REITs – Buyer Beware

Albert Meyer – Bastiat Capital | November 14,2019

Recently a prospective client ran a few investment ideas past us. It provided an opportunity to remind us about the kind of stocks we avoid and why.

The first stock on the list was South Western Energy (SWN). It didn't take us long to reject this idea. Recall back in 2011 after visiting the oil fields in North Dakota, we sold all our natural gas and oil stocks. There were oil rigs near the runway as we took off from DFW. Traveling from the airport in Bismarck, ND, we were surrounded by flares for miles and miles. Due to the lack of pipelines, the gas was allowed to burn off. This stunning visual suggested that an oil glut might be in the offing.

As we know, the price of oil is determined by supply and demand. From our perspective, a lack of supply was not a problem, but what about the situation of oversupply? How are we to know? How is anybody to know? With such uncertainty, we stepped off the energy bus.

Regardless, when it comes to SWN, one has to have ice in the veins to invest in a stock that lost -91% of its value over the past five years, while the S&P 500 gained +51%.

On another point, the stock trades at $2.24 per share, which means that no mutual fund would be allowed to own the stock. Most mutual funds sell out once the stock price drops below $10, and others bailout at $5. Lack of liquidity, i.e., not enough buyers, is an essential risk that investors need to keep in mind.

Another stock was a real estate investment trust (REIT). It had a market capitalization of $140 million and traded for $0.16 per share, which made it a risky proposition. We reject any stock that vaguely qualifies as speculative. Furthermore, small caps are not an option for us.

We do not invest our clients' capital in Real Estate Investment Trusts (REITs) or Limited Partnerships (LPs) for various reasons. We highlight a couple of issues that we have with this category of investments.

On the face of it, the fact that these entities do not pay tax might appear very attractive. The IRS gives REITs and LPs a tax break on the condition that they distribute all their profits as dividends to shareholders. Shareholders, in turn, are taxed on these dividends at their marginal tax rates.

An investment in a REIT holds less of an attraction for a taxpayer with a marginal rate of 35%. As illustrated below, if the dividend yield on the REIT is 8%, the taxpayer with a 35% marginal rate will only earn a yield of 5.2% after tax. The taxpayer with a 12% marginal rate does better with an after-tax return of 7.0%.

Dividend Yield	8.00%	Dividend Yield	8.00%
Marginal rate	35%	Marginal rate	12%
After-tax yield	5.2%	After-tax yield	7.0%

Even after factoring in the tax impact, these dividend yields could be enticing. Investors with low marginal tax rates might be more easily coaxed into these types of investments, but to their peril.

Companies need capital to drive growth. This capital comes mainly from the reinvestment of profits or earnings. Assume a company pays out 30% of its earnings to shareholders as a dividend. That would leave 70% of the year's net income for reinvestment purposes, which, in turn, would stimulate growth, both top line (sales) and bottom line (net income) growth.

However, when the tax code forces these REITs and LPs to distribute 100% of their profits, they have no earnings left to reinvest. To continue as a growing concern, they have to raise additional capital. A capital infusion can be achieved by issuing shares to shareholders and/or borrowing money.

Consider a REIT with, say, ten million shares outstanding. Assume an investor owns one million shares for a 10% ownership interest (1/10 = 10%). Assume the company issues two million shares to raise capital. Our 10% investor now owns one million shares in a company with 12 million shares in issue. Instead of a 10% ownership interest, the investor now has an 8.3% ownership interest (1/12 = 8.3%). The additional stock issue diluted the investor's ownership interest from 10% to 8.3%. The stock price might not decline by -17% (8.3/10-1) as a result of the stock issue. It certainly will if the company does not invest the additional capital efficiently to keep profits growing at more than 20% to negate the dilutive effect of the stock issue. REIT investors are often on a treadmill to nowhere. What shareholders gain through the dividend yield, they often forfeit in stock price declines when additional stock is issued.

If the company borrows to replace the hole made by the dividend distribution, the stock market could react negatively as additional debt always raises the risk profile of a company. We prefer investing in companies with no debt.

Another consideration when it comes to REITs is that each property owned by the REIT has to be evaluated in terms of location, the purpose of its use (multi-family units, hospitals, warehouses, etc.), and the credit quality of the lessees. The lessees are the tenants from which the REIT has to collect rent. They must be examined and evaluated on an individual basis. A REIT investment is fraught with credit risk.

The above also applies to LPs. The capital structure of LPs allows for a General Partnership that owns the limited partnership. Shareholders in the limited partnership are subservient to the general partner. This arrangement can cause all kinds of opportunities to divert profits to the general partner, to the detriment of the limited partners. They are called "limited" for a reason.

There are always exceptions that prove a rule. History might show that a handful of REITS and LPs have delivered decent returns. Still, the many failures on the way are sufficient to find more attractive investment opportunities with less risk among the equities that trade on the stock market.

We were also questioned about private companies. Unless you are a "billionaire," stay away from private companies, whether debt or equity. The SEC filings of private companies always include documents that investors have to sign to absolve all and sundry of any liability, should this investment not pan out.

One additional factor that warrants consideration is a matter of liquidity, also referred to earlier. Public companies are quoted on our stock exchanges. For the most part, one can trade their shares with the click of a mouse button. When the stock of a public company lacks liquidity, the spread between “bid” and “ask” widens to the detriment of the seller. When it comes to the equities or debt instruments of private companies, liquidity is a major concern. This lack of liquidity means any attempt to sell a holding in private equity could take days, if not weeks.

Exceptional returns come not only by way of good stock selection but also by avoiding the dodgy stocks, which is sometimes all too obvious. More often than not, it takes extensive due diligence to discover the flaws and unacceptable risks associated with what many stock pundits might describe as a “slam dunk.”

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