CHAPTER 3

REIT Dividends

As Chapter 2 highlighted, many investors are drawn to REITs first and foremost because of the attractive yield they offer relative to bonds or other stocks. A REIT's dividend yield is only attractive, however, if it is sustainable and, preferably, able to be increased over time. This chapter discusses how to calculate a REIT's yield, as well as how to assess the safety and sustainability of a REIT's common dividend. Additionally, because investors pay the taxes on the dividend income they receive, this chapter addresses REIT dividend taxation. Last, this chapter highlights the risks and rewards associated with investing in preferred stock of REITs. Preferred dividends provide a premium yield to common dividends of the same REIT, but there are several potential risks investors need to understand before investing in the preferred stock of any REIT.

Rockland REIT

Rockland REIT (ticker symbol: ROCK) is a fictional company used to illustrate concepts discussed in this and the remaining chapters.

REIT Yields

A REIT's distribution requirement is based on taxable income for IRS purposes, rather than income as calculated in accordance with Generally Accepted Accounting Principles (GAAP) for financial reporting purposes. Because REITs must pay out at least 90 percent

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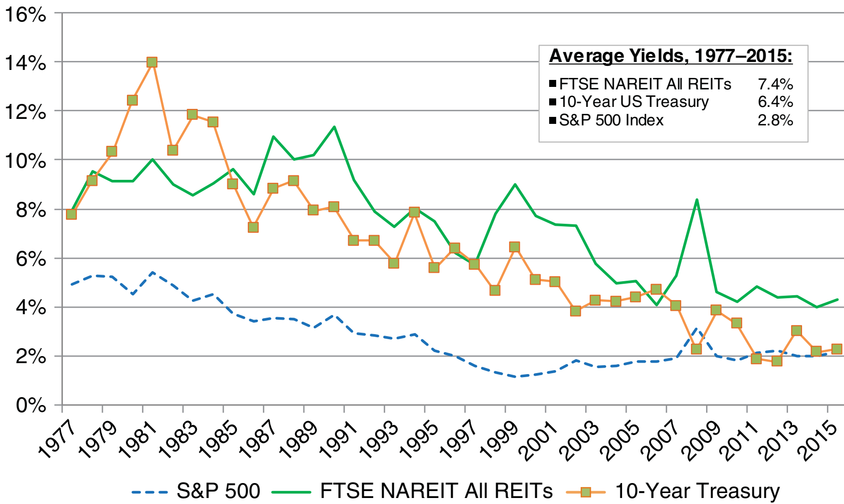

Figure 3.1 REIT Yields versus Yields on Other Investments

Sources: NAREIT; Yahoo! Finance.

of their taxable income each year to shareholders in the form of dividends, their yields tend to be higher than the yields on other income investments, such as U.S. Treasuries and corporate bonds. Figure 3.1 illustrates the average yield REITs have offered investors over time, versus the yield on the S&P 500 Index and on 10-year U.S. Treasuries. At the end of 2015, the FTSE NAREIT All REITs Index offered a 4.3 percent yield, or approximately 200 basis points higher than the 2.3 percent yield on 10-year U.S. Treasuries and the 2.2 percent dividend yield from companies in the S&P 500 Index. Additionally and according to statistics provided by NAREIT, from 1990 through 2015, the 6.4 percent average yield offered by REITs averaged 180 basis points higher than the average yield on 10-year Treasuries during the same period.

As with any stock, a REIT's current yield equals the current stock price divided into the most recently paid dividend, annualized (multiplied by four, in most cases). Because many investors hold investments for several years, it is also important to understand the concept of yield on cost, which is calculated by dividing the current dividend annualized by the investor's cost basis in the REIT's common or preferred stock:

$$\text{Yield on Cost} = \frac{\text{Current quarterly dividend} \times 4}{\text{Shareholder's per share cost basis}}$$

For example, assume an investor paid $10 per share two years ago for common stock of Rockland REIT. Today, Rockland REIT's stock price is $15 per share and it pays a quarterly dividend of $0.25, which annualizes to one dollar. The REIT's current yield is 6.7% (or $1 ÷ $15), but the investor's yield on cost is 10%, calculated as the $1.00 annualized dividend divided by their $10 cost basis. When evaluating whether to sell these REIT shares in order to invest in a different stock or bond, the investor will need to compare the 10% yield on cost to the current yields of competing investments.

A few REITs pay dividends on a monthly, instead of quarterly basis. In such cases, their current dividend needs to be multiplied by 12, rather than 4, to calculate their annualized yield. Note also that REITs sometimes pay special dividends, usually in association with realizing large gains on properties sold. It is important to exclude special dividends from the above yield calculations, as these cash payouts are nonrecurring. Table 3.1 lists those REITs that were paying monthly dividends at the end of 2015.

Table 3.1 U.S. REITs That Pay Monthly Dividends

	Ticker	Type
American Capital Agency	AGNC	Mortgage REIT
Apple Hospitality	APLE	Equity REIT
Armour Residential	ARR	Mortgage REIT
Chatham Lodging Trust	CLDT	Equity REIT
EPR Properties	EPR	Equity REIT
Five Oaks Investment	OAKS	Mortgage REIT
Gladstone Commercial Corporation	GOOD	Equity REIT
Gladstone Land Corporation	LAND	Equity REIT
Global Net Lease	GNL	Equity REIT
Inland Real Estate Corporation	IRC	Equity REIT
Independence Realty Trust	IRT	Equity REIT
Javelin Mortgage	JMI	Mortgage REIT
LTC Properties	LTC	Equity REIT
New York REIT	NYRT	Equity REIT
Orchid Island Capital	ORC	Mortgage REIT
Realty Income	O	Equity REIT
STAG Industrial	STAG	Equity REIT
United Development Funding	UDF	Mortgage REIT
Wheeler Real Estate Investment	WHLR	Equity REIT
Whitestone REIT	WSR	Equity REIT

Source: S&P Global Market Intelligence.

Are REIT Yields Safe?

REIT yields may be attractive, but they are meaningless if the dividend behind them is not sustainable. Brad Thomas, who writes for Forbes on his online platform, www.TheIntelligentREITInvestor.com, often warns readers to avoid REITs that pay a "sucker yield." Investopedia.com defines "sucker yield" as the allure that high-yielding investments have with many investors; hypnotized by the attractively high yield, these investors fail to realize the investment's fundamentals are unpredictable and/or unreliable, which ultimately leads to the dividend being partially or completely cut (i.e., the *sucker punch*).

REITs that offer sucker yields tend to be the exception rather than the norm. Historically, the contractual nature of rental revenue from leases has enabled REITs to pay dividends that have proved to be secure, even during most economic recessions. Equity REITs derive the majority of their income from leases that, depending on their duration and the credit of the tenant, provide REITs with recurring, more bond-like cash flows than most non-REIT companies can offer. Provided a REIT management team does not finance their company's growth with excessive levels of leverage, the preferred and common dividends of that company should be reasonably safe.

That said, the 2007–2008 global financial crisis that precipitated the Great Recession of 2008–2009 served as a grim reminder about economic and market forces that can jeopardize REIT dividends. According to S&P Global Market Intelligence, in 2008–2009 over two-thirds of all REITs cut or suspended their common dividends in order to conserve cash. Equity REIT returns were a dismal negative 37.7 percent in 2008, before rebounding to a positive 28.0 percent in 2009. (Please refer to Table 1.1 in Chapter 1 for annual REIT returns.) Despite widespread dividend cuts, in 2008 REITs underperformed the S&P 500 Index by only 73 basis points and then actually outperformed that index by 153 basis points in 2009.

The rash of dividend cuts by REITs during the Great Recession was similar to the percent of REITs that slashed their dividends in the wake of the savings-and-loan crisis of the late 1980s. In both instances, a broad liquidity crisis translated into dividend cuts for the majority of REITs. Unsurprisingly, the REITs that did not cut or suspend their dividends were ones with lower levels of debt, and also ones with little debt maturing during the crisis years.

Rule of Thumb

In a credit crisis, like the United States endured in 2007–2009 and in the savings-and-loan crisis of the late 1980s, many REIT boards of directors will elect to cut or even temporarily suspend dividend payments to preserve capital. To mitigate the risk of a dividend cut, invest in REITs with lower leverage levels than their peers.

Quantifying Dividend Safety

Investors can use two approaches to quantify dividend safety, the first of which focuses on near-term expected earnings growth and the second of which measures a REIT's balance sheet leverage. Chapter 8 provides the calculations for other metrics that assess the relative health of individual companies.

Dividend/FFO Payout Ratio

A REIT's expected dividend payout ratio is calculated as its current annualized dividend, divided by an estimate of next year's expected funds from operation (FFO) per share. REITs use FFO to measure profitability instead of earnings per share (EPS). Estimates of FFO per share may be obtained from individual company reports generated by investment banks' research departments and from data service providers, such as S&P Global Market Intelligence and Thomson's First Call. The resulting dividend/FFO payout ratio (which is also referred to as an *FFO payout ratio*) gives a quick thumbnail sketch about a REIT's ability to pay its current dividend. An FFO payout ratio below 1.0 indicates that Wall Street expects that REIT to generate FFO sufficient to cover its current annualized dividend. By contrast, an FFO payout ratio above 1.0 should generate immediate concern and cause potential investors to dig deeper into a REIT's expected earnings ability.

Investor Tip

If the Dividend/FFO ratio for a REIT is greater than 1.0, the dividend may be at risk.

Debt Ultimately Determines Dividend Safety

REITs can enhance the safety of their dividend by managing their operations with lower amounts of debt. Common dividends represent the most junior claim on a company's cash flow, meaning that a company is obligated to pay interest and principal due to lenders and dividends associated with any preferred stock before paying the dividend due to common shareholders. Accordingly, the less debt a company has, the more likely it will be able to pay its common dividend. Investors can calculate two leverage metrics—debt-to–total market capitalization and debt-to–gross book value—to determine if a REIT potentially has too much debt. Chapter 8 walks through the calculation of both metrics, so this chapter simply cites some historical data.

Debt-to–Total Market Capitalization Ratio

As of December 31, 2015 and according to NAREIT, equity REITs average debt-to–total market capitalization ratio was 36.0 percent. Including mortgage REITs, this ratio was 46.4 percent. Because the debt-to–total capitalization ratio changes depending on a REIT's current stock price, this ratio can over- or understate a company's leverage, depending on market conditions. For example, if Rockland REIT has $100 million of debt and 10 million common shares that trade at $15 a share, then it has a debt-to–total market capitalization ratio of 40 percent:

$$\$100 \text{ of debt} \div (\$100 \text{ of debt} + [\$15 \times 10 \text{ shares of ROCK}]) = 40\%$$

If Rockland REIT's stock dips to $10 per share, however, its debt-to–total market capitalization ratio increases to 50 percent:

$$\$100 \text{ of debt} \div (\$100 \text{ of debt} + [\$10 \times 10 \text{ shares of ROCK}]) = 50\%$$

Because a variety of events influence a company's stock price, not all of which are within a management team's control, a more certain way of gauging a REIT's leverage is to use a REIT's debt-to–gross book value ratio.

Debt-to–Gross Book Value Ratio

Gross book value can be calculated by taking total assets listed on the balance sheet of the financial statements, less any goodwill or

> **Less Is More**
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> To minimize the risk of investing in REITs that offer sucker yields, investors should focus on REITs whose debt-to–gross book value is 50 percent (or less).

intangibles, plus any accumulated depreciation and amortization (generally listed in the footnotes to the financial statements). As of December 31, 2015, the average debt-to–gross book ratio of equity REITs was 36 percent (including mREITs, this ratio was 46 percent). Putting this industry statistic into context, private landlords, including private equity firms that have taken publicly traded REITs private in 2005–2007, had employed as much as 90 percent leverage to finance their real estate purchases. At the end of 2006, which was the last year before the 2007–2008 global financial crisis, equity REITs had an average debt-to–gross book value of 57 percent. Although some REITs exceeded what, in hindsight, were prudent levels of leverage, REITs nonetheless were more conservative in their use of leverage than the average private real estate investor.

In fact, out of the 130 REITs that composed the FTSE NAREIT All REITs Index at the end of 2006 and before the global financial crisis, only one REIT, General Growth Properties (NYSE: GGP), filed for protection from its creditors under Chapter 11 bankruptcy. Before the crisis, General Growth Properties' debt-to–gross book value ratio was 74 percent, or 17 percentage points higher than the industry average. The company restructured its debt in the bankruptcy courts and, in November 2010, emerged from bankruptcy. At the end of 2015, General Growth Properties' debt-to–gross book value ratio was 54 percent, which is still higher than the industry average ratio, but much more conservative than the company's historical levels. (Note that most of the debt-to–gross book value ratios cited in the section were provided by S&P Global Market Intelligence.)

Legal Standing of Leases Supports Dividend Safety

As is discussed in Chapter 4, Leases, bankruptcy courts view leases as operating expenses, which are legally senior to non-operating expenses—meaning the tenant is obligated to pay their rent before paying any interest or principal on outstanding debt, or any dividends on preferred or common stock. Therefore, even if a REIT's

tenant goes bankrupt, the tenant must continue paying the REIT its contractual rent until the bankruptcy court judge allows the tenant to reject the lease. As a result, REITs generally do not go bankrupt, even when some of their tenants do. The relative stability and visibility of these underlying cash flows are a primary reason that investors view real estate and REITs as defensive investments that pay reasonably safe dividends.

REIT Dividends and Taxation

The two most widely known features of REITs are that they pay relatively high dividends and that they generally do not pay corporate income taxes. To qualify each year as a REIT for IRS purposes, REITs must pay their common and preferred shareholders dividends that equal at least 90 percent of what would otherwise be taxable income. If a REIT pays out only 90 percent of its taxable income, it will owe corporate taxes on the 10 percent it retains. By distributing 100 percent of taxable income (including capital gains) and satisfying other REIT requirements, REITs can avoid paying corporate income taxes. The REIT shareholders then pay their appropriate taxes on the dividend income received. As the example in Table 3.2 illustrates, the REIT structure provides higher after-tax income to shareholders, based on the following assumptions:

- C-Corp and REIT both have 35 percent marginal tax rates.
- C-Corp and REIT both have 90 percent payout ratios.
- The personal marginal tax rate for investors is 25 percent.

The 90 percent minimum distribution requirement governing REITs helps shareholders in two ways. First, it translates into above-average dividend income (almost always in cash). In the simple example in Table 3.2 the investor pockets an extra $23.62 (or $67.50 minus $43.88) in after-tax dividend income from the REIT investment versus the regular C-corporation investment. Second, REIT management teams must manage their portfolios and balance sheets conservatively enough to be able to maintain the dividend. REITs can elect to reduce or cut their common dividends, but not without severely damaging short-term stock price performance in the process. This chapter addresses basic facts investors should know before buying REITs for dividend income.

Table 3.2 Example of After-Tax Income for C-Corporations versus REITs

	C-Corp		REIT
Earnings before taxes	$100.00	Earnings before taxes	$100.00
– Taxes (35%)	–35.00	– Dividends (90%)	–90.00
Net income	65.00	Taxable income	10.00
– Dividends (90%)	–58.50	– Taxes (35%)	–3.50
Retained earnings	$6.50	Retained earnings	$6.50
	Investor		Investor
Dividend income	$58.50	Dividend income	$90.00
– Personal tax (25%)	–14.63	– Personal tax (25%)	–22.50
After-tax income	$43.87	After-tax income	$67.50

REITs Do Not Pay Out All of Their Cash in Dividends

Investors often make the mistake of thinking REITs pay out all of their free cash flow in the form of dividends. In fact, the cash REITs generate from their properties typically is greater than the dividends they pay to shareholders. From an accounting perspective, taxable income for IRS purposes is often less than the dividend paid to shareholders, resulting in no tax obligation to the REIT. Taxable income is calculated according to rules set by the IRS, whereas net income for public reporting purposes to the SEC is determined by GAAP. In calculating both types of income, REITs are permitted to deduct many noncash expenses, such as the annual depreciation of their buildings. Note that only the buildings themselves, and not the land on which buildings are constructed, are depreciable.

For example, if Rockland REIT buys a building for $11 million, and the land under it is worth $1 million, then Rockland REIT will depreciate the $10 million building over a 40-year period. This annual $250,000 expense (equal to $10 million divided by 40 years) reduces Rockland REIT's income for IRS and GAAP purposes; because the $250,000 represents an expense only for GAAP purposes, the company does not use cash to pay it. Instead, Rockland REIT reduces its basis in that building by $250,000 each year. Continuing the example, after four years, the Rockland REIT's basis in the property will be $9 million, calculated as the building's initial

$10 million cost, less four years of $250,000 depreciation expense (i.e., $10 million less [4 years × $250,000 annual depreciation expense]).

The Components of a REIT's Common Dividend

The example in Table 3.2 was an oversimplified illustration of how REITs' common dividends are taxed at the individual investor level. Rarely is a REIT's dividend taxed entirely as ordinary income. Instead, a REIT dividend generally consists of a combination of three types of income, which are taxed at different levels. These three income classifications are:

1. Ordinary dividends (individual shareholders' tax rates apply)
2. Capital gains (generally 15% at December 31, 2015), and
3. Returns of capital (nontaxable)

REITs typically disclose the tax treatment of each year's dividends in a press release issued in late January or early February. (Refer to each REIT's website for current and past press releases. Website addresses for the 223 REITs in the FTSE All REITs Index at the end of 2015 are provided in Appendix C.) The "dividend treatment" press release typically contains a table that clearly states how much of the common dividend should be taxed as ordinary dividend income, how much is a classified as capital gains, and how much, if any, is a nontaxable return of capital.

Ordinary Dividend Income

Generally, the majority of REIT common dividends are characterized and taxed as ordinary income, meaning that the business activities that generated the cash flow being paid out as dividends to shareholders were "ordinary," such as from collecting rents. So if investors receive $1.00 per share in dividends and are in the 25 percent ordinary income tax bracket, they will owe $0.25 of federal taxes on every dollar of REIT dividends they receive. However, if a REIT engages in transactions during its fiscal year that are not ordinary, such as selling a building at a gain or loss relative to its investment basis, the REIT may recognize long-term capital gains and/or returns of capital, both of which are discussed next.

Capital Gains

If a REIT sells an asset for more money than its depreciated basis (also referred to as its *net book value* in the property), the REIT will recognize a capital gain on the sale. The REIT can then pass the capital gains through to shareholders by classifying part of the common dividend as capital gains. Capital losses are not passed through to investors, however, because REITs are not limited partnerships. (See Chapter 6 for a comparison between REITs and limited partnerships.) Shareholders pay taxes on this portion of the dividend, but at the then-current capital gains rate, which for individuals in the 25 percent federal income tax bracket at December 31, 2015, generally was 15 percent.

Returns of Capital

If a REIT distributes more than its taxable income for IRS purposes, the additional amount paid to shareholders that exceeds 100 percent of taxable income is classified as a return of capital. Returns of capital are not taxed. Rather, they lower an investor's basis in a common stock (see examples in Tables 3.3 and 3.4) and eventually may be taxed in the form of capital gains when the investor sells his or her shares. Returns of capital, therefore, increase both an investor's tax-adjusted current yield, as well as the after-tax total return he or she realizes upon sale of the shares. Table 3.3 provides a simple practical example of how a portion of a REIT's dividend may be classified as a return of capital.

In summary, a REIT's common dividend generally consists of one or more types of income for taxation purposes: ordinary

Table 3.3 Return of Capital Calculation

Assumptions
Rockland REIT has taxable income of $1.25 per share in Year 1. Also in Year 1, Rockland REIT pays an annual dividend of $1.50 per share.
Conclusions
The amount of the dividend that exceeds 100% of Rockland REIT's taxable income—$0.25 per share in this case—is classified as a return of capital. Assuming Rockland REIT engaged only in ordinary business in Year 1, the remaining $1.25 per share of the dividend will be classified as ordinary income to be taxed at the investor level.

Table 3.4 Sample Calculations of Taxes on Rockland REIT's Dividend

Assumptions

- Rockland REIT pays a dividend of $1.00 per share
- The shareholder paid $20.00 for each share of ROCK (so original basis equals $20.00)
- The individual ordinary income tax rate is 25%
- The individual long-term capital gains tax rate is 15%
- Example A—Rockland REIT classifies 100% of its dividend as ordinary income
- Example B—Rockland REIT classifies 60% of its dividend as ordinary income, 25% as a long-term capital gain, and 15% as a return of capital

	Example A	Example B
Shareholder's dividend received from Rockland REIT	$1.00	$1.00
× Percent of dividend classified as ordinary income	× 100%	× 60%
Income taxable at ordinary rate	$1.00	$0.60
× Federal tax rate on ordinary income	× 25%	× 25%
(A) Income tax due on ordinary income	$0.25	$0.15
Shareholder's dividend received from Rockland REIT	—	$1.00
× Percent of dividend classified as long-term capital gains	—	× 25%
Income taxable at capital gains rate	—	$0.25
× Federal tax rate on long-term capital gains	—	× 15%
(B) Income tax due on long-term capital gains	—	$0.04
Shareholder's dividend received from Rockland REIT	—	$1.00
× Percent of dividend classified as return of capital	—	× 15%
Income taxable as return of capital	—	$0.15
× Federal tax rate on capital gains	—	—
(C) Income tax due on returns of capital	—	$0.00
(D) Shareholder's total tax liability (A + B + C)	$0.25	$0.19
Effective tax rate for shareholder	25%	19%
Shareholder's original basis in Rockland REIT shares	$20.00	$20.00
– Return of capital received	—	($0.15)
(E) New basis in Rockland REIT	$20.00	$19.85
After-tax yield on Rockland REIT shares [($1.00 – D)/E]	3.8%	4.1%

income, which is taxed at the highest individual or "ordinary" rate; capital gains, which are taxed at the long-term capital gains tax rate; and returns of capital, which are not taxed and which lower a shareholder's cost basis in each share. When a REIT classifies portions of its dividend as long-term capital gains or returns of capital, the shareholder's effective tax rate is lower than if the dividend were classified entirely as ordinary income.

Examples A and B in Table 3.4 illustrate how an individual investor in the 25 percent income tax bracket would calculate his tax liability on Rockland REIT's common dividend using 2015 tax rates.

Example A in Table 3.4 illustrates the investor's tax liability assuming the entire dividend is ordinary income. Example B in Table 3.4 illustrates how having some of the dividend classified as long-term capital gains or returns of capital lowers an investor's effective tax rate on dividends.

REIT Dividends and the Bush Tax Cuts

The *Jobs and Growth Tax Relief Reconciliation Act of 2003* (also known as the *Bush Tax Cuts*) lowered the individual's tax rate on previously taxed earnings of C-corporations paid out to shareholders as dividends to a maximum of 15 percent. The distinguishing characteristic of REITs continues to be that their dividends are exempt from the "double taxation" to which other C-corporation dividends are subject. As the example in Table 3.2 at the beginning of this chapter illustrated, dividends paid by C-corporations are taxed at both the corporate and investor levels. REIT dividends are not taxed at the corporate level, so the portion of a REIT's dividend that is characterized as ordinary taxable income does not qualify for the lower tax rate; that is, REIT dividends are not *qualified dividends* under this law. The Bush Tax Cuts did not affect the taxation rate shareholders pay on the ordinary income components of REIT dividends. In 2008, when they were originally designed to sunset, Congress extended the Bush Tax Cuts to 2012, at which time they again were extended and, as of now, have no expiration date. Should Congress ever decide to end the Bush Tax Cuts, the effective after-tax yield of other C-corporations will decline, whereas the current taxation of REIT dividends and the expected after-tax yield will not change.

Preferred Stock Dividends

As mentioned earlier, REITs can satisfy their 90 percent payout requirement by paying dividends to both its common *and* preferred shareholders. At the end of 2015 and according to S&P Global Market Intelligence, the liquidation value of REIT preferred shares outstanding totaled $29.8 billion, or only 3 percent of public REIT common equity. Though the market for REIT preferred stock is small, it nonetheless is worth knowing a few basic facts—and potential pitfalls—associated with its attractive yield.

Preferred Stock Basics

Preferred stock is often viewed as a hybrid security in that it shares characteristics with debt and common stock investments. Like a bond, preferred shares are sold according to a face (or *par*) value, which, in the case of preferreds, is usually $25 per share. Unlike bonds, perpetual preferred stock has no maturity date. Typically, a REIT that issues preferred shares has the right to redeem (or *call*) those shares at par after five years; if the REIT can issue new preferred shares or debt that has a lower recurring payment than the old preferred shares, then management will likely call those preferred shares and issue lower-cost capital to pay for the redemption. Similar to common stock, preferred shares pay investors a quarterly dividend. Like a bond, the preferred dividend is often a fixed amount based on par value, though sometimes the preferred shares contain a ratchet feature so that the preferred dividend increases by the same percentage as the common dividend in subsequent years.

Risks to Owning Preferred Shares

There are three risks investors need to keep in mind when investing in preferred shares for dividend income, each of which involves liquidity or lack thereof. First, the secondary market for REIT preferred stock is not as liquid as the market for common stock in the same company. This means that investors may have some difficulty selling (or even pricing) their preferred shares when they want or need their principal back.

> ### Unintentional Mezzanine Lenders
>
> During a change in control, investors of many REIT preferred stock issuances bear the risk of becoming unwilling mezzanine lenders, as the acquiring entity often is not required to "cash-out" holders of the target REIT's preferred stock.

Second, it is important to read and understand the term sheet in the prospectus of each preferred stock issuance before investing. Although the preceding paragraph detailed general terms that are typical for preferred stock issuances, there is no consistent underwriting standard to which issuers of preferred stock must conform. The difference that may exist between what preferred stock investors *assume* they are buying and the *reality* of what they actually bought can lead to unpleasant and costly surprises. For example, a REIT that pays a $0.75 per share annualized common dividend may issue a preferred stock that pays $1.00 per share each year. If that preferred stock does not contain a ratchet feature or some other covenant to protect the preferred yield relative to that of the common shares, the management team legally could increase the annual common dividend to be greater than $1.00 per share. If that happens, the preferred issuance will become illiquid, making it extremely difficult (or impossible) to sell the securities anywhere close to par. The investors in the preferred stock in this example will likely have to sell their shares at a steep discount if they want to exit this investment.

The third level of liquidity risk relates to when there is a change in control at a REIT, such as when a private equity firm or competing REIT buys a REIT that has preferred shares outstanding. In all too many instances, the preferred equity investors of the acquired (or *target*) REIT discover that the terms of their preferred stock allow an acquiring company to suspend their preferred dividend and/or that the acquiring entity has no obligation to "cash out" the target REIT's preferred shareholders. As a result, acquiring companies often treat existing preferred stock as a form of mezzanine financing to increase their returns on the deal. The preferred stock investors become financially marginalized in the new entity, and have no

recourse. In contrast, the target REIT's common stockholders will receive cash, stock in the acquiring entity, or both as compensation for their investment.

Conclusion

The income that investors can access by investing in REITs is a powerful wealth-building tool, but only if the REITs can sustain and preferably grow their dividends over time. The wealth destruction and underperformance associated with REITs that have cut their common dividends in the past is examined more thoroughly in Chapter 7, REIT Performance.