

# Are REITs a Leading Indicator for a Commercial Real Estate Recovery?

**Real estate investment trust valuations are likely to continue to increase—but with ongoing volatility—until property fundamentals clearly enter the recovery phase. What does this mean for the commercial real estate industry?**

WHILE THE CAPITAL MARKETS ended the year in positive territory, few real estate investors would say that 2009 was a “good year.” Property fundamentals, most notably rental rates and occupancy levels, continue to deteriorate; demand drivers showed few signs of recovery; and banks gave little indication of a desire to restart lending to commercial real estate. Furthermore, the bid/ask spread between buyers and sellers remains stubbornly high.

Nevertheless, real estate investment trusts (REITs), as measured by the National Association of Real Estate Investment Trusts (NAREIT) U.S. Real Estate Index, delivered an approximate 27 percent return during 2009. It was a bumpy ride along the way, with the index touching a multiyear low of 185 in March before ending the year at 325.

This strong performance was initially driven by investors’ realization that March valuations were absurdly cheap. These seemingly inconsistent data, dramatically rising REIT pricing in light of deteriorating property fundamentals, are rightfully causing investors to question the outlook for 2010.

In 2009, investors were keenly focused on specific risks, including liquidity, credit risk, and operating results. It appears that most REITs met the challenges and outperformed expectations early in the year. Nevertheless, REITs continue to face the headwinds of poor fundamentals and will need to manage investors’ expectations regarding the direction of their portfolios’ fundamentals in 2010.

While REITs readily met their capital needs in 2009 by issuing additional shares and unsecured debt into the secondary markets, there were no signs of such liquidity early in the year. The rate of decline of the REIT index was an indication of the lack of investor interest in real estate securi-

ties. However, by September nearly \$27.9 billion of capital—consisting of \$18.7 billion of common equity and \$7.7 billion of unsecured notes—was raised. Despite this capital-raising activity, liquidity remains a significant concern among investors. Clearly, the market is now focused on debt maturity schedules and the various means with which they can be met.

The most interesting facet of REITs’ debt maturities is the revolving syndicated bank loan segment of their capital structure. These revolving facilities typically have a three-year life; are very favorably priced; and are important sources of capital for acquisitions, developments, and refinance capital for secured loans. Given the short-term nature of these loans, nearly one-third of all facilities mature in 2010. An analysis of the 2009 maturing facilities reveals that pricing increased fairly dramatically, but the size of the facilities did not noticeably decrease. This is key and reflects the market’s sentiment and commitment to REITs.

In any normal economic climate, equity investors are primarily focused on the growth prospects of their investment’s cash flow and its related corresponding growth in value, while bond investors are focused on mitigating the downside risks to their principal. However, given the dynamic of the current recession and the depth of the credit market crisis, equity investors became focused on credit metrics such as loan-to-value (LTV) and debt-service coverage (DSC), as well as general transparency.

The General Growth Properties, Inc., bankruptcy in April 2009 was a painful lesson in the pitfalls of high-leverage balance sheets constructed without regard for debt maturity schedules. Of course, LTV is a tricky measurement because it depends on estimates of value. Many REIT

market participants use market capitalization as a proxy for value (value of publicly traded equity plus book value of debt).

However, in times of plunging stock prices, leverage levels increase dramatically. Such was the case in early 2009, when the market capitalization leverage increased from roughly 50 percent in 2007 to the mid-70 percent range. This number has since migrated back to the mid-50 percent range as REIT stock prices have recovered. Commercial lenders have also dramatically reduced their leverage targets for new loans. As a result, REIT investors are generally demanding a less-leveraged capital structure from REITs, which will definitively set public companies apart from private owners.

Related to leverage levels is debt-service coverage. Given the fairly recurring and stable nature of cash flow from commercial real estate, lenders typically tolerate lower coverage metrics relative to other industries; 1.20x (i.e., net income is 1.2 times the amount of debt service) is a fairly standard target throughout a real estate cycle. However, during times of economic stress and increased cash flow volatility, lenders require a greater DSC cushion—perhaps more like 1.4 to 1.5x. As a result of their lower LTV levels, REITs typically have stronger DSC metrics than private owners. Even in today’s economic climate, the average DSC is approximately 2.40x for the REIT space. Of course, there are outliers to this figure, but it represents the lower leverage used by REITs.

Finally, REIT investors have had an easier time understanding the credit risk of REITs because their transparency is far superior to that of private companies. REITs disclose operating results, acquisition and disposition activity, balance sheet composition,

and detailed debt maturity schedules. All of these windows into their operations and structure have a dampening effect on risk premiums. As a result, investors have felt more comfortable investing in public REITs than private transactions during the last half of 2009, further differentiating the REIT space.

REIT management teams are arguably more professional and vertically integrated than those of their private market counterparts; however, their operating results are more correlated to their lease maturity schedules and the credit quality of their tenants. REIT investors have historically been more income oriented, rather than seeking quick appreciation, and have rewarded management teams who structure long-term leases. While these longer-term leases are helping REITs produce more stable cash flow in the current economic environment, the estimate for 2010 cash flow generated from REITs is down nearly 15 percent from 2009.

Offsetting the concerns of contracting “same store” cash-flow generation, however, is the possibility of growing the portfolio through highly accretive acquisitions. Since REITs have larger infrastructures than their private market counterparts, they have the ability to spend more time chasing complex transactions such as bank REOs (i.e., real estate owned by banks/lenders) and defaulted loans in commercial mortgage-backed securities (CMBS) structures. While there has been a significant amount of private capital raised for such transactions, there have been very few deals actually consummated.

Part of this has to do with banks’ reluctance to part with assets at these implied price levels, but it also has to do with bidders’ return objectives. Public REITs have a longer-term “value creation” strategy while private funds have short-term “capital gain” strategies. The combined reasons will likely result in a healthy amount of these deals going to REITs during

**FIGURE 1: ESTIMATED ACQUISITION BY COMMERCIAL REAL ESTATE PARTICIPANTS**

	2002	2003	2004	2005	2006	2007	2008	2009
Private	38%	44%	45%	47%	42%	35%	47%	57%
Equity funds	8%	6%	7%	9%	14%	24%	11%	5%
End users	6%	5%	6%	3%	4%	3%	8%	15%
Public (REITs/REOCs)	20%	21%	19%	15%	9%	9%	11%	5%
International	11%	8%	7%	7%	7%	6%	7%	5%
Institutional	17%	16%	16%	19%	24%	23%	16%	13%

Source: Real Capital Analytics.

2010. There have already been a few transactions announced, particularly in the multifamily sector.

Investors have clearly been pumping capital into the REIT sector in anticipation of a stabilization in property fundamentals as well as a wave of accretive acquisitions. This is fairly typical as the public markets tend to “move” in advance of underlying fundamentals. Property types with shorter lease terms—notably, lodging and multifamily—may experience a shorter gap, while property types with longer lease terms, such as office, would experience a longer gap. In addition, REITs are rightfully expected to be significant buyers of distressed assets. The data in Figure 1 demonstrate that public REITs were fairly disciplined in their acquisition activity and will likely put their newfound liquidity to work purchasing distressed property.

But this does not mean that REIT stock prices will not be volatile in 2010. The “movement” of direct commercial real estate is generally less volatile than the REIT market because the direct market valuations are typically determined by appraisals, or internal readjustments based on yield expectations, as compared to stock prices. Stock prices reflect the ever-changing yield expectations of many different investors, which results in greater volatility in valuations.

This uncertainty has been reflected in the higher volatility of REIT

stocks, the beta of which remains at nearly 2.0 times, which is considerably higher than its historical norm of approximately 1.0x. It is likely that REIT valuations will continue to increase but with ongoing volatility until property fundamentals clearly enter into the recovery phase.

Most investors seem to agree that property fundamentals will begin to stabilize in 2010 but will not show significant signs of improvement until 2011. The general consensus is that distressed selling and bank REOs will present “once in a lifetime” acquisition opportunities in 2010. Therefore, the most likely source of growth in the REIT sector in the coming year will be from a wave of property entering the public markets.

At present, there are a significant number of portfolios held in private equity funds that are overleveraged and producing below pro-forma operating results. Many of these portfolios will either be spun out as initial public offerings (IPOs) or sold in bulk to existing REITs. A historical example of this is from the recovery period of the early 1990s.

A number of market commentators have begun debating the possibility of a stagnated U.S. economy. This would mean that gross domestic product (GDP) growth remains flat, affecting household formation; job creation does not materialize, affecting household formation; and inflation begins to kick in, resulting

in higher borrowing costs and higher cap rates. The net result is a continued “slow bleed” in property fundamentals. Coupled with a dormant financing market, investors may become very uncomfortable with current REIT valuations and exit the space, driving the indices downward.

While REIT stocks appear to be “fairly” valued and there are clear headwinds facing additional price appreciation, history has shown that publicly traded real estate performs very well during economic recoveries. Reliable REIT managers will find appealing acquisition opportunities, fundamentals will eventually improve, and there will undoubtedly be distressed private market owners who will sell into the public markets.

REIT investors are advised to avoid momentum plays and invest their money with those managers who outperform their submarkets and will likely have the greatest access to deal flow in the next six to 18 months. **UL**

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