

Analysts Say Dividend Cuts Not Cause For Concern

By Allen Kenney

Industry analysts say recent announcements of REITs' plans to cut their dividends are prudent, given current market conditions.

In fact, shareholders actually should expect more companies to revise their dividend policy in the near future, according to observers. However, they should not take that as a sign that REITs are in financial distress.

"We often see select dividend cuts in the REIT sector during a time of decelerating fundamentals," says Christine McElroy, an analyst with Banc of America Securities LLC. "Many of the dividend cuts today, however, are related to preservation of capital during a time when cost and availability of capital is in question."

Richard Moore, a managing director with RBC Capital Markets, dismisses the notion that the cuts were motivated by cash flow fears. "Few, if any, REITs have trouble paying their dividends at this point," he says.

Instead, the dividend policy decisions illustrate REIT managers' efforts to address the impact of the ongoing turmoil in the financial markets, according to Nem Marjanovic, an analyst with Cornerstone Real Estate Advisers LLC. "It's an indicator that certain companies within the industry are adapting to the current financial environment—a global de-leveraging process where asset values are being re-priced due to an aggressive use of debt in the housing and financial markets," Marjanovic says. "Cutting an expensive dividend—while maintaining REIT payout requirements—is an effective capital-raising decision in a tight credit market that is not contingent upon influences outside of upper management's control."

Hans Nordby, an analyst with Property & Portfolio Research Inc., notes that REITs differ from other common stocks when it comes to dividends. "In general, REITs have to pay out a high percentage of their taxable income as dividends," he says.

Federal law requires REITs to pay out a minimum of 90 percent of their taxable income to investors in the form of dividends. Most REITs' dividend policies go beyond the mandated minimum, though. In 2007, for example, more than half of all publicly traded REITs distributed dividends in excess of 100 percent of their taxable income. REITs paid out nearly \$20 billion in dividends for the year.

As such, REITs have ample room to decrease their dividends and preserve precious working capital, Marjanovic says.

“New capital, including debt and equity, is becoming a commodity given its scarcity and high cost. A dividend cut to retain capital either to conserve liquidity, retire debt or fund corporate initiatives is a prudent course of action,” Marjanovic says. “I see no rationale for a company to fund its dividend using its lines of credit in a capital-constrained marketplace.”

Moore echoes Marjanovic’s sentiments: “As long as the banks won’t lend, these companies need to come up with capital another way. In our opinion, it makes more sense to cut the dividend to the minimum amount payable under REIT status.”

Additionally, Moore notes that REITs’ stock prices remain depressed, producing high dividend yields. “At this point, REITs are not getting paid via the stock market. These stocks are trading as if these companies will never get another loan again,” he says.

Noting that some companies’ stocks are trading at greater than 20 percent dividend yields, Marjanovic contends that the market already may have factored a smaller dividend into stock prices. As such, the companies actually would be doing what the market expects, according to Marjanovic. He points out that some REITs’ stock prices have benefited from cutting dividends.

“Since the company is not receiving credit for its hefty yield, there is no point to maintain the current payout level. In some cases, we’ve seen that a cut is rewarded with a rally in the stock,” Marjanovic says.

LaSalle Hotel Properties (NYSE: LHO) on Oct. 22 announced a decrease in its 2008 dividend from an annualized rate of \$2.10 per common share down to \$1.02 per share. The lower dividend rate represented a 9 percent yield on the company’s closing price that day.

Hans Weger, LaSalle’s chief financial officer, said at the time of the announcement that the company initiated the dividend cut based on “the current challenging economic environment and the view that the U.S. economy, as well as the lodging industry, will likely continue to face declining economic trends through 2009.” The move was expected to generate an extra \$100 million in liquidity through the end of 2010, according to Weger.

Shopping center REIT Developers Diversified Realty Corporation (NYSE: DDR) is another company revising its dividend policies. DDR announced on Oct. 24 that it would not issue a dividend for 2008’s fourth quarter, while 2009 quarterly dividend estimates would be reduced from \$2.76 to \$1.50.

The company said the move would “enhance current liquidity,” freeing up \$230 million that primarily will be used to reduce its leverage. DDR noted that the company already had reached its required minimum dividend payout for 2008. Prior to the dividend announcement, DDR revealed the company had formed an \$890 million joint venture with an institutional investor, enabling the company to pay down more than \$200 million in near-term debt maturities.

DDR’s plans prompted Merrill Lynch REIT analysts Steve Sakwa and Craig Schmidt to upgrade their recommendation on the company from “neutral” to “buy.”

In a weekly equity research report released Oct. 24, Citi analyst Michael Bilerman pointed out that between 2000 and 2007, approximately 65 percent of REIT dividend distribution came from ordinary income, while more than 20 percent was classified as return of capital (a distribution of more than 100 percent of taxable income). Additionally,

he said net operating income would likely drop in 2009. All of which suggest that companies could continue to cut dividends and maintain REIT status, according to Bilerman.

Consequently, Bilerman speculated that the dividend cut announcements would continue, and even pick up speed.

“With the added pressure of the financing markets, REIT dividend reductions will likely accelerate over the next few months as companies try to conserve as much capital as possible,” he said.

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