Home Improvement

Profits Behind Bars
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There are ways to capitalize on rising crime rates without actually committing a crime. Prisons are, after all, basically just real estate developments that happen to house criminals. Shouldn't correctional facilities be considered as much of an investment as a shopping mall or an office property? Those who believe the justice system can produce a profit could throw their money into the real estate investment trust Correctional Properties Trust, which exclusively holds interest in correctional facilities.

It may not be the most tasteful way to make a buck, but it is an honest investment nonetheless. Correctional Properties Trust (nyse: CPV - news - people) is just one of many specialized real estate investment trusts, or REITs, that allow individuals to invest in specific types of real estate (such as movie theaters or golf courses). Specialized REITs operate exactly like mainstream retail or industrial REITs. Where they differ is that they tend to be much smaller trusts since they hold very narrow types of properties.

Correctional Properties Trust owns and leases 13 correctional properties, which are leased out to both private and government groups. (The company uses triple-net leases, which means it owns the property, while tenants pay taxes and insurance and maintain the property.) The majority of the taxable income goes to its shareholders. Last quarter, Correctional Properties Trust's income was up to 37 cents per diluted share, compared to 32 cents per share during the same quarter last year. If one takes the dim perspective that the number of facilities required to house America's criminals could increase over the years, there is no reason why the properties themselves shouldn't increase in value (assuming operating costs are kept in check).

Another specialty REIT, Entertainment Properties Trust (nyse: EPR - news - people), invests exclusively in "entertainment properties." Its portfolio consists almost entirely of multiplex movie theaters. By the end of the third quarter, the company had acquired $146 million worth of megaplex theater properties, and its net income increased to $7 million (from $6.1 million last year). Income available to shareholders was 41 cents per diluted share, the same as last year.

The lure of a specialty REIT is that it acts and looks just like a regular REIT; its portfolio is valued upon location, desirability, etc., but the trust's performance may also be based upon a mix of industry-specific variables. In a box-office record year, Entertainment Properties Trust could deliver healthy dividends. In a dismal blockbuster year, its performance may be distinctly disappointing. It's not always advantageous to hold a REIT that acts like an individual stock.

Privately-held CNL American Properties Fund, for example, got socked earlier this year after a few of its major portfolio brands took a financial hit. The company reported a 2001 annual net loss of $24.5 million, down significantly from $2.9 million in earnings in 2000. Its provisions for losses on loans jumped to $28.2 million in 2001 (up from $1.8 million in 2000), after three of its portfolio brands--Phoenix Restaurant Group, Houlihan's Restaurant Group and Roadhouse Grill--filed for bankruptcy between October 2001 and August 2002.

There is obviously a good deal of risk involved with specialty REITs, despite the fact that they may be perceived as a safe haven from the recession. Financial advisers typically recommend that individual investors who don't already own investment properties put about 5% of their savings into real estate funds. Most recommend,
however, that their clients stick with big-named funds (that hold commercial, office and residential realty), and tend to be wary of REITs that are too specialized and dependent on the business or economic climate.

"All REITs are specialized," says John Lyons, executive managing director of real estate investment firm Granite Realty Partners. "But when you're looking at less mainstream REITs that cater to specific sectors, their performance is based less on real estate fundamentals—that is, the tenants, location [and so on]."

The data on specialty REITs don't look favorable. Financial research firm SNL Financial tracks a specialty REIT index, which is down year-to-date on a total return basis by 2.899%, and down on a 52-week basis by 1.212%. By comparison, SNL's equity REIT index was up 0.17% year-to-date, and up 4.012% on a 52-week basis. Perhaps there is good reason why most investors avoid the unconventional REITs.