

Executive Summary
for the *Real Estate Research Institute*

**THE ‘REAL ESTATE AND CAPITAL MARKET MONITORING’
PARADOX^{†‡}**

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Comments are welcome.

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THE 'REAL ESTATE AND CAPITAL MARKET MONITORING' PARADOX

Executive Summary

Real estate investment managers distribute cash to investors for current income as well as a bonding mechanism that ensures managers' actions are in the best interest of investors. In the case of real estate investment trusts this bonding mechanism is mandated. However, the effort to reduce agency costs between managers and investors results in increased issuance cost as investment managers seek to acquire external capital. Why do real estate investment managers, particularly real estate investment trust managers, engage in what appears to be an inefficient practice of recycling capital? In simpler terms, why do real estate investment trust managers simultaneously distribute capital and issue securities? In this study, I provide some possible insight into the seemingly paradoxical dividend payout policies of real estate investment trust managers.

A Model of Competing Costs

Real Estate managers are logically expected to adopt optimal policies. In the case, of capital, agency and taxation costs the logical policy is total cost minimization. The real estate investment trust structure is arguably an effective means of minimizing taxation costs. However, the costs of capital issuance and agency can be viewed as competing costs whereby the manager will distribute capital to investors to reduce agency costs associated with the separation of ownership and control and, at the same time, the manager will attempt to conserve capital distribution so as not to incur issuance or transaction costs. The competing effects of capital distribution allow managers to seek an optimal dividend or payout policy that minimizes the total cost to owners of the firm.

Data and Method

To validate this model of optimal dividend policy for real estate managers, I identify 59 real estate investment trusts with complete payout information across the period 1995 to 1998. Interestingly, this is the only study of real estate investment trust dividends using post-1993 data. The model simply estimates the relationship between payout ratio and proxies for the competing effects of agency and transaction costs.

Research Findings

The principal finding in the paper include:

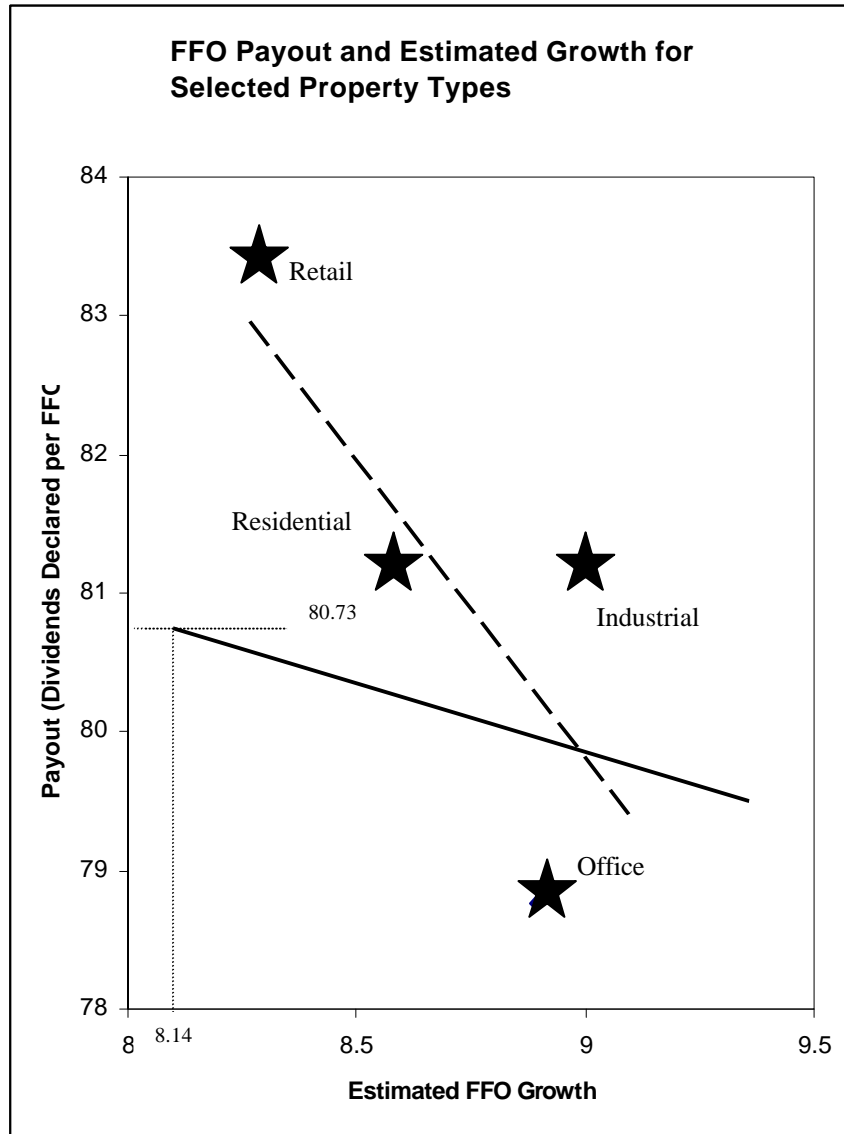
- ◆ The payout ratio policies of real estate investment trust managers are consistent with an optimal or equilibrium model of agency and transaction cost minimization.
- ◆ This finding is evident when payout ratios are defined as dividends declared by managers divided by funds from operations. Funds from operations is the real estate industry's relevant income measure for real estate investment trusts. This finding is not evident when payout policy is viewed in terms of the generally accepted accounting definition of net income.
- ◆ The model is able to account for differences that exist across property types represented in real estate investment trusts portfolios.
- ◆ The payout ratio of high occupancy rate firms is greater than payout ratio of lower occupancy rate firms, all else being equal. This finding is interpreted as consistent with the notion that real estate investment trust managers will distribute free cash flow to investors as a bonding mechanism.

Relevance for Institutional Investors

This research also has implications for real estate regulation and public market investing. However, the public market implication of competing costs in determining optimal payout policy may just as easily be extended to private market real estate investment. As for the regulatory environment, it is well known that the capital distribution requirements for real estate investment trusts are not binding, as evidenced by the proportion of firms that pay out capital well in excess of net income. However, the findings associated with this model of equilibrium payout for real estate managers suggests that the current capital distribution requirements may be relaxed without altering the optimal payout ratio. In addition, Figure 2 from the paper shows that the expectation of future growth does not reduce the payout ratio as much as would be expected if managers' only concern was the minimization of transaction costs. In fact, agency costs mitigate this process such that real estate managers that claim significantly positive investment opportunities must raise capital from external source, hence exposing themselves to the vicissitudes of capital market monitoring. The question of how this distribution policy is explicitly related to capital issuances has been left, however, to future research.

Figure 2 from RERI Project

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Note: This figure shows the relation between dividend payout and expected growth for four property type sectors in the real estate investment trust market. The solid dash line shows the estimated relation between changes in payout based on changes in expected growth. The slope of this line is taken from the estimated coefficient for expected growth in Table 3. The short dashed lines show the mean values of expected growth and payout for the entire sample. In contrast, the long dashed line is estimated simply from the four property types points show on the graph. The slope of the long dashed line is -4.5 suggesting that a 1.0 percent increase in expected growth will result in a 4.5 percent reduction in payout ratio. When in fact, the equilibrium model suggests that a one percent increase in expected growth will be associated with an approximately one percent decrease in payout ratio. Intuitively, the decrease in payout ratio is mitigated by agency costs.