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By Robert Barker

REITs: At Today's Prices It Pays To Be Picky

On July 1 the 225,223 people in IBM's ([IBM](#)) 401(k) plan can start putting their money in real estate investment trusts. Indeed, the number of plans offering a real estate fund has doubled in the past five years. Still, IBM's move comes at an odd moment. REITs have a fine long-term record and a terrific one since 2000. Yet suddenly this spring they faltered and today are trailing the broad market.

Fear of rising interest rates was the immediate excuse for the sell-off. But there's no escaping a more basic problem: REITs have gotten pricey. Chris Mayer is director of Columbia Business School's Paul Milstein Center for Real Estate. At a recent conference put on by the National Association of Real Estate Investment Trusts, he noted that in March, REITs traded at a 22% premium over the net value of their assets. That's up from a 19% discount in 2000 -- the highest level since '97. They now trade 10% above net asset values -- and those asset prices are up a lot, too. One REIT exec after another at the conference testified as to how pricey real estate has gotten, with bountiful pension-fund dollars chasing deals.

THAT TELLS ME TWO THINGS: If you want capital gains from a REIT, you better pick your REIT with more than usual care. Second, if you'll settle for the dividend income REITs offer, more than ever you not only must lower the odds that the dividend will be cut but also seek a dividend that's set to rise.

With this in mind, I went in search of one stellar candidate. I wanted evidence of deep loathing at the prospect of a dividend cut, along with a strategy and financial position that makes dividend growth probable. I settled on Federal Realty Investment Trust. For starters, Federal has a 36-year record of higher payouts, the longest among REITs. "Increasing our dividend is the most important asset we have," says CEO Donald Wood. "Nothing I see would keep that streak from continuing."

That's nice, but Federal's numbers lend greater confidence. With a focus on neighborhood shopping centers, Federal controls some 17 million square feet in dense parts of the Northeast, mid-Atlantic, and California, such as San Jose's Santana Row, which is heating up after a cool start. Safeway ([SWY](#)) is Federal's No. 1 tenant but accounts for less than 3% of total rents. With short-term interest rates set to rise, Federal this year halved its exposure to floating-rate debt, while its ratio of earnings to fixed charges has been rising. Last year, Federal saw

revenues grow 13%, to \$358 million, with funds from operations (a measure of cash flow used by REIT analysts) jumping 45%, to \$131 million, or \$2.70 a share. This year, Wood sees funds from operations of \$2.81 to \$2.84 a share; Wall Street expects maybe \$3 in 2005.

What does this imply for the dividend? At the current annual rate of \$1.96 a share, a buyer at \$39 a share gets a 5% yield. (Reminder: Most REIT dividends are still taxable as ordinary income, not at the lower rates that took effect last year for most corporate dividends.) If Federal winds up with funds from operations of \$3 next year and its payout rate holds steady, the dividend might rise 7% or so, to \$2.10, good for a yield of nearly 5.4%. Beyond that, Wood's goal is 8% to 10% growth in funds from operations, which he figures is doable via rent hikes and by renovating some of its shopping centers. That insulates Federal from having to pay today's inflated prices by adding properties in search of growth. "I can be very selective," Wood told me. You should be, too.

Questions? Comments? E-mail barkerportfolio@businessweek.com or fax (321) 728-1711