

GUEST COLUMN

Is REIT Corporate Debt a Panacea for Uncertain Economic Recovery?By **Scott Robinson**

Investors seeking a relatively safe, liquid opportunity to earn current income during an uncertain economic recovery have increasingly sought exposure to real estate investment trust corporate debt. Since the dark days of early 2009, the price appreciation of these bonds has been tremendous—and their risk profile is solid compared to many other real estate investment opportunities. While the value of most fixed-income instruments will likely come under pressure in the “new normal” economy, there are compelling reasons why REIT bonds may be buffered.

REIT corporate bonds are the unsecured liabilities of the corporate borrower. They have a senior unsecured creditors claim on the corporation's assets, making them structurally subordinated to secured mortgage debt in the event of default. Investors, however, benefit from fairly strict financial covenants, including limitations on leverage and debt service coverage, and the maintenance of an unencumbered collateral pool to support the amount of outstanding bonds. There are, of course, outliers but the standard covenant package limits leverage to 60%, requires interest coverage of 1.50x and requires an unencumbered collateral pool equal to at least 150% of the amount of outstanding unsecured bonds.

Year-to-date REIT bond performance has been solid as spreads have contracted by roughly 60 basis points since January 1. This is in addition to the phenomenal contraction of nearly 1,000 bps in 2009, reversing the unprecedented widening of approximately 950 bps in 2008. Despite this dramatic spread contraction, REITs still trade wide of most high-grade corporate bonds, at approximately 230 bps versus roughly 140 bps.

Credit Characteristics Improve

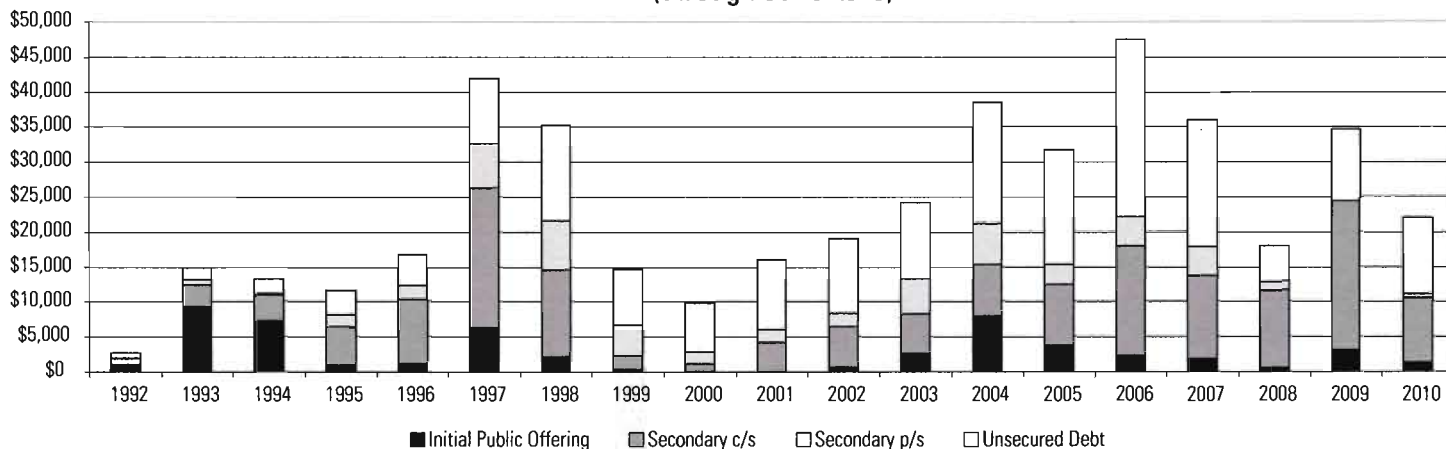
In July of 2009, investors were pricing unsecured real estate debt as if all REITs were teetering on the brink of default. This fear was driven by eroding property fundamentals and a lack of liquidity, particularly in light of the nearly \$135 billion of corporate REIT debt maturing between 2010 and 2013. Yet a quick glance at Figure 2 demonstrates that REITs issued an unprecedented amount of equity in an effort to deleverage, raising roughly \$22 billion in secondary offerings in 2009 and another \$10 billion through June of this year. During this same time period, REITs also raised a little more than \$21 billion of unsecured debt. This flurry essentially eliminated all liquidity fears and enabled REIT managers to de-lever by repaying approximately \$40 billion of outstanding debt.

Fundamentals Likely To Remain Stagnated

Real estate is a lagging industry and as such, it stands to reason that an uncertain economic outlook will only dampen an improvement in property fundamentals. Limited GDP growth, elevated unemployment, increased regulation and shifting consumer spending habits will stall any sustained improvements in occupancy and rental rates for the near-term.

REIT bond investors benefit from the diversified property portfolios held by the REITs. Most REITs have geographically diverse investment portfolios, which limits their exposure to specific markets, industries and tenants. Because of this, the near-term impact of economic downturns on cash flow and debt service coverage is usually relatively minor as leases expire and become

Historical REIT Capital Offerings
(through June 2010)



marked-to-market over time. Additionally, future acquisitions could provide a valuable offset to these rent roll-downs as rental rates drops are off-set by cash flow from higher-yielding investments.

Weak Capital Markets Limit Fixed-Income Opportunities

The broader capital markets will remain very fragile for the foreseeable future, driven by the economy and growing concerns over sovereign risk and fiscal imbalances. Commercial real estate investors have become more risk averse and will continue to focus on de-leveraging as they seek to unwind many of the complex capital structures that were engineered during the last cycle. As a result, the availability of capital to real estate, namely securitized debt, will likely be limited.

This lack of availability will not only limit the amount of commercial real estate transactions. It will also limit the amount of viable investment opportunities for fixed-income investors. Institutional investors seeking investment-grade investments can no longer look to the CMBS market as downgrades and risk of credit loss are significant. Direct mortgage opportunities are also difficult to execute due to the lack of transaction volume and required due diligence. REIT bonds therefore offer a transparent, liquid alternative opportunity.

REIT Bond Values Show Strength

In the near term, a slow economic recovery will likely keep deflationary pressures from easing, driving up the value of the dollar and keeping the yield curve flat. As the economic recovery eventually gains momentum, investors will begin to seek protection from possible inflationary pressures. Many investors will likely rotate out of fixed-income investments, which in turn could put downward pressure on their value. Real estate, however, is a classic inflation hedge and REIT bonds typically attract dedicated real estate investors.

Despite macro-economic uncertainty and volatile capital markets, REIT credit profiles should remain relatively stable. Strong cash flow protection measures, staggered lease maturities, ample liquidity and good transparency differentiate the REIT sector from other fixed income opportunities. In addition, the downside protection afforded by REIT bond covenants and a near-perfect track record of REIT defaults should further bolster investor confidence. As such, REIT bonds should continue to provide solid risk-adjusted returns for investors.

Scott Robinson is a professor at the NYU Schack Institute of Real Estate and a managing partner of Cadence Capital Group.