

Privatization Protection for REIT Preferreds

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U.S. REITs have transitioned magnificently from accessing the capital markets to recapitalize, to accessing the capital markets to execute growth strategies. While to date issuance of common equity and unsecured debt has dominated capital raising, we expect that new issuance of perpetual preferred securities by REITs will accelerate, and we encourage companies to utilize the market. There are large pockets of investor demand for preferreds globally in the current low interest-rate environment.

This paper makes the case for a subtle but important improvement to the preferred market that takes into consideration the damage done to some preferred investors during the recent global financial crisis.

Remember the Last Cycle

Unlike unsecured debt and bank loans, which increasingly have covenants to protect lenders, most preferred security structures do not have a redemption feature in the event of privatization that is not brought about by full liquidation. In a liquidation, many corporate charters call for preferred redemption at par. In the privatization wave that occurred from 2005–2007, some company managements took advantage of the lack of covenants for preferreds and left the securities in place post-privatization, which ultimately created substantial losses for preferred shareholders.

Effectively, preferred shareholders became mezzanine debt or “junk equity” financing in leveraged buyouts (LBOs) that were not structured as liquidations. At the time of privatization, the shareholders lost liquidity (the preferreds were de-listed), experienced a significant credit downgrade (as more debt was piled on above them) and, due to the privatization, experienced a significant increase in risk because the company lost access to the public markets.

We know how the story ended. These LBOs occurred just before the worst recession and credit crisis since the 1930s hit the U.S. When property values sharply corrected and market loan-to-value ratios for refinancing became more conservative, some preferreds were wiped out by market devaluation, dividend suspensions and foreclosures by senior lenders.

In these preferred “cramdowns,” investors lost all, or substantially all, of their capital. Examples of the casualties include preferred shareholders of Equity Inns, Eagle Hospitality Properties, InnKeepers USA, American Land Lease, Prime Group Realty Trust and CRT properties. Clearly, the coupons—in the 8–9% range in these examples—in no way compensated for the risks, and ultimately losses, that were assumed by preferred shareholders in these LBOs.

Not all managements reneged on their covenant with investors: management of Capital Automotive did the right thing and repaid preferred shareholders at par in its privatization. Management of Winston Hotels also bought out preferred shareholders at close to par. Examples of privatizations that were structured as liquidations—where REIT preferred shareholders received cash at par included Crescent Real Estate Equities, New Plan Excel Realty, Highland Hospitality and Equity Office Properties.

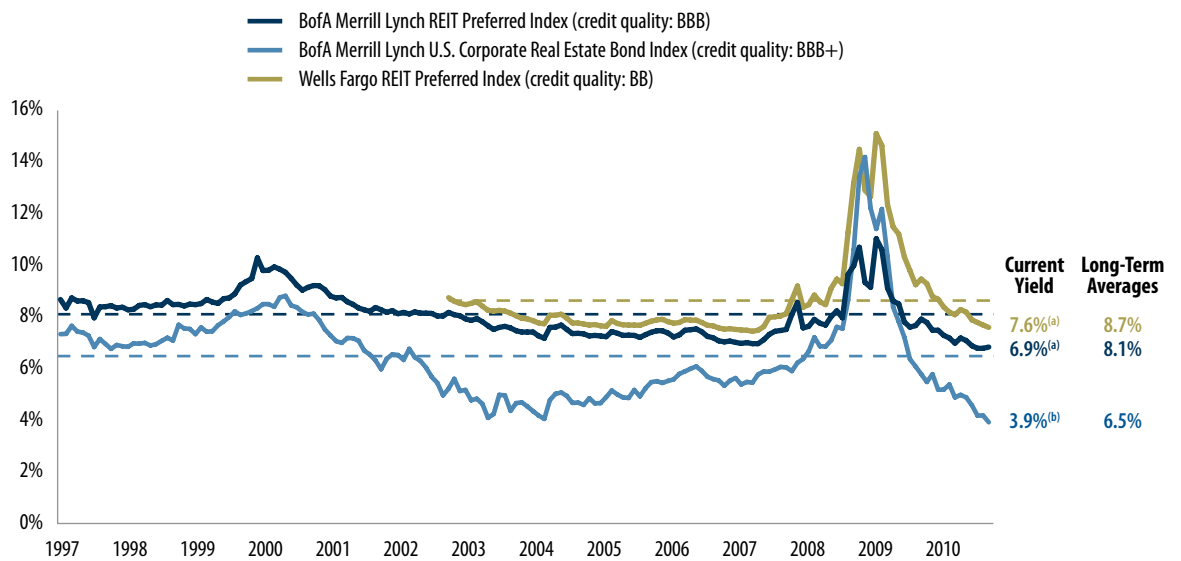
As REITs ask preferred investors to step up to the plate again, we strongly believe that privatization protections are warranted.

New Issuance Cycle

New preferred issuance will be driven by two factors, in our view: refinancing of existing preferreds and acquisition finance.

With the dramatic decline in the yield curve over the past three years, brought about first by the recession and driven down further by the Federal Reserve’s recent quantitative easing, REITs have an opportunity to call existing preferreds and replace them with lower-coupon preferreds that will enhance the issuers’ cash flow. For example, the current yield on non-investment grade REIT preferreds is 7.6%, which compares favorably with the average market yield since 2003 of 8.7%.

EXHIBIT 1. REIT PREFERRED YIELD HISTORY
January 1997–October 31, 2010



Past performance is no guarantee of future results. An investor cannot invest directly in an index.

Source: Bloomberg.

(a) Current yield.

(b) Yield to Maturity.

Looking at the refinancing opportunity, currently \$17 billion of REIT preferreds are outstanding, with an average coupon of 7.4%. Nearly all had five-year call protection at issuance. Much of that protection has burned off, however, so today the existing universe of securities has just 0.4 years of call protection remaining. As call dates pass, REITs will be able to refinance their preferreds.

While many factors influence refinancing decisions, including the cost of issuance, it can make sense to refinance a preferred security if coupon savings of as little as 50 basis points can be achieved.

With new-issue coupon rates of 6.5% (investment grade) to 8.0% (for non-investment grade but well-known companies), we believe that a lot of refinancing will occur. Recent examples of companies that have refinanced preferreds include Public Storage and PS Business Parks: Public Storage called a 7.125% coupon and replaced it with a 6.5% coupon preferred totaling \$120 million, and PS Business Parks called a 7.6% coupon and replaced it with a 6.875% coupon preferred for \$75 million.

New Investment Cycle

The property acquisition cycle has begun. Exhibit 2 below illustrates that U.S. REITs have made \$24 billion in acquisitions through three quarters in 2010, with a progression of \$4 billion in Q1 2010, \$5 billion in Q2 2010, and \$15 billion in Q3 2010. In October, Ventas Inc. added \$3.1 billion to the tally by acquiring the Atria Senior Living assisted living facility portfolio. With an estimated \$1.1 trillion of mortgage debt in the private market maturing through 2013—and with the significant amount of equity that will be required to refinance that debt on current underwriting terms—we expect that a significant number of acquisitions will take place as private owners are forced to sell assets or recapitalize.

EXHIBIT 2. 2010 U.S. REIT ACQUISITIONS

	Q1 2010	Q2 2010	Q3 2010
Total (\$ billions)	\$3.9	\$5.4	\$14.9
By Sector			
Office	\$0.3	\$1.2	\$5.0
Apartment	\$0.7	\$0.5	\$2.3
Health Care	\$1.0	\$1.1	\$1.4
Regional Mall	\$0.3	\$0.2	\$2.4
Mixed Office and Specialty	\$0.5	\$0.6	\$1.5
Hotel	\$0.4	\$0.5	\$1.4
Other	\$0.8	\$1.3	\$0.9

Source: Citigroup, Cohen & Steers and company reports.

While REIT preferreds are more expensive than unsecured bonds—investment-grade unsecured bonds are currently priced in the 4–6% range for ten-year money—we believe that preferreds can play an important role in the capital structure, especially as acquisition financing ramps up. At yields from 6.5–9%, preferreds are still cheaper capital than common equity. Several companies accessed the preferred market in 2010 by “opening up” existing preferreds issues for an add-on offering: SL Green Realty, Apartment Investment & Management Company, Glimcher Realty and CBL & Associates.

Another reason to consider preferreds: the global financial crisis shined a spotlight on the value to issuers of perpetual capital as compared with debt. It was all about liquidity during 2008–2009; and, with 20-20 hindsight, having perpetual preferreds that helped extend the duration of borrowings made a great deal of sense.

If total leverage for REITs should range from 30–50%, depending on property type and business model, we believe preferreds could fill 10–15 percentage points of the 30–50% total leverage structure—an amount that is large enough to be meaningful, but that balances the higher-cost/no maturity tradeoff with the lower-cost/stated maturity for profile debt. Moreover, although preferreds receive minimal equity credit from the rating agencies, they nonetheless can help issuers improve their financial flexibility and overall credit profiles through greater unencumbered assets ratios and better liquidity profiles. The equity characteristics of preferreds can also help with bank and debt covenants.

We see a special need for preferred capital—both straight perpetual preferreds and convertible preferreds—for new companies that are coming public during the current IPO cycle. Most will have an acquisition story, yet have a cost of capital disadvantage compared with existing REITs for several reasons:

- New companies cannot arrange a shelf registration for one year after going public
- Managements are untested
- Their shares have less liquidity

As a result, a new company seeking equity must file a registration statement that, generally, will have a two-week SEC review period. During that time, common share prices can take a hit—whether due to a market pullback or to shareholders or traders who might sell in advance of the offering—which could make the equity raise very expensive.

Preferred offerings can mitigate the problem of issuing common equity at a price that is below a company's IPO price and/or net asset value. They can provide companies more “runway” to show their ability to add value through acquisitions and give them more time after the IPO before returning to the equity market. For smaller, fast-growing companies, preferreds can be an alternative to secured funding and help establish the foundation for achieving an investment-grade rating down the road.

Solutions

We advocate that underwriters and preferred investors demand privatization protection before they participate in a new deal. The ideal solution would be mandatory redemption in the event of privatization (change of control and delisting of common shares)—but such a feature would create a grey area where preferreds would be considered debt instead of equity for accounting purposes. At present, redemption is possible only if a full liquidation of the REIT occurs: otherwise the existing structure stays in place in the privatization. However, some issuers have crafted provisions that would result in a takeout upon privatization through a conversion of the preferred securities to common shares, which in turn gets bought on the same terms as the common (but translated to par value) in the privatization transaction. Forest City Enterprises Series A convertible preferreds are structured this way. We believe issuers should follow this approach.

The next-best solution is to structure a coupon step-up that would either motivate management to call, or tender for, the preferred; or at least acknowledge the increased risk of privatization. In a recent example, DuPont Fabros Technology, the data center REIT, issued \$175 million of 7.9% perpetual preferred securities that have a 400 basis point coupon step-up in the event of privatization. We believe DuPont Fabros received a lower coupon because they incorporated this step-up. Therefore, benefits to issuers include a lower cost of capital and access to a broader range of investors. Accounting experts believe that a step-up of 500 basis points is the maximum threshold; anything higher would jeopardize the equity accounting treatment that is sought with preferreds. It may be possible to tack on additional coupon step-ups that are scaled for leverage levels.

Investors should also call for other structural features that would motivate a call/tender upon privatization, such as the addition of voting rights, the requirement for ongoing financial reporting, and the prohibition of distributions to equity holders as long as preferreds are outstanding.

Conclusion

REITs occupy an exceptional and unique position in the real estate industry due to their access to attractively priced capital. This access helped them recapitalize in 2009, and today they are using their much-improved cost of capital to acquire properties and help recapitalize the private market.

The market as a whole—investors, issuers and underwriters together—would be well-served by studying the last cycle and structuring protections for preferred investors in the event of privatizations. While a cynic might say that only investors would be well served by these protections, we believe they would benefit all stakeholders.

The very wide range of issuers that stands to benefit from accessing preferred capital requires an efficient, well-functioning market—which, in turn, requires action on this point. Issuers would enjoy a lower cost of preferred capital and access to a broader range of investors. We believe that preferreds will be an important part of the REIT capital menu, and that best practices for all parties include protections in a privatization.

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Risks of investing in preferred securities: Investing in any market exposes investors to risks. In general, the risks of investing in preferred securities are similar to those of investing in bonds, including credit risk and interest-rate risk. As nearly all preferred securities have issuer call options, call risk and reinvestment risk are also important considerations. In addition, investors face equity-like risks, such as deferral or omission of distributions, subordination to bonds and other more senior debt, and higher corporate governance risks with limited voting rights.

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