The Evolution and Development of Equity REITS: The Securitization of Equity Structures for Financing the U.S. Lodging Industry

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THE EVOLUTION AND DEVELOPMENT OF EQUITY REITS: THE SECURITIZATION OF EQUITY STRUCTURES FOR FINANCING THE U.S. LODGING INDUSTRY

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ABSTRACT

The mid-1990s saw the alignment of real estate and capital markets. The primary driver of this convergence was the increasing securitization of real estate debt and equity investments. This article discusses the evolution of REITs as innovative equity instruments during this period and their resulting impact on financing the U.S. lodging industry.

Introduction and Study Context

Excess room inventory, the declining value of hotel real estate, the inability of hotels to meet debt service, the savings and loan debacle, and a national recession all combined to shut down virtually all funding for hotel projects in the early 1990s. In particular, traditional lenders, such as commercial banks, life insurance companies, and savings and loans, stopped lending for hotel projects. A survey of lenders in 1990 by Hospitality Valuation Services indicated that only 33 percent of lenders would consider new hotel loans. The remaining lenders stated that new hotel loans were too risky, and that they did not plan to return to hotel lending in the near future. During this period, lenders were more concerned with disposing of the non-performing hotels that they had foreclosed on or working with hotel owners to restructure their loans.

The investment climate during the early 1990s is reflected in a survey conducted by PKF Consulting during this period (Slay, 1993). The survey indicates the increased risk of a hotel investment, which is reflected in higher interest rates, capitalization rates, debt coverage ratios, return requirements, and a reduction in loan-to-value ratios. It should be noted that, although by 1992 interest rates had come down, hotel loans were still difficult to obtain. Since capital was difficult to obtain, investors had to use more of their own equity to secure loans, thus reducing loan-to-value ratios.

The true nature of the real estate "credit crunch" during 1992–1993 is summed up in a research newsletter published by the real estate advisory firm Grubb & Ellis (1993): "The truth seems to be that the crisis in real estate finance, where it exists, is not a crisis born of a shortage of loan funds. Instead it is one of confidence, on the part of both lenders and buyers, in the integrity of investment real estate in a severely overbuilt market." From 1990 to 1993, when traditional hotel financing sources curtailed their lending, alternative sources of financing emerged to partially fill the gap, and to take advantage of the depressed values of hotel real estate. In particular, two new sources of debt and equity financing emerged during this period and have revolutionized the way in which commercial real estate is financed:

1. Securitization of real estate debt financing: Commercial mortgage-backed securities (CMBS).
2. Securitization of real estate equity financing: Equity real estate investment trusts (equity REITs).

Study Objectives and Methodology

The purpose of the study was to review and analyze the evolution, structure, and purpose of REITs as innovative equity securities as they emerged in the 1990s to finance the lodging industry. A cogent review and explanation of this "new order" will help us understand the changing nature of U.S. lodging capital markets. The present study is historical research and relies upon secondary literature including texts, relevant articles, research studies, and other significant documents from each of the early to current periods studied. Commenting on historical research, Baumgartner states, "Using the historical approach, the researcher endeavors to record and understand events of the past. In turn, interpretations of recorded history hold to provide a better understanding of the present and suggest possible future directions." (Baumgartner & Strong, 1994)

Overview of Institutional Sources of Capital for Commercial Real Estate

Institutions providing debt and equity capital for commercial real estate in the United States include life insurance companies, pension funds, commercial banks, savings and loan associations, foreign investors, REITs, and issuers of CMBS. As seen in Table 1, the capital coming from mortgage debt is more than four times the amount derived from the equity market. As Table 1 illustrates, REITs and CMBS, which were a very insignificant part of real estate finance ten years ago, have now become a major source of capital for the commercial real estate industry, providing about 39 percent of the equity capital and almost 15 percent of the debt capital, respectively.

Table 1
Institutional sources of capital for U.S. real estate
(September 15, 2001)

Capital Source	Equity (Billions)	Debt (Billions)
REITs	$146.6 (39.3%)	$8.6 (0.5%)
Non-Government CMBS Issuers	NA	$247.8 (14.8%)
Pension Funds	$144.0 (38.6%)	$37.6 (2.2%)
Life Companies	$39.9 (10.7%)	$218.7 (13.0%)
Commercial Banks	$1.9 (0.5%)	$704.0 (42.0%)
Savings Association	$1.1 (0.3%)	$156.5 (9.3%)
Foreign Investors	$39.2 (10.5%)	$177.7 (10.6%)
Federally Funded Mortgage Pools	NA	$69.3 (4.1%)
Other	NA	$55.8 (3.3%)
Total	$372.7 Billion (100%)	$1.676 Billion (100%)

Source: Rosen Consulting Group, Lend Lease Real Estate Investments

Securitization of Commercial (Hotel) Real Estate: Real Estate Investment Trusts (REITs)

The securitization of real estate was one of the solutions to the problem of scarce capital availability for commercial real estate in general and hotels in particular during the early 1990s. Selling debt securities (CMBSs) to the broader public market increased the flow of capital to the lodging industry. On the equity side, another solution to the scarcity of capital during this period was offered by the reemergence of real estate investment trusts (REITs). However, the equity REITs of the 1990s were different from the mortgage REITs of the 1970s. While both mortgage REITs and equity REITs sell shares to individuals and institutions, the former were akin to banks (because they used the funds to make loans), while equity REITs are similar to corporations, because they are investment vehicles that use the funds to acquire or construct hotels and other forms of real estate. In the mid-1990s, equity REITs were a new type of hotel ownership entity and became an increasingly popular alternative form of hotel real estate ownership.

Origin and Early Development of REITs

The modern equity REIT can trace its development back to the Real Estate Investment Trust Act of 1960. The congressional sponsors of the 1960 legislation used the growing success of the mutual fund industry as a model for attracting capital to the real estate industry. The equity REIT structure was designed to be a "mutual fund" for real estate. Those with inadequate means to buy individual properties could nevertheless participate in the real estate market by buying shares in an equity REIT.

The New York Institute of Finance (1988) states:

> "A REIT may be a corporation, business trust, or association primarily developed to own or finance real estate. As with most corporations, a board of directors or trustees elected by shareholders sets policy and arranges the day-to-day operation of the REIT by professional managers or advisors. Persons with real estate experience, such as real estate brokers or mortgage bankers, organize many REITs. They may also be organized by commercial banks or insurance companies."

Once legally organized, an equity REIT begins its existence by issuing shares of stock. To purchase properties, equity REITs sell securities to institutional investors, issue commercial paper, and borrow from banks. Traditional equity REIT investments include the purchase of office buildings, apartments, shopping centers, warehouses, and hotels. REIT shares trade on the major stock exchanges, providing liquidity to the holders of REIT shares.

Besides being a type of mutual fund for purchasing real estate and being organized like a corporation, REITs are also intended to be a tax "conduit," according to section 856-60 of the Internal Revenue Code. This means that REITs are exempt from corporate income tax as long as they distribute 90 percent of their taxable income to their stockholders.

Factors Affecting the Emergence of Modern REITs

Arnold (1994) states that the resurgence of equity REITs in the 1990s can be traced to three primary motivations:

1. As the traditional financing sources such as banks, savings and loans, and insurance companies stopped funding commercial real estate (including hotels), it created a vacuum. As a result, real estate developers, managers, and owners saw REITs as a means to raise capital and finance growth.
2. The demand for REITs also came from institutional investors such as mutual funds and pension funds. These investors wanted to continue investing in real estate but needed an exit strategy. Investment in REIT shares provided the ideal solution.
3. For many investors, especially small individual investors, the Tax Reform Act (TRA) of 1986 took away the tax-shelter advantages of investing in commercial real estate (including hotels). The tax shelter partnerships and syndications that were formed prior to the passage of the TRA were no longer the ideal business format for investing in real estate. At the same time, there was an excess inventory of real estate, resulting in unprofitable operations and the eventual decline in the value of commercial real estate (including hotels) by the early 1990s. During this period, many investors wanted to purchase hotels and other real estate because of their reduced values. Since traditional capital sources were not available, and the previously used limited-partnership formats were not suitable for raising capital, REITs became the vehicle of choice for raising capital to make real estate purchases. In fact, many of the early hotel REITs got their start by buying hotels in this overbuilt environment at 50 cents on the dollar.

Advantages and Disadvantages of REITs as Investment Vehicles

REIT investors should be familiar with the various advantages and disadvantages of a REIT structure before selecting REITs as part of their investment portfolio. Listed below are the major benefits and drawbacks of REITs.

Advantages

- The corporate character of the REIT (ownership takes the form of corporate stock).
- The liquidity of REIT shares and the ability to trade them.
- Diversification.
- Tax advantages (no corporate-level tax).
- Established state law regarding corporate governance.
- Flexibility—most REITs can operate in any state or city (banks and S&Ls may have restrictions related to expansion).
- Professional management.

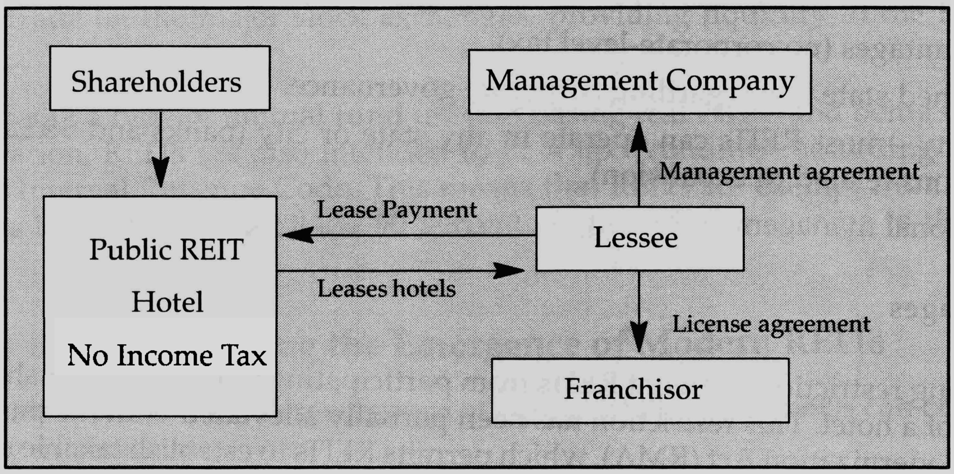
Disadvantages

- Operating restrictions prevent REITs from participating in managing or sharing in the profits of a hotel. This restriction has been partially alleviated with the passage of the REIT Modernization Act (RMA), which permits REITs to establish taxable subsidiaries to operate their real estate.
- By imposing the 75 percent minimum-gross-income threshold, the business activities of REITs are restricted primarily to rents, mortgage interest, and the gains from the sale of real estate assets.
- REITs cannot own more than 10 percent of a tenant (in the case of hotels, the tenant is the hotel operator). Additionally, the sponsor of the REIT is restricted to 10 percent ownership of the REIT if he also owns the management company.
- REITs cannot pass on operating losses to investors, which is allowed in syndication structures.
- As 90 percent of a REIT's income is distributed to the shareholders, it is continuously seeking capital through secondary stock offerings, issuance of convertible debentures, bank borrowings, and joint ventures. The danger is that if most of a REIT's growth is fueled by externally generated funds (versus accumulated equity), its continued performance and maintenance of its share price determine its success in raising capital.

Types of REIT Structures

There are typically three forms of REIT structures. In the traditional structure, the REIT owns the real estate (hotels, apartments, and office buildings), and these are then leased to a lessee, who arranges management and franchise agreements. (See Figure 1 for a diagram of a traditional REIT structure.) In the case of hotels, the lessee frequently was a private company owned by REIT management. However, recently many of these private companies have been sold (by the REITs) to non-related entities to avoid the inherent conflict between the public REIT and private lessee (Shroders & Co., 1998). Despite the creation of this arm's length lease structure, inherent conflicts of interest continue to exist between the REIT and the lessee. For example, as lease payments to the REIT (lessor) increase with higher occupancies, typically a lessee's management decisions favor cost containment as opposed to revenue enhancement decisions (Beals & Arabia, 1999).

Figure 1
Traditional REIT structure



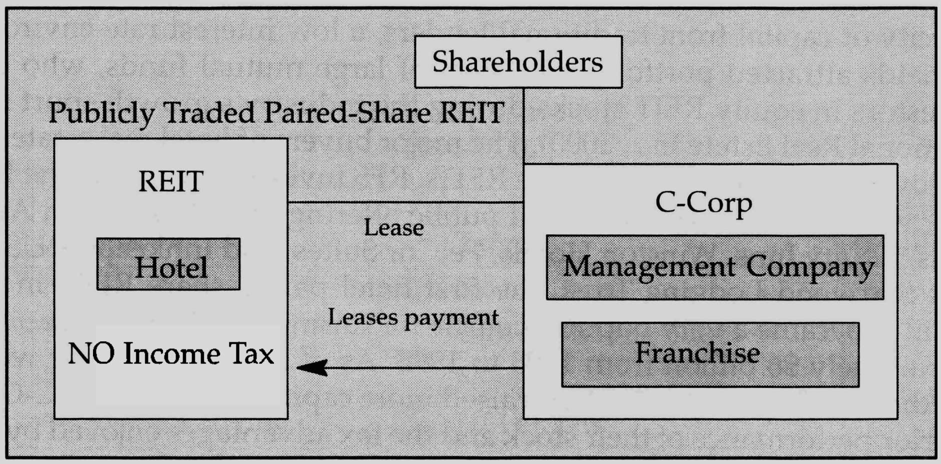
Source: Shroders & Co., Inc.

A paired-share REIT pairs a REIT with a C-Corp[1] (see Figure 2). This combined company is then traded as one. This integrated structure is advantageous to investors because the REIT leases the hotel properties to the C-Corp, which then is the operating company (and, in some cases, the franchisor); this structure avoids what is inelegantly termed in the industry "leakage." The term leakage refers to the cash lost to the lessee, which is potentially significant as a hotel's volume increases beyond breakeven. In a paired-share REIT, the leakage occurs but is recaptured by the C-Corp. "Since paired-share shareholders own an equal stake in both the REIT and the C-Corp, the profits forgone by the REIT flow back to the security holder via the C-Corp." (Shroders & Co., 1998). This arrangement, however, does not exempt the taxable C-Corp from paying its necessary share of income taxes—and provides another compelling reason to reduce leakage.

Under the IRS Restructuring and Reform Act of 1998, the tax advantages associated with the unique structure of paired-share REITs were discontinued for future

[1] C-Corp is an organization formed under state and federal law, an artificial entity separate from its owners. Shareholders, who own the organization, elect a board of directors. The board, in turn, appoints the corporate officers who run the day-to-day business of the C-Corp.

Figure 2
Integrated paired-share REIT structure



Source: Shroders & Co., Inc.

acquisitions. As a result of the act, Starwood Lodging (the largest lodging equity REIT) effectively abandoned its paired-share status and converted to a tax paying C-Corp (Giovanetti, 1998). The lodging industry currently has no paired-share REIT structures. The last paired-share structure, La Quinta Companies (formerly The Meditrust Companies) rescinded its structure in December 2001. The new structure makes La Quinta Properties (REIT) a subsidiary of La Quinta Corporation (C-Corp) (Higgley, 2001). As in the case of the Starwood restructuring, the new structure will allow the company to "grow its portfolio, management operation, and brand franchising program, without the restriction imposed by the federal tax legislation." (La Quinta Companies Annual Report, 2001).

Another REIT, similar to a paired-share REIT, is known as a paper-clip REIT. The principal difference between the two is that paired-share REITs trade the shares in the REIT and the C-Corp as one integrated share; a paper-clip REIT trades shares in the REIT and the C-Corp separately. (However, the REIT and the C-Corp have common management control.) A current example of a paper-clip REIT is MeriStar Companies, which was formed by merging Capstar (a C-Corp) and American General Hospitality (a traditional REIT) in 1998 (Nozar, 1998). The company combines MeriStar Hospitality Corporation, a REIT, and MeriStar Hotels & Resorts, Inc., a hotel management company, into the unique paper-clip structure. Under this form of ownership, the management company and the REIT are independent, but closely aligned (paper-clipped) by creating inter-company agreements and sharing of corporate officers and directors. For example, MeriStar Hotels & Resorts (management company) has the right of first refusal to lease and manage all properties acquired by the REIT, MeriStar Hospitality.

Growth and Development of Lodging REITs (1994–2002)

REITs as we know them today emerged in the early 1990s. Kimco Realty, a regional-mall REIT, was the pioneer in the field with its public offering in November 1991. In fact, the asset class that led the emergence of equity REITs was regional malls. As the operating performance of hotels improved, they became the next target for REITs (Lefleur, 1995).

The scarcity of capital from traditional lenders, a low interest rate environment and high REIT yields attracted portfolio managers of large mutual funds, who became the primary investors in equity REIT stocks during the industry's growth spurt in 1993 and 1994 (Institutional Real Estate Inc., 2000). The major buyers of hotel real estate during this period of recovery from 1994 to 1997 were REITs. RFS Investors, Inc., the first hotel equity REIT, led the way with a successful initial public offering of $30 million in August 1993. Jameson Inns, Equity Inns, Winston Hotels, FelCor Suites, and Innkeepers USA followed in 1994, and Starwood Lodging Trust, the first hotel paired-share REIT, in 1995. After that, hotel REITs became a very popular vehicle for raising public equity capital, contributing approximately $6 billion from 1995 to 1998. As of April 1998, there were 15 hotel REITs. With the exception of 1997, REITs raised more capital than lodging C-Corps (Table 2). The superior performance of their stock and the tax advantages enjoyed by their structure were the primary factors in creating this surge in capital flows from this public source.

Table 2
Comparison of lodging equity REIT with C-Corp offerings
(1981–2002)

Offering Year	Total Proceeds Equity REITS	Total Proceeds C-Corps
1981	$10,400,000	$39,025,000
1985	$25,500,000	$83,350,000
1986	$66,650,000	$391,700,000
1993	$73,600,000	$490,562,500
1994	$560,318,750	$389,268,000
1995	$1,219,760,000	$790,644,250
1996	$1,693,875,000	$3,361,777,500
1997	$2,495,760,175	$1,655,547,500
1998	$703,610,229	$548,845,625
1999	$380,125,000	$310,345,003
2000	$0.0	$219,00,000
2001	$0.0	$0.0
2002	$0.0	$0.0

Source: PricewaterhouseCoopers; Securities Data Corporation

As noted in Table 3, REITs were on a "shopping spree" in 1997 and 1998. In fact, in 1997, REITs accounted for 10 out of the 15 hotel merger and acquisition deals. Some of the major acquisitions during this period included ITT Sheraton, Interstate Hotels, Westin Hotels and Resorts, Wyndham Hotel Corporation, La Quinta Inns, and Bristol Hotels.

REIT acquisition activity was a major contributor to the consolidation of the U.S. lodging industry, which has resulted in a larger number of hotel rooms being controlled by fewer companies.

Table 3
REIT acquisitions
(1994–2002)

Year	Acquirer	Target	Dollars (Millions)
1994	None	None	0
1995	FelCor Suites	Crown Sterling Suites	141.5
1996	None	None	0
1997	Starwood Lodging	HEI Hotels	327.0
	Patriot American	Carefree Resorts	256.6
	Patriot American	California Jockey Club	238.0
	Starwood Lodging	Flatley/Tara Hotels	470.0
	Sunstone Hotels	Kahler Realty	322.0
	Patriot American	Grand Heritage Hotels	22.0
1998	Patriot American	WHG Resorts & Casinos	300.0
	Patriot American	Summerfield Hotel Corp	180.0
	Patriot American	Arcadian	296.0
	Starwood Lodging	ITT Corp	$17,000.0
	Patriot American	Interstate Hotels	2,100.0
	Starwood Lodging	Westin Hotels	1,570.0
	Patriot American	Wyndham Hotel Corp	1,100.0
	Patriot American	Carnival Hotel and Resorts	485.0
	Boykin Lodging	Red Lion Inns	271.0
	Meditrust	La Quinta Inns	2,650.0
	FelCor Suites	Bristol Hotels	1,700.0
	MeriStar	South Seas Properties	Not Available
1999	Jameson Inns	Signature Inns	105.1
	Humphrey Hospitality Trust	Supertel Hospitality Inc	43.3
2000	None	None	0
2001	None	None	0
2002	MeriStar Hotels & Resorts	Interstate Hotels Corp	68.0

Source: PricewaterhouseCoopers; Bear Stearns, Securities Data Corporation

As 1998 drew to a close, however, lodging REIT companies had tremendous difficulty raising capital because their stock prices dropped. REIT investors earned negative returns in 1998 of –52.8 percent. Ironically, it was falling stock prices and not industry weakness that led to these negative returns. Smith Travel Research statistics indicate that the lodging industry maintained healthy profits of $20 billion, and posted steady RevPAR growth of 3.5 percent. Finally, with removal of the paired share structure, in 1998 the reduction in the number of REITs continued (either by de-REITing or conversion to private structures) and the industry had ten fewer REITs by the end of the year than at the beginning.

This trend continued into 1999, when capital markets and investors turned their attention to the dot-com frenzy (Frabotta, 2000). The negative hotel REIT returns of 1998 continued to plague the industry in 1999, which ended the year with –16.2 percent returns. As in 1998, the lodging fundamentals remained strong, as the industry profits held steady at $21 billion with a 3.1 percent growth in RevPAR. The net result of declining stock prices was a reduction in lines of credit that resulted in a slowdown of REIT acquisition activity in 1999 (Table 3). As noted earlier REITs are required to distribute 90 percent of their taxable income to shareholders each year, and are thus dependent upon external financing for continued growth. With their stock prices caught in a downdraft and external financing shut off, REITs during this period found themselves at a competitive disadvantage. Furthermore, the two largest REITs (Starwood Lodging and Patriot American) had converted to C-Corps, which considerably hampered the future growth of REITs.

After two years of negative performance, the industry turned the corner in 2000 when REITs outperformed most other sectors of the domestic equity market. The lodging sector in particular outshone all other REIT asset classes in 2000 and posted a positive return of 45.86 percent for the year (NAREIT, 2000). A NAREIT research report identified four factors that contributed to the strong performance of REIT stocks in 2000. First, after a slowdown in earnings growth in 1998 and 1999, average earnings growth for REITs in 2000 was about 10 percent and earnings reports suggested that future earnings prospects were strong and that earning multiples had stabilized. Second, with the real estate industry's transformation from private ownership to public ownership, investors were more confident that the sector was less prone to the speculative overbuilding of earlier years. With greater public ownership of real estate, including REIT stocks, the management and decision making of owners and developers were open to scrutiny from analysts, investors, and financial regulators. As a result, the prevailing sentiment was that the increase in public information decreased the likelihood of speculative construction.

Third, investors sought safe haven in REIT stocks, as the broader equity markets grew more volatile. In particular, NASDAQ and the technology sector, with its outlandish multiples, turned negative in 2000. In this environment, investors realized the importance of including in their portfolios companies (such as REITs) with predictable cash flows, high dividends, and lower multiples. Finally, equity REIT yields provided good value to investors as dividend yields increased.

While the total number of REITs was about the same (as of August 2000, there were 16 hotel REITS), the total inventory of rooms they controlled and overall market capitalization had declined considerably since the their peak in 1997 (Hanson, 2000). As of September 11, 2000, Lodging REIT market capitalization was approximately $8 billion (NAREIT, 2000).

Impact of the REIT Modernization Act (RMA)

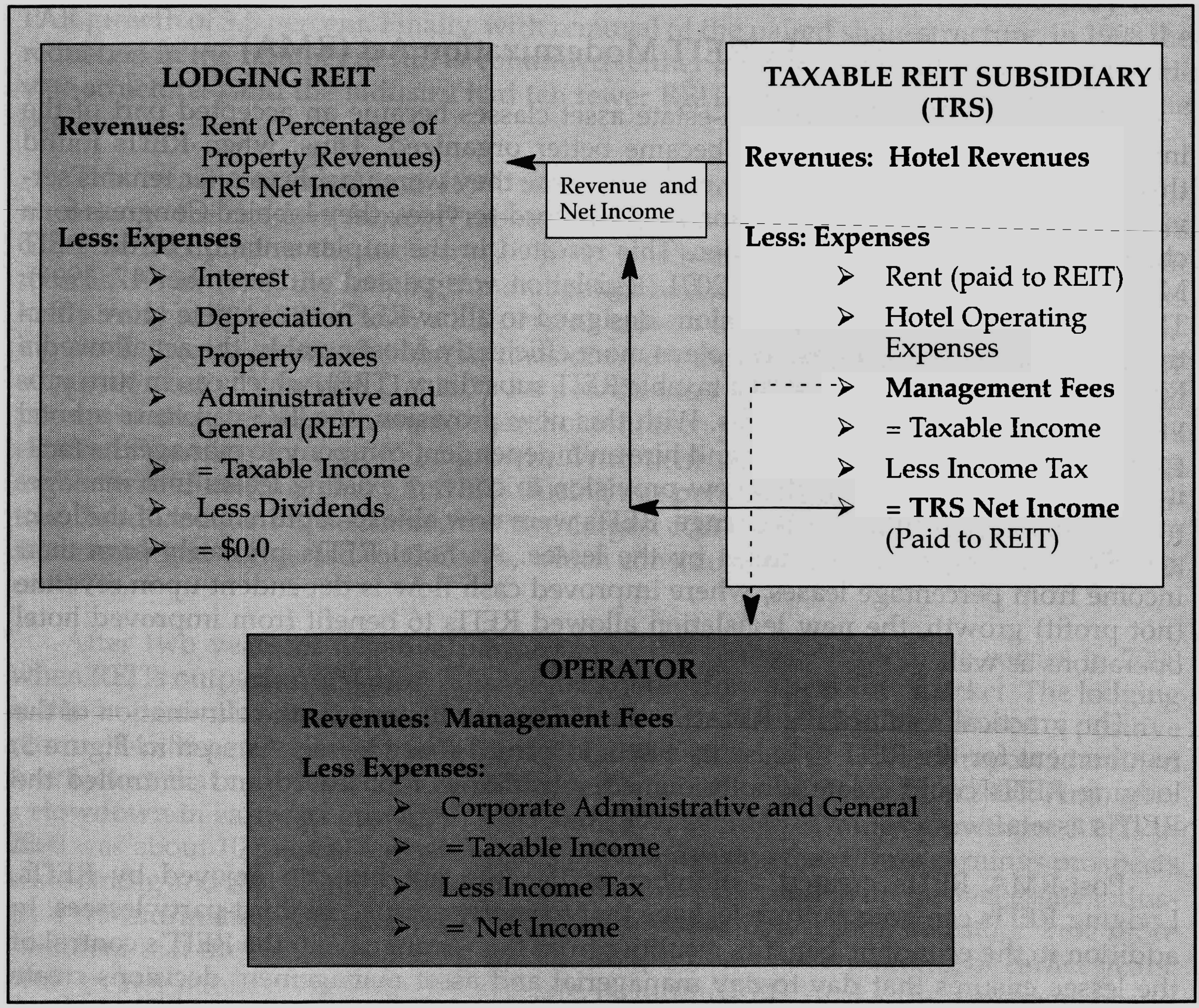
As REITs holding various real-estate asset classes became an accepted part of the investment landscape, the sector became better organized. Thus, when REITs found themselves at a competitive disadvantage because they were unable to offer tenants services beyond "reasonable and customary" landlord services, they lobbied Congress for a change in the governing regulations. This resulted in the implementation of the REIT Modernization Act on January 1, 2001 (legislation was passed on December 17, 1999). The act created several new provisions designed to allow REITs to compete more effectively and carry out their business plans more efficiently. Most notably, the act allowed a REIT to own up to 100 percent of a taxable REIT subsidiary (TRS), which can in turn provide services to the REIT's tenants. With this new provision, the TRS can lease a hotel property from the affiliated REIT and hire an independent company to manage the facility. Many hotel REITs used this new provision to convert existing leases into management contracts. Because of this change, REITs were now able to capture most of the leakage that was previously captured by the lessee. As hotel REITs primarily earn their income from percentage leases, where improved cash flow is dependent upon revenue (not profit) growth, the new legislation allowed REITs to benefit from improved hotel operations as well.

The practical result of the RMA for the lodging industry was the elimination of the requirement for the REIT to lease its assets to a third-party lessee. As seen in Figure 3, lodging REITs could create wholly owned subsidiaries that leased and controlled the REIT's assets.

Post-RMA REITs created a number of benefits not hitherto enjoyed by REITs. Lodging REITs can now capture leakage that formerly accrued to third-party lessees. In addition to the economic benefits resulting from this arrangement, the REIT's control of the lessee ensures that day-to-day managerial and asset management decisions create value for the REIT's shareholders. Furthermore, as seen in Figure 3, the post-RMA structure provides investors with a more transparent earnings model, a welcome change from the arcane lease terms of the pre-RMA REITs. Finally, RMA reduced the required dividend payout from 95 percent to 90 percent of taxable income, providing managers with a margin of error in case the dividends declared in the course of a year do not track closely enough to the REIT's taxable income.

Although the RMA had significant positive implications for REITs, the changes do not restore the "utopian" benefits of the paired-share model. Some of the restrictions imposed by RMA include the inability of REITs to manage or franchise through their TRSs. Moreover, to ensure that the REIT remains focused on core real estate ownership, the scope of the activities a TRS might engage in is inherently limited because "no more than 20 percent of a REIT's gross assets may be securities of a TRS." (Edwards, 1999). In addition, the longstanding rule that 75 percent of a REITs income must come in the form

Figure 3
Post-RMA lodging REIT structure



of rental payments, or so-called "good" income, remains in force. As the RMA makes explicit, dividends from a REIT's TRS do not qualify as good income. The RMA also explicitly limits the amount of debt and rental payments from a TRS to its affiliated REIT, thus ensuring that the TRS is subject to an appropriate level of corporate taxation. Finally, in a "leave-no-stone-unturned" clause, the RMA provides for the imposition of a 100 percent excise tax on any transaction between a REIT and its TRS that is determined to have been conducted on a less-than-arm's-length basis.

As hotel real estate investors will explain patiently to their counterparts in residential, office, retail, and industrial real estate, lodging *is* different because value creation in the sector depends on the successful management of a complex operating business. Accordingly, an entity structure that distances the owners of lodging assets (or their agents) from the day-to-day operation of their holdings is potentially detrimental to shareholder value. By these criteria, as an asset class, hotels offered the worst fit with the REIT structure.

Passage of the RMA removed much of the incongruence between the REIT structure and the objectives of REIT managers and shareholders. Post-RMA, the paired-share structure that pushed the envelope of tax compliance becomes a historical footnote. The RMA also obviates the need for REIT managers to form closely held, potentially conflict-laden lessees to operate a lodging REIT's assets. Similarly, the zero sum competition between third-party lessees and REIT lessors to protect their individual economic interests ceases to exist when the lessee is a subsidiary of the REIT. It is not surprising therefore that most lodging REITs moved quickly to adopt the newly permitted structure.

Recent Events and their Impact on the REIT Industry

The terrorist attack on September 11, 2001, was the most profound recent event affecting the REIT industry. Its effects continue to affect the industry. Whereas the economy was already in a cyclical downturn, the terrorist attacks completely disrupted travel and had a catastrophic impact on hotel revenues and on investors and lender confidence. One of the largest hotel REIT mergers, between FelCor Lodging Trust and MeriStar Hospitality Corporation, was terminated as a direct result of the September 11 attacks. A first quarter NAREIT conference call in 2001 was optimistic about the outlook for lodging REITs (predicting returns between 10 and 15 percent for 2001). After the September 11 attacks and the ensuing war on terrorism, the future performance was uncertain. In the face of this uncertain outlook, lodging REITs ended 2001 with a dismal –8.6 percent return.

Michael Grupe, Senior Vice President of Research and Investment at NAREIT, identified two anomalies with regard to REITs in 2002. First, despite the recovering national economy (GDP growth of 1.7 percent in Q1, 2002), the real estate recession appears to be deepening (as evidenced by declining occupancy and rates). Poor lodging industry results are easily attributed to reduced travel due to September 11 and consequent declines in occupancy, RevPAR, and profitability. In addition, real estate usually leads a recession and lags a recovery, providing another explanation for this anomaly. His overall outlook for the lodging industry is "near term less bad and long term great." Accordingly, he predicts slow growth in 2002 with a strong recovery in 2003 and 2004. The "long term great" forecast is primarily due to cutbacks in hotel construction lending, which will favorably affect the supply-demand equilibrium for the industry (NAREIT, 2002). This optimistic outlook for lodging REIT companies is supported by REIT equity research analysts, many of whom have upgraded hotel REITs to "buy" or "hold."

Despite the real estate recession, REITs posted strong returns in the first quarter of 2002, causing the second anomaly. The Morgan Stanley REIT index, a total return index, was at an all time high (466 on January 2002). Stock prices of lodging REITs are up by 18 percent for the first quarter of the year and have reverted to pre-9/11 valuations. As noted in Table 4 all property sectors have generated positive returns this year, with the lodging sector being the leading performer in 2002 (30.5 percent) and substantially outperforming the Equity REIT index by over 16 percent.

Table 4
Trends in property sector REIT returns
1999–2002

Property Sector	YTD 4/12/02	2001	2000	1999
Lodging/Resorts	30.5 %	−8.6 %	45.8 %	−16.2%
Healthcare	18.8	51.9	25.8	−24.8
Diversified	15.7	12.5	24.1	−14.4
Retail	15.3	30.4	18.0	−11.8
Self Storage	14.6	43.2	14.7	−8.0
NAREIT Equity REIT Index	**14.0**	**13.9**	**26.4**	**−4.6**
Office/industrial	12.2	7.1	33.4	3.4
Residential	11.1	9.0	34.3	9.5
Specialty	7.6	7.6	−31.6	−25.7

Source: NAREIT

A variety of factors may explain why REITs have performed well despite somewhat weak property fundamentals. First, REITs have now developed a ten-year track record, which demonstrates that REITs have performed well. The historical data help investors make sound investment decisions versus speculating on future performance. Historical data also demonstrate that REIT stocks have low correlations with other equities and thus reduce risk in a diversified investment portfolio. As the market for REIT shares has grown in the past few years, REIT market liquidity has improved and added to investor confidence. Furthermore, investors have more confidence in REIT executives, who have survived the two bear markets of 1989 and 1999, and are expected to use their sharpened management skills to steer their companies successfully through the present difficult environment. Finally, given the positive prospects for recovery, investors are seeking companies with the greatest potential for growth during a recovery. Jason Ader of Bear Stearns Equity Research states, "In our view, hotel real estate oriented businesses are best positioned to benefit from a demand recovery given the operating leverage in the business model" (Ader, 2002). In a recent interview, FelCor Lodging Trust Chief Executive Officer Thomas J. Corcoran stated, "In the past three recessions, when the economy turns around, you get four or five years of growth." Most REIT watchers and investors are looking for this past macro-economic behavior to repeat in the future (Smith, 2002).

Growing from a market capitalization of $44 billion in 1994 to $170 billion in 2002 (Table 5), the REIT industry had evolved into a mature and stable provider of equity capital for commercial real estate. While the total number of REITs has been reduced, the average size of each REIT is much larger. It is expected that the consolidation trend will continue into the future. Lodging REITs are not part of the core REIT universe but the existing 16 REITs enjoy a market capitalization of over $10 billion, or six percent of the total REIT capitalization (Table 6).

Table 5
Trends in REIT market capitalization

Year	Number of REITS	Market Capitalization (Millions)	Percent Growth Previous Year
1994	226	44,306	
1995	219	57,541	29.9%
1996	199	88,776	54.3
1997	211	140,533	58.3
1998	210	138,301	(1.6)
1999	212	145,387	5.1
2000	189	138,715	(4.6)
2001	182	154,898	11.7
2002	179	170,334	10.0

Source: NAREIT

Table 6
REIT equity market capitalization
April 30, 2002

Property Sector	Number of REITS	Market Capitalization (Millions)	Percent of Total
Industrial/Office	34	$48,697,129	28.58%
Retail	42	36,870,486	21.64
Residential	24	33,350,796	19.57
Diversified	20	13,747,626	8.07
Lodging/Resorts	16	10,291,158	6.04
Self Storage	3	5,864,245	3.44
Healthcare	12	8,509,435	4.99
Specialty	8	6,934,427	4.07
Mortgage	20	6,069,441	3.56
Industry Totals	179	$170,334,747	100%**

Source: NAREIT

** Totals will not equal 100 percent due to rounding error.

Impact of Securitization on Lodging Real Estate Finance

The 1990s were a time of tremendous change with regard to financing the lodging industry. In many ways, changes in the past decade were a response to events of the 1980s. Due to the excesses of the 1980s, the decade began with a period of capital scarcity. In response to this shortage, investment banks created financially engineered products. These included the various debt securities using mortgage as a collateral. In addition, equity capital was available with the emergence of the REIT.

As we move into the 21st century, the interrelated events and lessons learned in the past decades have led to a restructuring of capital sources and a redesign of lodging industry finance:

- Formerly, capital sources to the lodging industry were primarily private, but now both public (issuance of debt and equity securities) and private (direct investment in hotel real estate and commercial mortgages) sources of capital are available to the industry. As the availability of public capital from both debt and equity slowed down in 1999, so did room starts. It is interesting to note, however, that when the public capital markets started to decline in 1998, this presented opportunities to the traditional lenders (commercial banks and life insurance companies), who stepped forward to fill the vacuum. This is an interesting change from financing earlier in the decade, when the traditional lenders stopped financing and lodging industry public capital markets filled the vacuum.
- In this current financing environment, where capital is available from both public and private sources, the financing environment may be described as one of conservative competition between the various sources of capital. This is reflected in the changes in the lending terms. While interest rates have declined from the mid-1990s as compared to the 1980s, lenders are conservative in terms of their debt-coverage ratio and loan-to-value ratios, which are more stringent compared to the 1980s.
- As real estate and the public markets become more integrated, capital market factors exogenous to the property markets have an impact on the flow of capital to real estate. For example, the Asian currency crisis disrupted fixed-income markets and triggered widening CMBS spreads in the fall of 1997. None of these macro events reflected local property market dynamics (Gordon, 2002).
- With the introduction of securitization of debt and equity, hotel real estate investments do not carry the same amount of risk. Instead of investing in bricks and mortar, which are illiquid, investors have a liquid investment with an available exit option. However, the downside to increased liquidity is that in unpredictable capital markets, the capital flows into real estate can be shut off almost overnight. With an increase in investment information, a more agile investor can move in and out of an asset class very quickly. The ultimate impact of these creative instruments was to bring flexibility to real estate investing, which makes investing in real estate appeal to a wider range of investors.
- With the introduction of securitization, a new player—the rating agency— entered the hotel-financing arena in the 1990s. One of the main reasons for the overbuilding of the 1980s was a breakdown in the quality of the loans underwritten by the banks and

thrifts. The rating agencies are expected to prevent an excess flow of capital to the lodging industry as they evaluate a potential issuer's credit quality (default risk) and assign a rating based on the issuer's business and asset class (hotel, regional mall, warehouse), management quality, and other financial measures such as profitability, size, and leverage (Kirtland, 1995). Therefore, it is expected that the securitization process and the role of the rating agencies will keep capital flows in check, preventing oversupply.

- Financing of the hotel industry changed from being merely mortgage lending to what is called "credit-based financing." In this lending environment, loans are more akin to corporate loans, in which the borrower is treated as a business. "Credit-based financing takes into account not just the value, cash flow, and risk profile of a single property, but rather the borrower's overall credit, based on an evaluation of all the borrower's assets and operations" (Levy & Furman, 1997).
- The profile of equity investors in the 1990s has changed from those in the 1980s. While limited partnerships and syndications were the dominant source of equity capital in the 1980s, the 1990s started with opportunity and acquisition funds buying depressed hotel real estate. From the mid- to late-1990s, hotel C-Corps and REITs became the major channels for directing equity capital to the lodging industry. Today there are 29 public hotel companies (C-Corps) and 16 equity REITs that raise capital through the issuance of equity and debt. While this activity slowed down in 1999, it remains at much higher levels than in the 1970s and 1980s.

Conclusion and Future Outlook

The 1990s were a time of tremendous change with regard to financing the lodging industry. The decade began with a period of capital scarcity. However, the scarcity spurred innovations in real estate financing instruments. With the introduction of securitization, which is an extension of financial engineering or structured finance, many new and creative financial instruments were introduced, including equity REITs. As the preceding discussion suggests, lodging REITs have staked their claim to a durable role in the investment universe. This progression has been facilitated considerably by the passage of the RMA, which resolved the conflicts that made the REIT structure incompatible with the investment and operating characteristics of hotels.

Notwithstanding their secure place, lodging REITs are not poised for the expansion that marked the mid-1990s. Some consolidation may occur as smaller lodging REITs owning limited-service properties join forces to increase their liquidity and improve their ability to raise capital. However, significant acquisition activity by lodging REITs will occur only if their rising share prices provide a handsome premium over their net asset values. Although "never say 'never'" is an appropriate cautionary adage for the equities market, for the reasons cited in the preceding section, a sustained rise in lodging REIT share prices is a possibility, but not an eventuality. Nevertheless, even absent a dramatic upside through price appreciation, lodging REITs offer investors the opportunity to share in the economic benefit (and risk) of the lodging sector, on a tax efficient basis, without most of the conflicts of old.

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