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The Dawn of a New REIT Era?

by Rachel Speirs

Real estate investment trusts (REITs) have been hit particularly hard in the current bear market, and commercial real estate fundamentals aren't expected to improve for years. So why are industry insiders so hopeful?

The past three years have not been kind to REIT investors. The FTSE NAREIT All REIT Total Return Index, which tracks the equity and mortgage REITs, declined 17.83 percent in 2007 and another 37.3 percent in 2008 amid investors' growing concerns about the financial services industry, the recession, property and stock overvaluation, and growing credit risks. And then, in April, those risks turned into realities. That month, mall REIT General Growth Properties along with 158 of its properties filed for the largest real estate bankruptcy in U.S. history. Investors feared the worst for the REIT industry and fled the market. The FTSE NAREIT All REIT index lost another 39 percent in the first three months of the year alone.

But then — almost as suddenly as the market turned from bad to worse — the situation began to improve. Recapitalized with nearly \$16 billion of public equity, the REIT market began to rally in the second quarter. Shares have skyrocketed 60 percent since hitting an 18-year low on March 6.

Brad Case, vice president of research and industry information at the National Association of Real Estate Investment Trusts (NAREIT), explains the situation: "When those equity

issuances started, investors began to understand that REITs were going to be able to raise the money they needed to pay off their debt; they weren't going to go out of business. Investors are now asking, 'What are these portfolios worth, given that these REITs are going to say in business,' versus before when they were asking, 'What are these portfolios worth given there's a serious chance the company may go out of business?' That chance is no longer there," he says. "I'm not quite willing to say we've hit the bottom, but it looks awfully like the bottom."

Industrywide, many analysts, investors and researchers are watching the U.S. REIT market closely and with growing excitement. REITs, they believe, could be poised for another bull market run, and soon. Their belief is founded on the basis that REITs have been able to — and should continue to be able to — access capital through public markets. This access would allow many, if not the majority of companies, to pay down their debt and shore up cash reserves to be able to buy during what may be one of the biggest distressed buying opportunities of the decade.

In fact, the idea is not far-fetched; it's happened before. In 1991, a year marked by high leverage and heavy losses in commercial real estate, the REIT market experienced a surge of growth that would ultimately spawn a seven-year bull run. During second quarter 1991, REIT equity

offerings raised roughly 4.5 percent of the industry's total market capitalization. The initial surge was then followed by a larger wave of new security issuances as more and more real estate companies flocked to public markets in an effort to pay off maturing debt. In the years that followed, REIT equity offerings averaged 10.8 percent of the total market cap per year for the next three and a half years. For the next seven years, the REIT market saw average total yearly returns of about 20 percent.

"The parallels are very, very strong," Case says.

During second quarter 2009, REITs raised \$16 billion, approximately 6 percent of the total market cap. In May alone, 18 secondary equity offerings raised \$5.3 billion, about the same amount of equity that was raised in all of 2008. Case and his colleagues at NAREIT believe much more could be on its way.

In a presentation given at the association's REITWeek conference in New York City in June, NAREIT outlined its projection of the REIT market, forecasting that REITs could see nearly \$654 billion in new security issuances, or \$43.6 billion per quarter on average, through 2012. The projections are based on assumptions about the market's movement in 1991 and don't factor in current economic forecasts, but if the projections are correct, or even close, it would have big implications for the industry, researchers say.

According to NAREIT, the industry could potentially raise enough capital to reduce its leverage by 25 percent by mid-2010 and amass nearly \$582 billion (suggesting \$728 billion in property value) by the end of 2010. Through acquisitions and deleveraging, REITs could become a more dominant player in the broader real estate markets. NAREIT argues the REIT industry could see its property market share grow from its current 5 percent to upward of 30 percent.

"It's very exciting for REITs," Mike Kirby, chairman of REIT research firm Green Street Advisors, told reporters during REITWeek. "It will be one heck of an opportunity because what you'll see is that the price of real estate, as always, is dependent on the cost of capital as the primary source that is able to

finance real estate. It will be the cost of capital for REITs that drives the bus, in terms of how real estate gets priced."

RECAPITALIZATION

Of course, few in the market had such high hopes for REITs six months ago. Spurred by growing concerns about the financial services industry, the recession, property and stock overvaluation, and growing credit risks, investors fled the market in droves. Recapitalization changed all that.

Joseph Harvey, president and chief investment officer at Cohen & Steers, has had an up-close view of the process. Cohen & Steers, which has \$16.3 billion in assets under management, took a heavy hand in promoting REITs' survival.

"We felt that the risks were escalating," said Harvey. "If REITs couldn't show the market they had access to the capital, the markets would increasingly shut down on them.

"We felt stock prices were so low, reflecting this distress, if we could show the world they had access to equity — even if it was very expensive — share prices would lift to reflect the fact that the worst-case scenario had been taken off the table," Harvey explains.

Cohen & Steers chose several REITs, which they felt could best weather the financial storm and would most sway public confidence. Their first prospect was mall giant Simon Property Group. Through an investment bank intermediary, the company proposed taking a lead investor position with Simon Property Group. The firm would purchase \$140 million in common equity and corporate bonds if the REIT would issue a secondary offering in a significant enough amount to cover its debt maturities and stabilize its operations.

It was a risky move in an uncertain environment, but it seemed to do the trick. On March 20, Simon issued a secondary offering of \$540 million, priced at \$31.50 per share. Less than five months later, Simon stock was trading above \$60 per share.

"While this is what we road-mapped out, we were positively surprised that it happened faster than we thought it would, and more dramatically than we thought it

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***— Joseph Harvey, president and chief investment officer,
Cohen & Steers***

could, in terms of how many companies were able to access capital and how much equity was raised in a very short time," Harvey says.

In recent months retail and office owner Vornado Realty Trust, mall operator Kimco Realty Corp., data center developer Digital Realty Trust and numerous others have issued secondary offerings in an effort to rebalance their financials. A number of entities also have filed for initial public offerings, mostly to become mortgage REITs. Most recently, Starwood Capital launched Starwood Property Trust, in the largest IPO of the year. The newly formed REIT, which will focus on distressed commercial and residential real estate, raised \$951.5 million.

"These transactions, in which many times we've been a lead investor, give us confidence that the heart of our investment universe is regaining its footing," says Harvey.

But REITs aren't out of the woods yet. *The Wall Street Journal* reports that REITs must refinance a daunting \$152 billion in debt through 2013. To make matters worse, some REITs still have crushing debt levels. Office landlord Maguire Properties, for example, has a 94 percent debt to capital ratio.

"It's extraordinarily difficult out there," Harvey says. "There are still companies in the public market that haven't raised the equity they need."

Harvey estimates the REIT industry has raised about sixty percent the equity that it needs to manage its debt obligations, but he notes the

amount is “highly concentrated in the largest, most important companies.”

It has quickly become feast or famine for REITs, says Gary Koster, head of the real estate fund services practice at Ernst & Young.

“It’s a classic tale of two cities,” Koster explains. “All of the REITs that are long on real estate right now are praying the government stimulus will kick in and the economy will have job growth and consumer spending. This will, in turn, lead to increased demand for rental space of all kinds. At the same time, those REITs that have deep pockets and the ability to draw on fresh capital are looking at what could be the best buying opportunities that they’ve had in the last 25 years. They’re excited about what they might be able to buy and perhaps not so anxious for a speedy recovery. As long as they can survive, they will limp along with their existing portfolio while the market is in distress and accumulate bargains from those suffering from liquidity issues.”

“The course of the past six to eight months has all been defensive plays: ‘How do we survive into the next period?’” he adds. “Surviving is the new winning.”

THE NEXT PHASE— ACQUISITIONS

The REITs that do survive should be well positioned to buy when distressed properties eventually show up on the market, industry experts say. Many firms that have recapitalized have earmarked a portion of those funds for acquisition. Vornado Realty Trust, which issued \$710 million worth of new shares, has about \$2 billion in cash and borrowing capacity it can use to increase its holdings when the opportunities arise, for example.

Few deals have actually transacted, but many believe opportunities are just on the horizon. According to research firm Delta Associates, the total value of distressed commercial real estate (including properties in distress, foreclosure or lender REO) nationally was \$49.2 billion in February. That amount is expected to balloon in 2012 and 2013 as a large amount of debt reaches its maturity. According to Delta Associates, the market could see in excess of \$300

billion of mortgage maturities that must be addressed by the commercial mortgage market in those years.

“The next phase of alpha generation, of excess returns in real estate is going to come from the acquisition opportunity. And I think there are

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— *Joseph Harvey, president and chief investment officer,
Cohen & Steers*

only a few types of players who can deliver that; public companies which are shoring up their balance sheets are one of them,” says Harvey.

In the current capital-restricted environment, the market will favor REITs that have access to public capital, own quality assets and have overall relatively low leverage, says Gary Mozer, principal managing director at George Smith Partners, a Los Angeles-based real estate investment bank.

“We’re seeing this bifurcation of the marketplace where there’s the haves and have-nots. If you have great real estate and great markets and relatively low leverage, you can go to the life insurance companies. If you want shorter terms, you go to big institutional banks, but you have to put up deposits and recourse. Otherwise you go to the opportunistic lenders, which is expensive money,” he explains.

“There’s capital out there, but most high-net-worth and most institutional borrowers can’t function in this market,” says Mozer. “With the REITs, they’re so well capitalized, they’re able to use the low proceeds to their advantage because they’re really the only ones with the ability, the ones with enough liquidity, to handle the low levels of borrowing.”

A Federal Reserve program offering financial banking for debt, called the Term Asset-Backed Securities Loan Facility, or TALF, is also

expected to help big REITs secure debt at subsidized levels, but the program is still in its infancy.

MIXED REACTIONS FROM INSTITUTIONS

Although the apocalyptic mood in the market has lightened, pension funds have remained cautious amid the REIT market’s mood swings. In the aftermath of last fall’s abrupt stock market decline, many investors were forced to dump REIT stock to balance their shifting portfolios. The pension funds that stayed in the market, suffered the violent mark-to-market drops.

In November, Bloomberg News reported big losses at California Public Employees’ Retirement System (CalPERS). The pension giant bought shares in 112 REITs just before the stock market deteriorated last fall, and lost, on paper at least, nearly 45 percent of the value of those stocks by December 2008. Although the market has since rebounded somewhat, caution prevails, and for good reason: Ratings agencies, despite the uptick in stock prices, have continued to downgrade REITs on continued concerns of their creditworthiness. Between January 1, 2008, and April 30, 2009, Moody’s Investors Service made 40 rating changes to REITs; 38 were downgrades.

A few pension funds, including the \$11.9 billion City and County of San Francisco Employees’ Retirement System and \$94 billion New York State Teachers’ Retirement System (NYSTRS) are starting to test the water again. San Francisco recently hired European Investors and ING Clarion Real Estate Securities to manage a global REIT portfolio of \$75 million, and in July, NYSTRS renewed their agreement with Cohen & Steers, which manages the pension fund’s real estate preferred securities.

At Cohen & Steers, Harvey says he is continuing to see the greatest demand for global REIT mandates from institutions around the world, but he’s also seen an increase in standalone U.S. portfolios by investors who hope to take advantage of the distress in the U.S. market.

But Ernst & Young’s Koster says the uncertain economic outlook and poor fundamentals have kept many investors cautious.

“What’s really starting to become clear now is that the REIT market is the part of the market that’s going to survive.”

— Brad Case, vice president of research and industry information, NAREIT

“Understanding how the declining fundamentals have been priced into values and how significant the continuing decline of fundamentals is going to be is a real question mark,” says Koster. “We continue to see occupancies falling, rents falling and expect to see that for some time. Ultimately, NOI goes down. There are two things that impact valuation: One is the property return, and the other is the risk associated with achieving the return itself. The return itself is expected to fall in the short run. What has the market really priced in that equation? That comes down to whether you really believe in the efficient market theory or not.”

FUNDAMENTALS TAKE A HIT

In the short term the market fundamentals look bleak. Rents and occupancies are under pressure, borrowers are still defaulting on loans, and property values are expected to continue to decline.

Prudential Real Estate Investors’ second quarter *Market Perspective* notes, “The ongoing deterioration in property market fundamentals will weigh on REIT earnings through 2010, while forward earnings estimates for the broader market are improving.”

“With the market fundamentals falling away, [investors] are asking how sustainable is that return going forward. Everybody is looking at the tea leaves to make the assessment as to whether this is a bear market rally or not,” says Koster.

Dean Frankel, senior portfolio manager of U.S. REIT strategy at URDANG, says investors should prepare for some “sticker shock” ahead.

“The IRR models show REITs

putting up low to mid-double-digit returns over the next 10 years ... but it’s hard to say what stories are going to unfold over the next year. Obviously the fundamentals are just about to hit ‘bad,’” he says.

Frankel estimates that the industry will see NOIs decline to 15 percent during this recession and suggests cap rates could move back to “reasonable levels” of 7 percent to 7.5 percent or 8 percent to 8.5 percent, depending on the sector. Properties that were sold off during the market peak could have cap rates as high as 8.5 percent or 9 percent, he says.

But the coming valuation declines may, in fact, be already priced in to REIT shares. According to NAREIT’s Case, the public markets have historically lead the private markets; they reach their peak one year ahead of private market, and hit their trough two and a half years ahead of the private market.

“If you think property values are going to go down, that’s a good reason to have sold off your REITs a year and a half ago, not now,” says Case. “That’s already been priced in. That train has left the station.”

REITs, he says, have gone through the kind of price correction similar in size and scale to the writedowns that are just starting to unfold in the private funds. From peak to trough, REIT share prices lost 68 percent in total returns in the last cycle, approximately the amount experts say the private markets will ultimately write down.

REITs, therefore, are particularly attractive as a way to access the commercial property market at discounted pricing that is not widely available in the direct market, he says.

Frankel and others say REITs also look attractive and relatively cheap as a long-term investment. At the end of June, REITs were trading at implied cap rates of about 8.8 percent, on average, roughly 360 basis points higher than at the peak of the market in early 2007, according to Merrill Lynch. REIT earnings multiples also have fallen dramatically since the market peak. Merrill Lynch data shows the average price-to-FFO multiple for equity REITs, based on forward earnings, was about 10x as of mid-July, slightly below the 10-year average.

“We still think that’s a very good dollar return, and because you’re paying a low price to get in, I think it’s a pretty good time to buy from a long-term perspective,” says Frankel. “Yes, the volatility has gotten a little bit extreme, but if you don’t close your eyes to it, you can find good returns here.”

The Essential REIT’s Ralph Block agrees. In a recent note to investors, he writes: “If you do expect an eventual recovery, you will want to participate in a rising market — yes, it will happen some day — but you gotta make earnings and cash flow estimates to be comfortable. It’s never easy to do, [especially] in this environment.”

When it comes to picking the winners, managers say to choose REITs that don’t have debt issues and to choose firms that have larger and higher quality properties. Frankel adds that during the market turnaround, REITs that have proven operational acumen and management experience, and those companies that are good local sharpshooters, will shine.

NAREIT’s Case is confident that a REIT index fund would work too.

“There’s a tendency among stock market investors to try to figure out which REITs are stronger and which are weaker, to separate the winners and the losers. But that’s not a very useful game because what really matters is who are the winners and losers within the real estate market. It’s been clear since March that REITs are going to be among the winners,” says Case. “What’s really starting to become clear now is that the REIT market is the part of the market that’s going to survive.” ♦

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