



## real estate finance & investment

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### GUEST COLUMN

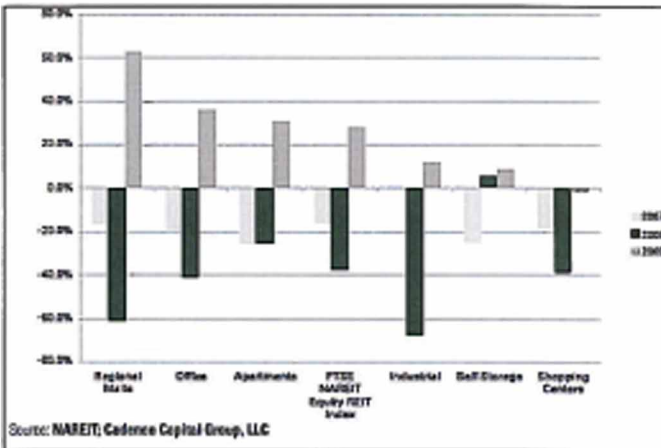
## The General State of REITs

By **Scott Robinson**

While the capital markets ended 2009 in positive territory, few real estate investors would say that it was a good year. Property fundamentals, most notably rental rates and occupancy levels, quickly deteriorated, demand drivers showed few signs of recovery, and banks gave little indication of a desire to restart lending to commercial real estate. Further, the bid-ask spread between buyers and sellers remained stubbornly high.

Nevertheless, REITs (as measured by the NAREIT index) delivered an approximate 27% return during 2009. It was a bumpy ride along the way, with the index touching a multi-year 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. This seemingly inconsistent data, dramatically rising REIT pricing in light of deteriorating property fundamentals, is rightfully causing investors to question the outlook for 2010.

**Figure 1: Annual Performance REITs**



### What Are Investors Looking For?

Stock investors generate returns from two components: cash flow growth and appreciation (academically measured as a decrease in perceived risk). Investors also make investment decisions based on their expectation for the direction of these components. As a result, the share prices of publicly traded real estate companies often move in advance of property fundamentals, depending on investor's expectations for the future of fundamentals. Investors will buy stocks if they expect

an improvement in fundamentals and will sell shares if they expect fundamentals to deteriorate.

Investors have driven REIT stock prices higher during recent months not only because they believe property fundamentals will improve but also because they believe REITs will be able to take advantage of historic buying opportunities. Multifamily REITs have been an interesting example of this philosophy. The short-term nature of their leases and their relative availability of capital through government-sponsored entities (such as Fannie Mae), have attracted investor interest in the past six to ten months.

**Figure 2: Annual Performance of Individual multifamily REIT stocks**

Company	2007	2008	2009	2010*
Apartment Investment & Management (AIM)	-36%	-67%	38%	45%
Associated Estate Realty Corp (AEC)	-31%	-3%	23%	28%
AvlonBay Communities, Inc. (AVB)	-29%	-30%	52%	23%
BRE Properties Inc. (BRE)	-36%	-31%	18%	25%
Canada Property Trust (CPT)	-36%	-34%	43%	14%
Colonial Properties Trust (CLP)	-52%	-64%	41%	48%
Equity Residential (EQR)	-29%	-22%	25%	30%
Essex Property Trust, Inc. (ESS)	-25%	-21%	9%	31%
Home Properties (HME)	-25%	-8%	18%	5%
Mid-America Apartment Communities Inc. (MAA)	-25%	-13%	30%	16%
Past Properties (PPS)	-23%	-53%	19%	40%
United Dominion Realty Trust (UDR)	-40%	-30%	19%	29%

\* through 1/1/10  
Source: ENL Financial, LLC; Bloomberg; Cadence Capital Group, LLC

### What Are Investors Expecting In 2010?

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. There are a significant number of portfolio's currently held in private equity funds that are over-leveraged and producing below pro-forma operating results. Many of these portfolios will either be spun out as IPO's or sold in-bulk to existing REITs. A good historical example of this is from the recovery period of the early 1990's (see chart)

**Figure 3: IPOs during the 1990s**

	# of IPO's	Capital Raised
1992	8	\$919.0
1993	50	\$9,335.0
1994	45	\$7,176.0
1995	8	\$922.0
1996	6	\$1,108.0
1997	26	\$6,297.0
1998	17	\$2,129.0
1999	2	\$292.0

Source: NAREIT; Cadence Capital Group, LLC

**What Could Go Wrong?**

Many market commentators have begun debating the possibility of a stagnated U.S. economy, hampered by the increasing level of global sovereign risk and the unknown impact of scaled back fiscal stimuli. This stagnation could result in relatively flat GDP growth that negatively affects household formation and consumer spending, little to no job creation that will negatively

affect household formation, and a risky interest environment resulting from sovereign debt fatigue. The net result could be a continued slow bleed in property fundamentals. Coupled with a relatively dormant financing market, investors may become very uncomfortable with current REIT valuations and pull back from the sector, driving the indices downward. As Figure 4 highlights, current stock valuations exceed Wall Street analysts' expectations of net asset value.

**Figure 4: Analyst Consensus NAV versus Current Stock Price**

*What Does History Tell Us?*

While the argument can be made that REIT stocks are fairly valued based on external growth opportunities, there are clear headwinds facing additional price appreciation. Nevertheless,

Company	Consensus NAV (5.4.10)	Stock Price (5.4.10)	Premium / Discount
Apartment Investment & Management (AIV)	\$16.49	\$23.33	41%
Associated Estate Realty Corp (AEC)	\$13.59	\$14.40	6%
AvalonBay Communities, Inc. (AVB)	\$60.24	\$106.28	76%
BRE Properties Inc. (BRE)	\$32.69	\$41.39	27%
Camden Property Trust (CPT)	\$33.65	\$49.01	46%
Colonial Properties Trust (CLP)	\$14.29	\$16.43	15%
Equity Residential (EQR)	\$24.26	\$46.70	92%
Essex Property Trust, Inc. (ESS)	\$72.68	\$109.99	51%
Home Properties (HME)	\$36.65	\$50.05	36%
Mid-America Apartment Communities Inc. (MAA)	\$38.00	\$55.93	47%
Post Properties (PPS)	\$19.35	\$27.44	42%
United Dominion Realty Trust (UDR)	\$12.25	\$21.27	74%

Source: SNL Financial, LLC; Bloomberg; Cadence Capital Group, LLC

history has shown us that publicly traded real estate performs very well during economic recoveries. Good REIT managers will find outstanding 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 have a track record of outperforming their submarket competitors and who will likely have the greatest access to deal flow in the next six to eighteen months.

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