The auditors had to decide how to report this debacle to shareholders and creditors. The central question was the value of loan collateral. Cash-flow shortfalls proved that the collateral was not generating cash as projected. It was illiquid and seriously inadequate. Real estate market conditions had worsened suddenly and profoundly. Properties which had earlier seemed respectable, prudently financed entities, operating under the guidance of seasoned professionals, suddenly turned into useless derelicts. Their owners were insolvent.

The issue confronting auditors, therefore, was not limited to the computation of operating losses. It required recognizing and providing for portfolio deterioration and probably loan losses. As auditors worked on year-end 1974 statements, they had to deal with several imponderables:

- ☐ *A forecasting problem.* Real estate market conditions were still worsening, and it was not the auditors' role to predict when or if the recovery would begin.
- ☐ *Declining asset values.* Many loans which were still technically in earning status at year-end were sliding into default, and the accountants had to anticipate these eventualities.
- ☐ *Defaulted loans.* The trusts had not begun foreclosure proceedings for many loans which were already in default. But the auditors had to evaluate the defaulted loans on the basis of eventual cash recovery. They could not appeal to the market value of the underlying collateral.

The auditors, recognizing that there was no possibility of computing loan losses precisely, chose to make conservative judgments. It is logical that they should have done so. They dropped the going-concern assumption and established the value of each trust's loan portfolio assuming orderly liquidation. Whether they liked it or not, they had to respect the real estate market conditions of the moment. Precedent called for computing a workout recovery value for each defaulted loan, and setting up a loan loss provision to account for the difference between original book value and probable recovery value.

Then, in June 1975, the AICPA issued SOP No. 75-2, which established conservative procedures for making these computations. The approved procedures stood in contrast to earlier methods of computing loan loss reserves, and led to a severe discontinuity in valuations. In 1973 there had been no loan loss reserves; suddenly in 1975 there were loan loss reserves which were larger than the amounts eventually lost.

Between year-end 1973 and year-end 1975, aggregate REIT shareholders' equity fell from $5.84 billion to $3.48 billion; at year-end 1976 it was $2.75 billion. Of course, for many construction and development REITs, shareholders' equity was wiped out altogether.

Was SOP No. 75-2 Too Harsh?

The valuation procedure outlined in SOP No. 75-2 ignored an important fact: the REITs had been careless in many aspects of their business, but they usually had the good sense to obtain the senior claim on each asset they financed. Events have shown that these senior claims were valuable indeed. The trusts have been able to obtain cash from time to time since 1976 by selling loans or properties taken in foreclosure. They have used the cash to upgrade properties and to wipe out

junior claims. As time has passed, they have upgraded their properties, improved liquidity, and paid off bank debt and bonds.

The loan loss provisions imposed on the REITs in their year-end 1974, 1975, and 1976 reports were established under much harsher rules than those which established the loan loss provisions that the REITs had hitherto been required to maintain. The loss loan reserves went from being excessively small to excessively large. It is possible that this change in treatment contributed to the roller-coaster volatility of REIT share prices during the period 1972-1981.

WORKOUT, RECOVERY, AND PORTFOLIO REVALUATION

During the period 1976-1978, many REITs began to work out their problems. Real estate prices were rising. The value of the properties that the REITs had taken in foreclosure rose apace. These became more salable as work continued on them.

The REITs were able to improve their position in several ways. They renegotiated bank loans and reduced bank debt by exchanging properties and mortgages for outstanding debt. And they improved properties they held or had acquired through foreclosure. As the real estate recovery continued, REITs began to sell properties at prices above their book value.

No Upward Portfolio Evaluation

Most REITs chose not to revise the carrying value of any property except to record additions at cost. Stated industry practice was to review the portfolio each quarter and to increase or decrease the loan loss provision established for each loan or property as market conditions changed. If REIT managers had actually done this, it is clear that they would have increased the carrying value of many of their assets during this period, and they would have taken some of their loan loss reserves into earnings, recognizing these book adjustments as extraordinary gains.

Actual industry practice, however, was decidedly more conservative. The primary purpose of quarterly and annual reviews of REIT portfolios was to check the adequacy of loss reserve provisions. But when management found that the loss reserve for a particular asset was large, they tended to leave it unchanged. There were several reasons for taking this approach:

- Market conditions could worsen, and the large loss reserve might turn out to be correct after all.
- It would be optimistic to change a valuation on the basis of a mere appraisal.
- The auditors would probably not allow management to increase the carrying value of a mortgage or property unless the mortgage payments were up-to-date or the property was sold.
- There was no incentive for managment to consider increasing the carrying value of an asset.

The last reason for leaving asset values unchanged was probably the most compelling. Raising an asset's value would increase stated profits and equity and might lead creditors or shareholders to believe they could realize greater return for their investment. Furthermore, it might invite IRS scrutiny. From the management's standpoint, it was best to leave loan loss reserves alone. The time to recognize extraordinary gains was after completing the sale of each asset.

Emergence of "Extraordinary" Gains

In time, REITs began to roll up a series of "extraordinary" gains. Soon it became commonplace for the extraordinary gain from the sale of an asset to exceed the loan loss reserve provision which the REIT had set up for the asset. REITs sold properties at prices higher than their original cost basis. Thus REIT valuation practices seriously distorted REIT book equity figures. The degree of distortion depends on the type of REIT, its history, and its portfolio composition. Connecticut General REIT, sold in mid-1981, went for a premium of approximately 60 percent over book value. Realization of the degree of variability that can be found in a single REIT's portfolio can be obtained by examining the 10-K reports of various trusts. In reports that this writer has studied, the differences in per-acre valuation that one REIT assigned to similar tracts of partially developed land were 1,000 percent.

Such differences in valuation may be due to several factors: location, zoning, percentage of useful acreage, etc. But the most obvious explanation for differences of this order of magnitude is that conservative accounting practices during a period of rising real estate values have created some incredible undervaluations.

CONCLUSION

Financial reporting has served the business community well. American accounting reporting conventions are a standard of disclosure completeness and precision. It is not the intention here to attack these conventions, or to minimize the thorny valuation problems faced by REITs. But auditor conservatism has persisted during six years of great real estate recovery. Unfortunately, investors use financial reports as keys to future performance, not as chronicles of past performance. And equally unfortunately, financial reporting conventions often cause auditors to misrepresent the major factors determining the going-concern value of the firm.