Important Information about Real Estate Investment Trusts (REITs)

Baird has prepared this document to help you understand the characteristics and risks associated with an investment in securities of a real estate investment trust ("REIT"), so that you can make an informed decision when buying or selling these securities. REITs are not suitable for all clients. Your Baird Financial Advisor can further explain the features, characteristics and risks of any particular security under consideration for your account. Most of the REITs that can be purchased through Baird are publicly traded, although some REITs are non-traded or private REITs which involve special risks. See "Understanding the risks" below.

Characteristics of REITs

A REIT is a corporation, trust or association that owns and typically operates income-producing real estate or real estate-related assets. The income-producing real estate assets owned by a REIT may include office buildings, shopping malls, multi-family housing, student housing, hotels, resorts, hospitals and health care facilities, self-storage facilities, data centers, warehouses, and mortgages or loans. Most REITs specialize in a single type of real estate – for example, apartment communities. There are retail REITs, office REITs, residential REITs, healthcare REITs, and industrial REITs, to name a few. What distinguishes REITs from other real estate companies is that a REIT must acquire and develop its real estate properties primarily to operate them as part of its own investment portfolio, as opposed to reselling those properties after they have been developed. REITs provide a way for individual investors to earn a share of the income produced through real estate ownership – without actually having to go out and buy the real estate.

Types of REITs

REITs generally fall into three categories: equity REITs, mortgage REITs, and hybrid REITs. Most REITs are equity REITs. Equity REITs typically own and operate income-producing real estate. Mortgage REITs, on the other hand, provide money to real estate owners and operators either directly in the form of mortgages or other types of real estate loans, or indirectly through the acquisition of mortgage-backed securities. Mortgage REITs tend to be more leveraged (that is, they use a lot of borrowed capital) than equity REITs. In addition, many mortgage REITs manage their interest rate and credit risks through the use of derivatives and other hedging techniques. You should understand the risks of these strategies before deciding to invest in mortgage REITs. Hybrid REITs generally are companies that use the investment strategies of both equity REITs and mortgage REITs. Because they often invest in debt securities secured by residential and commercial mortgages, mortgage REITs can be similar to certain investment companies that are focused on real estate. Generally, companies that invest a majority of their assets in real estate are exempted from the rules that govern investment companies, such as mutual funds.

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REITs can either be internally or externally managed. In an internally managed REIT, the officers and employees of the REIT manage its portfolio of assets. In an externally managed REIT, an external manager manages the REIT's portfolio for which it often receives both a flat fee (frequently based on a percentage of the value of the REIT's assets) and an incentive fee (based on the returns on the sale of assets).

REITs can have different structures. Common structures are traditional REITs, umbrella partnership real estate trusts (or "UPREITs") and DownREITs. Traditional REITs own their properties directly rather than through operating partnerships. Publicly traded REITs are generally structured as UPREITs. In a typical UPREIT structure, the REIT holds substantially all of its assets through one operating partnership. The REIT owns a majority of the operating partnership and often serves as its general partner, but the operating partnership may have minority owners as well. With an UPREIT structure, the REIT can acquire properties by having the operating partnership acquire the assets in exchange for units in the operating partnership. Those units are typically convertible into shares of the REIT after expiration of a holding period. Property owners transferring properties to an operating partnership in exchange for units in the operating partnership generally can defer their gain until they convert the units for REIT stock. In a DownREIT structure, the REIT typically holds its assets directly and in multiple operating partnerships (often each operating partnership owns a single property or group of acquired properties). Similar to the UPREIT structure, property owners who contribute their assets to a DownREIT operating partnership generally receive units in the operating partnership that are convertible into REIT stock.

Many REITs are registered with the SEC and their common stock and preferred stock are publicly traded on a stock exchange. These are known as publicly traded REITs. Others may be registered with the SEC but are not publicly traded. These are known as non- traded REITs (also known as non-exchange traded REITs). This is one of the most important distinctions among the various kinds of REITs. Before investing in a REIT, you should understand whether or not it is publicly traded, and how this could affect the benefits and risks to you.

Tax Status

The shareholders of a REIT are responsible for paying taxes on the dividends that they receive and on any capital gains associated with their investment in the REIT. Dividends paid by REITs generally are treated as ordinary income and are not entitled to the reduced tax rates on other types of corporate dividends. For this reason, some investors prefer to own shares of a REIT or REIT fund inside a tax-deferred account (such as a retirement account) in order to defer paying taxes on the dividends received and any capital gains incurred from that REIT until they start withdrawing money from the tax-deferred account. Finally, a REIT is not a pass-through entity. This means that, unlike a partnership, a REIT cannot pass any tax losses through to its investors. Consider consulting your tax adviser before investing in REITs.

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To qualify as a REIT under the Internal Revenue Code, a company must have the bulk of its assets and income connected to real estate investment and must distribute at least 90% of its taxable income to shareholders annually in the form of dividends. REITs must also satisfy other requirements, such as having at least 75% of its assets invested in real estate; deriving at least 75% of its annual gross income from real estate-related sources, including rents from real property, gains on the sale of real estate, and mortgage interest on real estate ("real estate income"); and having at least 95% of its income be passive income (including real estate income and other dividends and interest). A company that qualifies as a REIT is allowed to deduct from its corporate taxable income all of the dividends that it pays out to its shareholders. Because of this special tax treatment, most REITs pay out at least 100% of their taxable income to their shareholders and, therefore, owe no corporate tax.

Baird's Equity Research department maintains research coverage on numerous REITs. Please consult with your Baird Financial Advisor on whether Baird provides research reports on the REITs in which you propose to invest and obtain copies of such reports. Baird's Investment Banking department may also serve as underwriter on public offerings of REIT securities. Your Baird Financial Advisor will receive a selling concession on the sale to you of REIT securities that Baird underwrites and thus have an incentive to offer them to you.

Understanding the risks

The risks associated with purchasing REIT securities are important considerations in making a purchase decision. The risks for any particular REIT investment are generally contained in the prospectus and/or in the REIT's information filings (such as annual reports, quarterly reports and current reports that are filed with the Securities and Exchange Commission), which are publicly available at www.sec.gov. Please read the information carefully and consult with your Baird Financial Advisor before investing in REIT securities.

Common risks associated with an investment in a REIT include, but are not limited to, real estate portfolio risk (including development, environmental, competition, occupancy and maintenance risk), general economic risk, market and liquidity risk, interest rate risk, sector diversification and geographic concentration risk, leverage risk, distribution risk, capital markets risk, growth risk, counterparty risk, conflicts of interest risk, key personnel risk, and structural and regulatory risk. These risks may cause volatility in the prices of REIT securities and trading volumes, and affect liquidity.

- Real estate portfolio risk. REITs own and usually operate income-producing real estate properties and real estate-related assets. The success or failure of a REIT is based on the success or failure of its real estate holdings. Real estate investments are subject to various risks that affect their values and the income they generate. Real estate investments are affected by changes in the general economy, prevailing interest rates, local economic and market conditions, competition for tenants, declining occupancy rates, oversupply or reduced demand for space where the properties are located, tenant defaults, increased operating, insurance, maintenance and improvement costs. Many costs associated with owning and operating real estate are fixed even when revenues from the properties are declining. Additionally, real estate development activities are subject to various risks, such as excess construction costs, unfavorable

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financing terms, construction delays and other challenges, issues with the developer, and changing market conditions. Owners and operators of real estate are also exposed to potential liability under environmental, zoning, tax and other laws.

- General economic risk. Economic conditions in the United States may affect real estate values, occupancy levels and property income, and thus could have a material adverse impact on a REIT's earnings and financial condition. Economic conditions are affected by numerous factors, including inflation and employment levels, energy prices, slow growth and/or recessionary concerns, consumer confidence, credit markets, public debt levels, geopolitical events, the regulatory environment, and interest rate fluctuations.
- Market and liquidity risk. The prices of a REIT's securities are subject to market risk. These prices will fluctuate as a result of numerous factors, both within and outside the REIT's control. Also, there can be no assurance that the securities issued by a REIT will have an established trading market, adequate trading volumes or sufficient liquidity.
- Interest rate risk. Because REITs generally borrow money to make investments, their net income will be adversely affected by increases in prevailing market rates. A relatively high interest rate environment may make it more difficult for REITs to acquire or develop properties on attractive terms. An increase in rates would affect a REIT's interest costs on variable rate debt and impact its ability to refinance existing debt or the willingness of third parties to buy assets that the REIT wishes to sell.
- Sector diversification and geographic concentration risk. Many REITs focus on a particular sector of the real estate market, such as apartments, student housing, hotels and hospitality, health care, office buildings, shopping malls, warehouses, self-storage facilities and the like. These REITs are subject to risks associated with sectors in which they are focused. Additionally, many REITs may own properties that are concentrated in a particular region or geographic location, which subject them to the risk of deteriorating economic conditions in those areas.
- Leverage risk. REITs typically borrow significant amounts of money in order to finance and operate real estate properties. With significant leverage, a REIT may be at risk that its cash flow will be insufficient to meet required principal and interest payments. Significant leverage also may make it difficult for a REIT to refinance or obtain additional financing in order to grow.
- Distribution or dividend risk. Although REITs are required to make annual dividends or distributions of their net investment income, the amount of cash available for distribution by a REIT will fluctuate based on the performance of its income-producing assets, which may result in the REIT not being able to maintain or grow dividend levels in the future. Distributions made by a REIT to shareholders out of its earnings and profits are taxed as ordinary income and not as qualified dividends (which are taxed at a lower rate); however, if a portion of the distribution constitutes a return of capital, that portion is not taxed until the shareholder sells or liquidates his/her position at which time the amount will be taxed at capital gain rates.

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- <u>Capital markets risk</u>. The success of a REIT generally depends on its ability to raise capital and obtain financing to make acquisitions and investments at acceptable prices and on acceptable terms. Because REITs make annual distributions of substantially all of the net investment income and capital gains, REITs need continual access to capital in order to make investments. At times, it may be difficult for a REIT to access the capital markets. A disruption in, or tightening of, the credit markets may prevent a REIT from securing a credit facility from one or more banks or to refinance an existing credit facility. If funds are not available, a REIT may not be able to make new acquisitions or investments, thus curbing its growth, and the REIT's value could be negatively impacted.
- <u>Growth risk</u>. Because REITs annually distribute nearly all of their ordinary taxable income, they need to obtain financing in order to make acquisitions or new investments. Difficulties experienced by a REIT in obtaining financing may slow its growth. Additionally, a REIT may face challenges in acquiring new properties on acceptable terms due to competition. Acquired properties may expose a REIT to unknown liabilities. A REIT may also seek to grow by developing new properties and thus be subject to various development and construction risks. A REIT that successfully acquires new properties may face the risk that it may not be able to manage such growth effectively.
- <u>Counterparty risk</u>. REITs often engage developers, contractors, management or operating companies and joint venture partners in connection with their real estate properties and holdings. Challenges or issues with such counterparties could have a material adverse impact on those real estate holdings and on the REIT generally.
- <u>Conflicts of interest risk</u>. Many REITs may be managed or operated by affiliated sponsor firms and pay significant fees to their affiliates. Certain REITs may pay incentive fees that may cause their managers or operators to take actions that may be detrimental to the REIT. Affiliates of REITs may also manage other real estate businesses that may compete with the REITs for acquisition and investment opportunities.
- <u>Key personnel risk</u>. REITs depend on investment professionals to identify, structure and manage the REIT's investments. If a REIT is unable to hire or retain qualified personnel or lose a member of its leadership, management or investment team, the REIT's performance can be adversely affected. The ability of a REIT to hire qualified personnel is also important in order to manage growth.
- <u>Structural and regulatory risk</u>. REITs are required to meet certain requirements in order to remain qualified as such under the Internal Revenue Code. A company that fails to qualify as a REIT would lose various tax advantages, including the deductibility of the distributions it makes to shareholders. The present federal income tax treatment of a REIT may be modified by legislative, judicial or administrative action at any time, and such modifications may adversely affect the REIT. In addition, in order to qualify as a REIT a company must annually distribute to its shareholders nearly all of its ordinary taxable income. This distribution requirement limits the ability of a REIT to accumulate capital for use for other business purposes. Moreover, if a REIT does not have sufficient cash or other liquid assets to meet the distribution

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requirement it may have to borrow money or sell properties at disadvantageous times in order to make the required distribution. In addition, many REITs impose limits on the percentage of the outstanding shares or interests that may be beneficially owned by a person or entity, and various other anti-takeover or defensive provisions.

- Non-Traded REIT risk. Some REITs are "non-traded," meaning that while the REITs are registered with the Securities and Exchange Commission and are required to make regular disclosures their securities are not listed or traded on an exchange. Some REITs are "private" REITs, meaning that they are not registered with the SEC and do not make required disclosures and thus investors may not have access to relevant information, and their securities are not listed or traded on an exchange. Securities of non-traded or private REITs are very difficult to value and are illiquid. Securities of such REITs may have redemption features, but those features have significant limitations on the amounts that can be redeemed and such redemptions may be delayed or suspended. Non-traded and private REITs may also have high fees, including offering expenses, selling compensation and organizational costs. Non-traded and private REITs may start out as blind pools, which have not specified the properties to be acquired. REITs may acquire properties in the future that do not require shareholder approval. For more information about non-traded and private REITs, please see the FINRA Investor Alert, "Public Non-Traded REITs – Perform a Careful Review Before Investing."

Before investing in REIT securities, it is important to understand and discuss with your Baird Financial Advisor the structure and terms of the security and the potential risks. Investors in REITs should have a high tolerance for risk, including the willingness and ability to accept significant price volatility and volatility of regular distribution amounts, potential lack of liquidity and potential loss of their investment. If buying such investments in an offering, you should obtain and read the prospectus. If buying such securities in the secondary market, you should review the issuer's publicly available financial and other information (such as recent annual, quarterly and current reports). You can obtain these materials from your Baird Financial Advisor or on the SEC's EDGAR database at www.sec.gov. Additionally, the SEC Office of Investor Education and Advocacy has relevant information about REITs that can be found at www.investor.gov.

For more information on the risks of non-rated, split-rated and below investment grade securities (including notes, debt securities and preferred stocks), please reference the disclosure – "Important Information About Non-Rated, Split-Rated or Below Investment Grade Securities, and Securities In Lowest Investment Grade Category" located at bairdwealth.com/retailinvestor.

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