Stability Of Dividends And FFOs: The Case Of REITs In Malaysia

Ting Kien Hwa, Ph.D and Mohd Yunus Abdul Rahman
Department of Estate Management
Faculty of Architecture, Planning & Surveying
University of Technology MARA
40450 Shah Alam, Selangor
Malaysia

Abstract

Historically, the dividends of real estate investment trusts (REITs) contribute significantly towards the total return of REITs. This paper examined whether dividend returns of REITs/LPTs in Malaysia are affected by economic conditions and whether the level of dividends declared could be sustained in a weak economy.

The research shows that the dividends declared by listed property trusts (LPTs) are found to be not stable as it is affected by the level of funds from operations (FFOs) attained by LPTs. FFOs are in turned affected by its sources of income. LPTs with investments of unstable market values e.g. shares which have declined in values is found to affect FFOs due to the need to account for its diminution of values in the accounts.

The findings have an impact on investors who expect consistent dividend distributions from LPTs thereby affecting their investment allocations on LPTs.

Keywords: dividends, FFOs, LPTs, Malaysia.

Introduction

Real estate investment trusts (REITs) have traditionally been able to attract investors because of their relatively low risks and high dividend yields. The high dividend yield of REITs is the main reason investors invest in the REIT market. Investors e.g. pensioners who rely on regular dividend payments are attracted to REITs as an income producing investment.

REIT returns are composed of both price appreciation and rental yield from real estate. The rental component forms a significant portion of REIT return. Income streams from real estate are more predictable and relatively low in volatility compared to changes in capital values. The low volatility coupled with the high payout in the form of dividends adds a bond-like feature to REITs.

However rental incomes from investment properties are cyclical and may come under pressure during poor economic conditions. Thus the stability of dividends of REITs is an important issue.

The reasons why REITs consistently pay out high dividends are for the following reasons (Chan, Erickson and Wang 2003):

(a) to reduce agency costs,
(b) to signal private information,
(c) to signal the volatility of future cash flows,
(d) to reduce information asymmetry,
(e) to attract investors.

REIT is a unique corporate structure due to tax requirement to distribute 95% of net income to its shareholders. REITs in US are required by law to pay out 90% of their net cash flow from operations. The scope for REITs to determine their dividend payout policy is more limited compared to non-REIT companies. Wang, Erickson and Gau (1993) reported many REITs pay out more than the minimum requirement. REITs generally declare higher than average dividend yield compared to shares. The average yield on REIT is about 7% as compared to 2% for companies in the Standard & Poor's 500 stock index.

Investors who rely on regular dividend payments will be attracted to REITs. However economic conditions would affect the performance of real estate. In particular during a weak economy, rental income from commercial properties will be under pressure causing reduced rental income. Since rental income forms a large portion of funds from operation (FFOs), the declinein rental income will affect directly the FFOs. Dividends are distributed from FFOof a REIT. A high FFO indicates the potential of a high dividend distribution and there arise the issue of the stability of REIT dividends. Finance theory posits that firms with fluctuating dividends will be penalised (Kallberg, Liu and Srinivasan, 2003).

In this paper the issue of stability of REIT dividends is investigated. REITs with different investments are included in the study and an analysis of the relationships among the funds from operations (FFO), its dividends and market price are examined. It is hypothesised that a weakened economy will put downward pressure on FFO leading to reduce dividend distribution.

Literature review

Dividend policy is relevant for portfolio considerations because of the likely impact on the risk-return characteristics of individual stocks. Wang, Erickson and Gau (1993) examined the dividend policies of 123 REITs in USA between 1985 and 1988. They found that equity REITs pay a significant higher portion of their incomes as dividends than mortgage REITs. The authors also observed that REITs often pay out more dividends than are required by tax regulations, which suggests that their dividend decisions are dictated by imperfect information in the real estate market and the resulting agency costs.

In another study, Bradley, Capozza and Seguin (1998) examine the link between cash-flow volatility and dividend payout. Using the asymmetric and signaling theories, they developed a single-period model that predicts a negative relationship between dividend payouts and cash-flow volatility. They argue that firms with cash flow volatility would seek to minimise the penalty associated with dividend cuts by announcing a lower current dividend. Using a sample of seventy-five equity REITs over the 1985 – 1992 period, the authors found evidence of a negative relationship between cash-flow volatility and dividend levels. In addition, REITs with low debt to total assets ratio and large, well diversified property portfolios pay out more dividends.

The REIT industry use funds from operation (FFO) to measure performance and to establish dividend payouts. FFO is defined as the net income, excluding gains and losses from debt restructuring and property sales, adding back property depreciation and amortisation, and after adjustments for unconsolidated partnerships and joint ventures.

Kallberg *et al* (2003) reported that REITs consistently pay out about 85% of FFO as dividends. The payouts from REITs are consistently higher than other types of regular equities.

Wang, Erickson and Gau (1993) found that REITs on average pay 165% of their taxable income. Bradley, Capozza and Seguin (1998) also report that the dividend payouts are about twice the level of net income.

Chan, Erickson and Wang (2003) find that equity REITs pay out more dividends than mortgage REITs. Finite-life REITs also pay out more income as dividends than infinite-life REITs. The reason is because finite-life REIT have no growth potential and therefore do not need to conserve cash for new investments.

Wang, Erickson and Gau (1993) find an abnormal return on dividend increase announcements of 0.66% for equity REITs and 0.38% for mortgage REITs. For dividend decreases, the authors reported a corresponding figures of -1.9% and -0.11%.

Aharony and Swary (1980) argue that dividend payments can serve as market signals, conveying asymmetric information regarding the firm's future earnings. Kallberg *et al* (2003) reported that the current dividend payout of REITs is a credible signal of the future prospects of the firm. The dividend pricing model is also reported to be a better model that fit REITs than for other equities.

Using a sample of 75 REITs, Bradley, Capozza and Seguin (1998) report that the stock market reacts negatively to REIT dividend-cut announcements. The ability to continue paying high dividends is determined largely by the return characteristics of the underlying properties held in a portfolio. They further report that REITs with greater leverage, smaller asset bases or undiversified assets offer lower dividend payout rates when compared to other REITs.

Data and research method

The data used in this study span the years from 1989 to 2005 cover a complete property cycle. This study period allows an investigation of LPTs ability to sustain dividend payouts under different market conditions in particular the impact of recession on dividend payouts.

For this study only the listed property trusts (LPTs) are used i.e. Amanah Harta Tanah PNB (AHP), Amanah Harta Tanah PNB 2 (AHP2), AmFirst Property Trust (AMFPT) and First Malaysia Property Trust (FMPT). The number of total LPTs in the Malaysian market was down from five in 1997 to four in 2001 with FMPT having being liquidated from the Bursa Malaysia.

REITs in Malaysia are first introduced in 2005 hence new REITs (i.e. Starhill, UOA, Tower, Alaqar and Axis REITs) are not included in this study. Since November 2006, AMFPT is in the process of conversion into a REIT known as AmFIRST REIT.

Data for the calculation of FFOs and dividend information on LPTs are collected from the respective LPT annual reports. Monthly closing prices of LPTs are collected from Investors Digests.

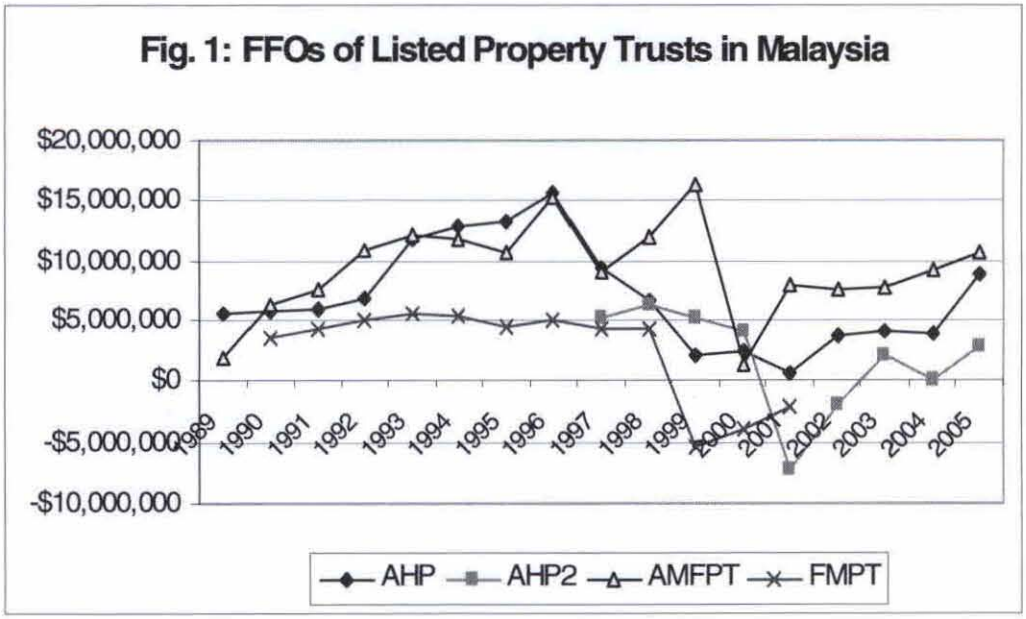
Results and analysis

Table 1 provides the descriptive statistics for the average LPT prices and monthly returns. Three of the LPTs provide positive average monthly returns except for AHP2 which has a negative average monthly return of -0.69% for the 1997-2005 period.

Table 1: Average dividends, LPT prices and share returns

	Average dividends pa	Average monthly LPT price (RM)	Average monthly returns (%)
AHP (1989-2005)	7.56%	1.34	2.36%
AHP2 (1997-2005)	5.00%	0.567	-0.69%
AMFPT (1990-2005)	8.40%	1.015	0.52%
FMPT (1990-2001)	5.64%	0.98	1.03%

Fig. 1 and 2 shows the trends of annual FFOs and dividend distributions over the study period



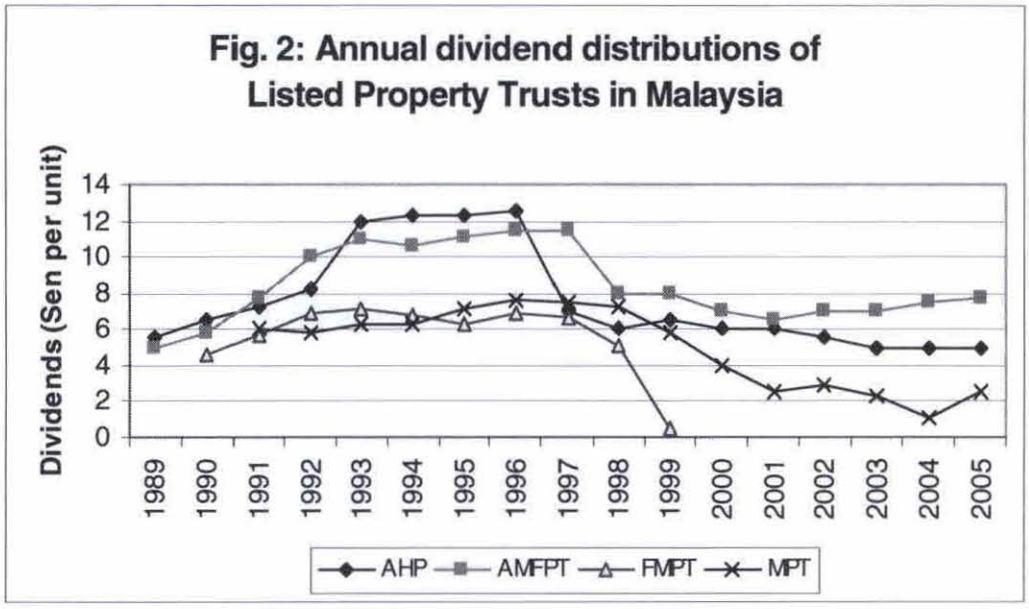


Table 2 reports the descriptive statistics for the FFOs and the dividend per share (DPS). Among the four LPTs, AHP2 shows the lowest average FFO values and also the lowest average DPS indicating a possible close relationship between FFOs and dividends.

Table 2: Descriptive statistics

	FFO (Maximum) RM	FFO (Minimum) RM	FFO (Average) RM	DPS (Maximum) %	DPS (Minimum) %	DPS (Average) %
AHP (1989-2005)	15,557,930	693,777	7,002,629	12.50	5.00	7.56
AHP2 (1997-2005)	6,247,068	-7,319,478	1,865,701	7.50	1.05	3.98
AMFPT (1990-2005)	16,396,109	1,305,560	9,775,625	11.50	5.75	8.61
FMPT (1990-2001)	5,584,477	-5,380,221	2,529,987	7.18	0.00	4.70

Table 3 shows the correlation coefficients between FFOs and dividends per share. The results for the overall period show a relatively high correlation between these two variables indicating a close relationship between FFOs and dividend payouts. Overall in the long run, there is a strong positive relationship between FFOs and dividend distributions.

Table 3: Correlation coefficients between FFOs and dividends per share

	AHP	AMFPT	FMPT	AHP2
Overall period				
1989-2005	0.841	0.633		
1990-2001			0.963	
1997-2005				0.66
Buoyant period				
1989-1997	0.925	0.879		
1990-1997			0.865	Note 1
Recessionary period				
1998-2000	-0.553	0.958	0.976	0.998
Recovery period				
2001-2005	-0.726	0.288	Note 2	-0.196

Note 1: AHP2 is listed in 1997.
Note 2: FMPT is delisted in 2001.

Table 3 further shows the results of the correlation analysis between FFOs and dividend distributions for buoyant, recessionary and economic recovery periods.

Buoyant period (1989-1997)
The correlation coefficients are high for the buoyant period (1989-1997) with values higher than 0.86 indicating a close relationship between FFOs and dividend distributions. Fig.3 to Fig. 6 shows rising FFOs during the buoyant period indicating higher income levels from its investments. In tandem with higher FFOs, LPTs have declared higher DPS.

Recessionary period (1998-2000)
A mixed result is found for the recessionary period. A very strong correlation is found for AMFPT, FMPT and AHP2 (r e" 0.958). But there is a negative correlation coefficient for AHP.

AHP has been consistently declaring a dividend of 6% during this period despite the FFOs have declined. The declination in FFO is due to accounting treatment of value of investments in quoted shares. Thus the decline in FFO is merely due to accounting loss which did not affect AHP's ability to declare stable dividends.

AHP is owned by Permodalan Nasional Berhad (PNB), the largest government unit trust agency in Malaysia which has the responsibility to consistently declare dividends to its national unit trusts holders to achieve social restructuring of equity and wealth. For this reason AHP has been

Table 3: Correlation coefficients between FFOs and dividends per share

	AHP	AMFPT	FMPT	AHP2
Overall period				
1989-2005	0.841	0.633		
1990-2001			0.963	
1997-2005				0.66
Buoyant period				
1989-1997	0.925	0.879		
1990-1997			0.865	Note 1
Recessionary period				
1998-2000	-0.553	0.958	0.976	0.998
Recovery period				
2001-2005	-0.726	0.288	Note 2	-0.196

Note 1: AHP2 is listed in 1997.
Note 2: FMPT is delisted in 2001.

Table 3 further shows the results of the correlation analysis between FFOs and dividend distributions for buoyant, recessionary and economic recovery periods.

Buoyant period (1989-1997)
The correlation coefficients are high for the buoyant period (1989-1997) with values higher than 0.86 indicating a close relationship between FFOs and dividend distributions. Fig.3 to Fig. 6 shows rising FFOs during the buoyant period indicating higher income levels from its investments. In tandem with higher FFOs, LPTs have declared higher DPS.

Recessionary period (1998-2000)
A mixed result is found for the recessionary period. A very strong correlation is found for AMFPT, FMPT and AHP2 (r e" 0.958). But there is a negative correlation coefficient for AHP.

AHP has been consistently declaring a dividend of 6% during this period despite the FFOs have declined. The declination in FFO is due to accounting treatment of value of investments in quoted shares. Thus the decline in FFO is merely due to accounting loss which did not affect AHP's ability to declare stable dividends.

AHP is owned by Permodalan Nasional Berhad (PNB), the largest government unit trust agency in Malaysia which has the responsibility to consistently declare dividends to its national unit trusts holders to achieve social restructuring of equity and wealth. For this reason AHP has been

declaring stable dividends of about 6% pa even though its FFOs are declining during the recession period.

Recovery period (2001-2005)

For the recovery period, a mix set of correlation coefficients is found. AHP and AHP2 was found to have a negative correlation between FFOs and dividend distributions. Again the explanation for AHP is that it is declaring dividends to fulfill its social obligations. The same explanation can be offered to AHP2 since the trust was taken over by PNB in 2001.

Figure 1 to 4 shows graphically the FFOs of the four LPTs. Generally there is a decline in FFOs of the four LPTs during the recession period of 1998-2000.

Fig. 3: AHP - FFOs and Dividends

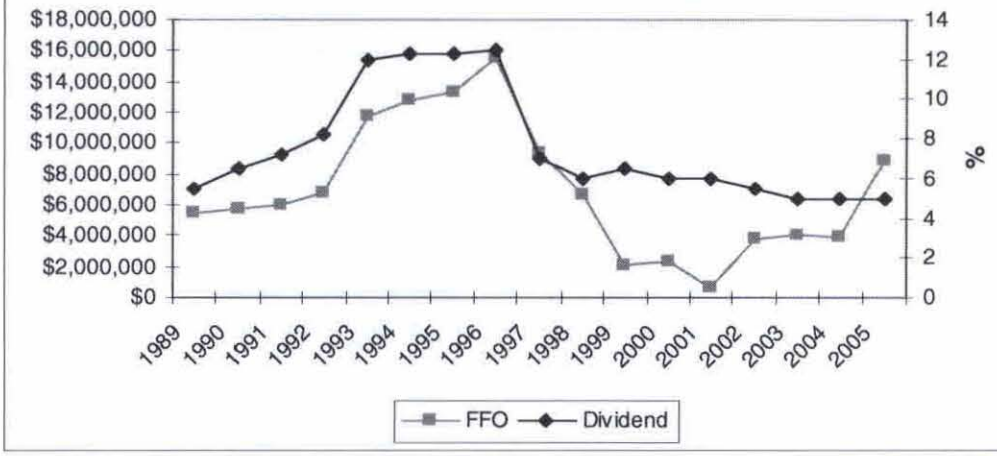


Fig. 4: AHP2 - FFOs and dividends

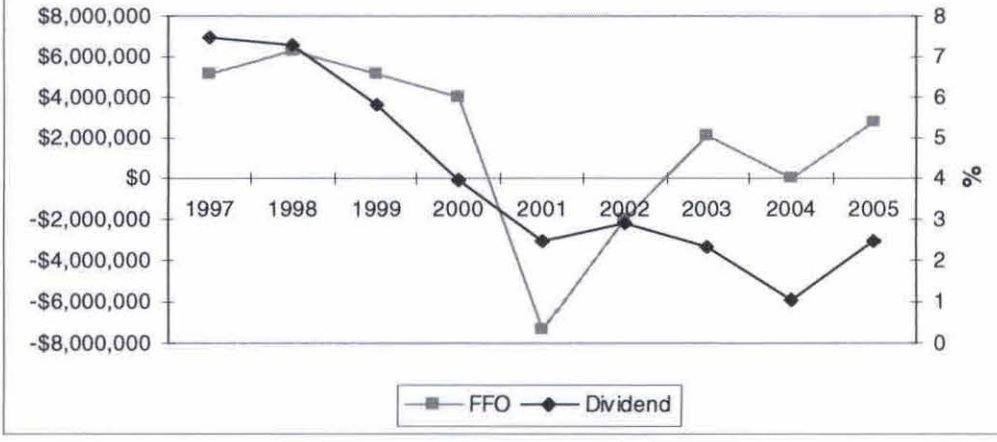


Fig. 5: AMFPT - FFOs and Dividends

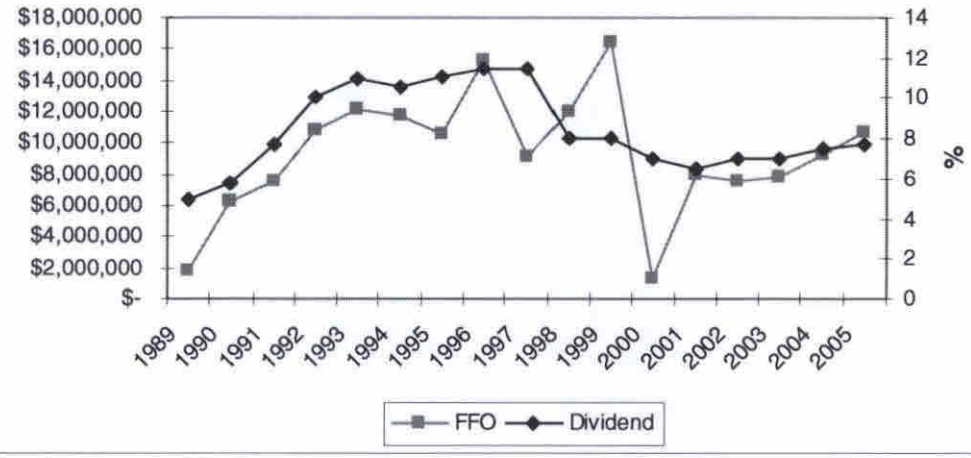
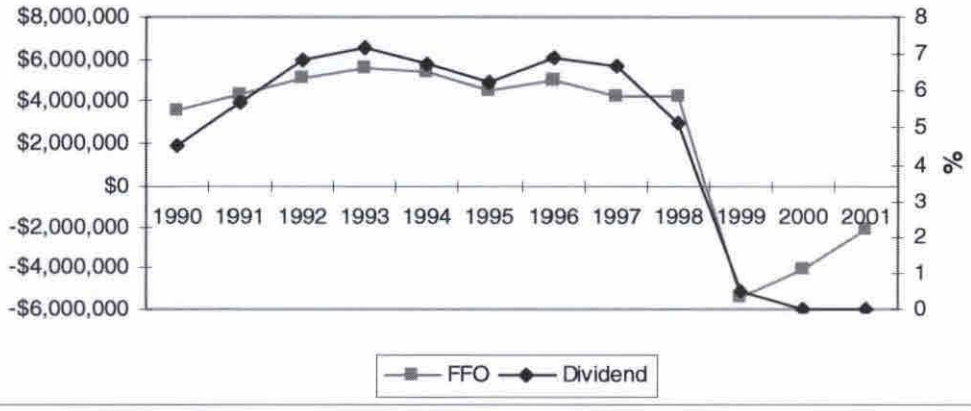


Fig. 6: FMPT - FFOs and Dividends



Case study: AHP

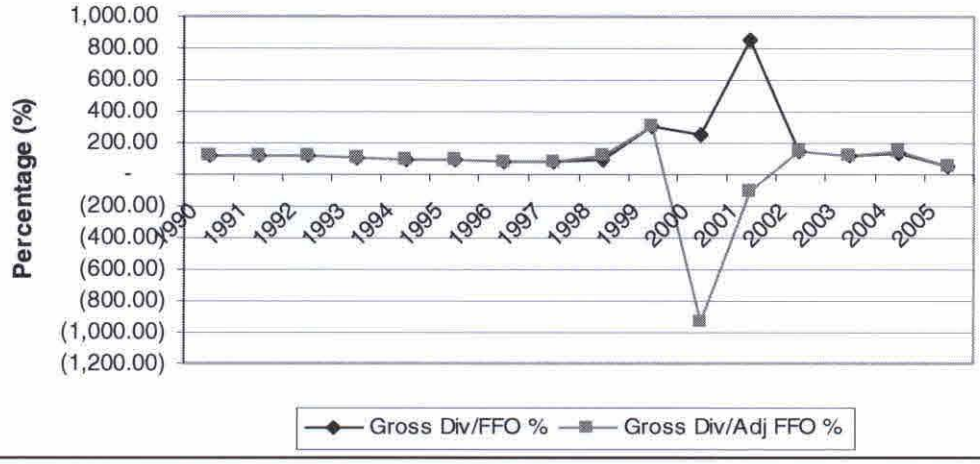
AHP was initially launched as a finite LPT. Under the Deed of Trust, AHP would be terminated after the expiration of seven years and before the expiration of ten years from the date of the principal Deed of Trust. However AHP was converted from a finite to an infinite property trust upon the approval of its unitholders at the EGM convened on 3 November 1998 with the extension of the term to an indefinite period upon its expiry in 20th March 1999.

AHP being a finite LPT (1989-1998) and holding a mixed investment portfolio offers an interesting case for a detailed analysis.

(a) Does a finite LPT (e.g. AHP) pay out more dividends than infinite LPTs?

The average gross dividend to FFO payout ratio is 99.18% for the finite trust period and 267.39% for the infinite trust period. However the payout ratios are distorted by provisions for diminution of share values. To reflect the actual level of FFOs, the FFOs are adjusted for the diminution of share values. Fig. 7 shows the trend of adjusted FFOs.

Fig.7: AHP - Dividend to FFO Payout ratios



With the adjustment, the average gross dividend to adjusted FFO ratio is 102.3% for the finite trust period (1990 to 1998) whilst the same average ratio is -35.7% for the infinite trust period (1999 to 2005).

The result indicates a higher payout ratio during the finite trust period compared to the infinite trust period. However the result is inconclusive since the 1999 to 2005 period is distorted by poor economic condition which affects income from property investment and the poor stock market performance has affected share returns. In addition the issue is complicated by the fact that AHP has been declaring consistently high dividend distributions due to its social obligations to its unitholders.

(b) FFOs and share investments

AHP has investments in quoted shares. Due to accounting policies, the fluctuations in the market value of quoted shares are found to affect the calculation of FFOs where shares are stated at cost less provision for diminution

in value of investment. The average dividend to FFO for the 1990-2005 period of AHP is 163%. However after adjusting the FFOs for diminution of value of investment in quoted shares, the payout ratio has dropped to 107%.

The sources of income differ among the LPTs. In the case of AHP and AMFPT, both have invested in quoted shares. For AHP, the decline in FFOs is partly due to the decline in income from share investments.

Thus the calculation of FFO is found to be affected by provision for diminution in value of investment, particularly share investment.

Conclusions

The above research shows that the FFOs of LPTs is affected by economic conditions and the sources of income for FFOs.

The stability of dividends declared by LPTs are found to be unstable as it is affected by the level of FFOs attained by LPTs. FFOs are in turn affected by its sources of income. A LPT with unstable investment market values e.g. shares affects FFOs due to the need to comply with accounting standards.

The findings have an impact on the attractiveness of LPTs as a source of investment that could provide stable income distributions throughout its investment holding period. Investors may need to investigate the types of investments comprising the investment portfolios. Share investments are found to introduce a higher level of variability in the FFO levels thereby causing higher level of uncertainty in dividend distributions.

Since the bulk of source of income of LPTs are derived from rentals, future research may look into the impact of the types of property owned, the portfolio mix, types of tenants on locations etc. on FFOs.

References

Aharony, J and Swary, J (1980) Quarterly dividend and earnings announcements and stockholders' returns: An empirical analysis, *Journal of Finance* March, 1-12.

Block, R. L. (2006) *Investing in REITS* Bloomberg Press, New York.

Bradley, M, Capozza, D R and Seguin, P J (1998) Dividend policy and cash-flow uncertainty *Real Estate Economics,* 26(4), 555-580

Chan, S H, Erickson, J and Wang, K (2003) *Real estate investment trusts,* Oxford University Press, New York.

Glascock, J. L., Michayluk, D. and Neuhauser, K. (2004) The riskiness of REITs surrounding the October 1997 stock market decline, *The Journal of Real Estate Finance and Economics,* 28(4), 339-354.

Kallberg, J G, Liu, C H and Srinivasan, A (2003) Dividend pricing and REITs, *Real Estate Economics,* 31(3), 435-450.

Mooradian, R M and Yang, S X (2001) Dividend policy and firm performance: Hotel REITs vs N0n-REIT hotel companies, *Journal of Real Estate Portfolio Management,* 7(1),79-87.

Ooi, Joseph, T L (2001) Dividend payout characteristics of UK property companies, *Journal of Real Estate Portfolio Management,* 7(2),133-142.

Sing, T. F. and Ling, S. C. (2003) The role of Singapore REITs in a downside risk asset allocation framework, *Journal of Real Estate Portfolio Management,* 9(3), 219-235.

Smith, R A (2003) Weak economy undermines the stability of REIT dividends, *Wall Street Journal*, 5th July.

Wang, K, Erickson, J and Gau, G W (1993) Dividend policies and dividend announcement effects for real estate investment trusts *Journal of American Real Estate and Urban Economics Association,* 21(2), 185-201.