The REIT Engine: Is Growth in FFO Sustainable?

by Gary Ralston & Richard Hornbeck

The authors recognize there is considerable uncertainty as to what the future holds for REIT growth engines . . . The changing environment simply requires REIT management to use any and all available resources to create an increase in value for their shareholders.

INTRODUCTION

The stock price of a REIT is driven by FFO (Funds From Operation) per share. So it is only natural that REIT analysts and investors are concerned about the sustainability of current FFO per share growth rates.

In recent REIT history, two strategies—increasing rental income and making accretive acquisitions—have become the predominant methods for maintaining FFO growth. Some observers believe there are natural limitations to REIT growth and, as a result, have suggested the potential for growth in FFO per share is more limited than the earnings growth of traditional operating companies. In effect, some analysts are suggesting that a REIT's FFO can only grow so fast, so long, or so far.

Why is it that Barnes & Noble, Best Buy, Eckerd, OfficeMax, and Pier 1 Imports are considered growth companies, but their REIT landlord is not automatically granted the same status? While some inherent limitations certainly do exist for the REIT, a more comprehensive look at the REIT business model reveals multiple growth opportunities with unlimited potential. The approaches to increasing FFO per share will change, just as engines changed from steam to internal combustion when steam engines reached their limit. This presents an interesting metaphor for the changing real estate industry.

In this article, we describe a fundamental change in attitude now developing amongst real estate practitioners. We then categorize and explore eight strategies for fueling growth in FFO per share, each with multiple variations and tactics. We illustrate how this eight-cylinder REIT growth engine reflects the premium of a REIT's market value over its net asset value (NAV)—in essence, its company (or franchise) value. Finally, we examine how this translates into FFO growth per share and how it mitigates a REIT's operating risk.

REDEFINING THE REAL ESTATE BUSINESS

In the past, landlords simply provided space, and in return, received rent.

The landlord licensed the tenant to use space and thus the focus was on the possession of that space. Today, the real estate business must be redefined more holistically. Landlords must focus on the space user and not solely on the space. A one-size-fits-all approach will no longer work. The landlord must understand the tenant, how the tenant will use the space, and how such space can add value for the tenant.

Change in the real estate industry is apparent, as noted by the growing importance of the REIT structure as an ownership vehicle. We believe this change is even more fundamental than a simple realignment in ownership structure. In today's era of radically expanding customer expectations, users of real estate demand more than four walls and a roof.

The evolution of drug stores from in-line to free-standing is a good example. Drug store customers are demanding a new, higher standard of convenience. Therefore, the landlord must provide not merely space, but space that meets the express needs of today's drug store tenant – highly visible, readily accessible, convenient parking, and a drive-through window. The increased utility of the space generates increased revenues for the tenant and subsequently the landlord.

We expect REITs to evolve from managing the balance sheet (with a focus on size of total assets) to managing the income statement (with a focus on the customer and the resultant revenue generation). If the real estate practitioner or REIT is only in business to provide basic space to its customers, it will remain solely an asset-based company and will cease to grow at some point. On the other hand, if REIT management is able to redefine its business as one that provides the most **useful** space possible to meet its customers' expanding wants and needs, it will become a marketing company, thereby opening significant, unlimited opportunities.

The addition of that small word—**useful**—dramatically impacts both landlord and tenant. Not only is physical space provided, but the locational, linkage, and spatial attributes that impact the tenant can be incorporated into this model. There are many factors beyond the shape and location of the real estate that are important. These include: how that space is used by the customer; how it is serviced for the customer; how it can be adapted to better meet the customer's changing needs; what technological connections it holds; and, how it can provide the user with a competitive advantage over time.

All of these characteristics are part of the bundle of benefits provided by the landlord of **useful** space. Lease terms and structures may change to more specifically meet a customer's goals. Flexibility to meet changing customer needs across many locations will become a competitive advantage and a source of real estate revenue. These factors are limited only by the useful space provider's willingness to meet the customer's need to compete more effectively.

EVOLUTION OF REAL ESTATE INVESTMENT VEHICLES

Figure 1 illustrates the evolution of real estate investment vehicles and their changing nature and characteristics.

Figure 1

Evolution of Real Estate Investment

	MORTGAGE	RE PORTFOLIO	REAL ESTATE COMPANY		GROWTH REIT
		Closed-end Commingled fund	REIT (Advised)	REIT (Self-Adm)	REIT
Growth Drivers	Interest Income				
		Rental income	Rental income Accretive acq.	Rental income Accretive acq. Cost efficiencies	Rental income Accretive acq. Cost efficiencies Other revenue
Mgmt. Focus	BOND-LIKE	ASSET SPACE	ASSET SPACE	ASSET SPACE COST	CUSTOMER USEFUL SPACE REVENUE

Mortgage

Financial institutions often invest in real estate by lending money to real estate owners at a fixed or variable rate of return. Income from this type of investment vehicle is based solely on the interest income of the debt instrument and will not increase over time. There is no opportunity to grow earnings. The mortgage investment is passive and bond-like.

Real Estate Portfolio

Real estate closed-end/commingled funds provide the institutional investor with the option of passively owning real estate. In this case, the sole opportunity to grow earnings is to increase rental income from the assets.

Real Estate Company – Advised REIT

The advised REIT can grow FFO per share in two ways: by increasing rental income; and, by making accretive acquisitions. When a new property is purchased at a price that generates a return greater

than the cost of the funds used to purchase it, the positive spread accrues to all existing shareholders. With an external advisor, any cost efficiencies at the management level or any newly generated non-rental revenue are usually retained by the advisor and do not directly benefit REIT shareholders.

Real Estate Company – Self-administered REIT
The earnings growth equation of the self-administered REIT also begins with the basic capability to increase rental income and to make accretive acquisitions. Additionally, this vertically integrated operating company format provides the opportunity to grow FFO per share through numerous corporate and capital efficiencies. However, once optimal cost efficiencies are realized there is no further contribution to growth in FFO per share.

The Long-term Growth REIT
A company becomes a new generation, or long-term growth REIT, by shifting its focus from controlling costs to understanding customers. Management thinking moves from asset-management to customer-management, *i.e.*, creating space utilization that exceeds tenants' expectations.

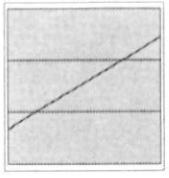
The long-term growth REIT has redefined its business from owning space to providing useful space to meet customers' demands. While it sounds minimal, the effect of such a change in business definition is monumental. It is like changing from steam power to V-8 power.

THE EIGHT-CYLINDER REIT GROWTH ENGINE

REITs that do not recognize the need to change will not be able to sustain growth in FFO per share. They will end up approaching the inherent limits of an asset-based/cost-based philosophy. As noted by Glenn Mueller, there is a limit as to how far cost reduction can go toward increasing FFO.[1]

While true in an asset-based business model, it is not a characteristic of a market or customer-based model. Only a customer-based/marketing approach will be able to exceed these limitations over time. This section outlines the eight cylinders currently available to equity REITs to continue driving and growing FFO well into the future.

Growth Cylinder 1 – Increase Rental Income



The first cylinder of our V-8 engine is the REIT's ability to increase rental income. Increasing overall occupancy rates or increasing rental rates upon releasing will generate additional income which increases FFO per share. Beyond this, the REIT is in a position to redevelop or expand property over time to improve the usefulness of the space, thus increasing the potential rent.

Most of today's leases have built-in increases either for inflation or increases from performance-based, percentage rents. In either case, income grows over time. This in itself should deflect the oft-stated claim that REITs act like bonds since bonds do not have automatic increases in coupon rates over time.

Though it may be limited in potential for any one year, this growth cylinder is unlimited over time. It is also not limited by the size of the total real estate portfolio. Whether the portfolio is $500 million or $20 billion, rental increases will add to FFO growth. Each one percent increase in NOI grows FFO per share by almost 1.5 percent *(see Figure 2)*.

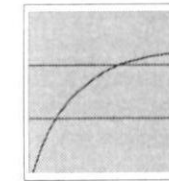
Figure 2

FFO Impact of 1% NOI Increase

Operating cash flow analysis for a typical $1 Billion REIT
(in $millions)

		Increase NOI @ 1%
Real Estate Assets	***$1,000.0***	***$1,000.00***
Net Operating Income (@ 9.50% cap rate)	$95.00	$95.95
less general & adm expenses (@ 5.50% of NOI)	(5.23)	(5.28)
EBITDA	89.77	90.67
less depreciation expense (75% of investment over 39.5 years)	(18.99)	(18.99)
less interest expense 35% leverage @ 7.75% interest	(27.13)	(27.13)
Taxable Income	43.65	44.55
less taxes	-	-
less dividends @ 97% of taxable income	(42.34)	(43.21)
plus depreciation expense	18.99	18.99
[Operating] Cash Flow	$20.30	$20.33
FFO (Taxable income plus depreciation)	$62.64	$63.54
Increase in FFO		1.44%

Growth Cylinder 2 – Accretive Acquisitions



In the 1990s REIT cycle, accretive acquisitions have been the predominant method of growing FFO per share. We expect this method to continue to serve as a primary growth cylinder for some time into the future.

Accretive acquisitions can be either single property purchases or entire portfolios. Currency for acquisitions can be cash, stock, UPREIT units, or any combination thereof. REITs have acquired other REITs, real estate companies, and in some cases, traditional companies with large real estate holdings, such as Vornado's acquisition of Alexander's.

Considering that REITs only own 3.6 percent of

commercial real estate,[2] limits to growth in FFO from accretive acquisitions may be more a question of market share than absolute size. Two virtually untapped sources of properties are pension funds and corporations. Many pension funds are actively seeking to swap properties for stock.

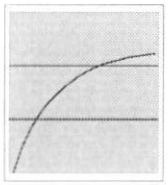
The sale-leaseback potential is gigantic—corporations own $1.7 trillion in real estate, more than 40 percent of the nation's commercial real estate.[3]

When the market value of property exceeds the cost of production, the most accretive acquisitions result from development. Customer-focused REITs are already capitalizing on build-to-suit opportunities and some have created efficient, national programs optimizing space utilization. Many REITs are currently stockpiling raw land or space at favorable prices for future accretive development.

Though continuing as a major generator of growth, the impact of this cylinder will tend to diminish as a REIT gets larger due to the small-base effect.[4] Accretive acquisition growth, while important, is limited in the long-term.

Acquiring properties at a higher return is one way to defer the flattening of the FFO per share growth curve. Sound capital management can position a REIT to take advantage of changing economic conditions. With a conservative debt structure, a REIT can benefit during an economic downturn by acquiring quality properties when others are forced out of the market, thus allowing greater returns attributable to reduced competition.

Growth Cylinder 3 –
Lower the Cost of Capital

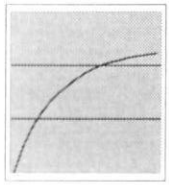


Growth in FFO per share can be created through capital management—lowering the cost of capital, increasing financial flexibility, using alternative sources of capital and dividend reinvestment plans (DRIPS). Fine-tuning the capital mix of debt, preferred stock and equity can minimize the overall cost of capital. Additionally, reducing risk through sound portfolio management and financial structuring will decrease investor return requirements, thus reducing the cost of equity and lowering the cost of capital. When done well, it often leads to an investment-grade rating.

Although lowering the cost of capital generates growth in FFO per share, the benefits available from lowering the cost of capital diminish over time. Cost of capital can only be reduced so far before it stabilizes at some optimal minimum level.

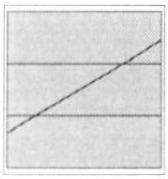
Customer-focused REITs are already capitalizing on build-to-suit opportunities and some have created efficient, national programs optimizing space utilization. Many REITs are currently stockpiling raw land or space at favorable prices for future accretive development.

Growth Cylinder 4 –
Reduce Operating Expenses



Operating efficiencies at either the property or the corporate level can increase FFO per share. Additionally, ever-larger REITs are well positioned to take advantage of economies of scale to reduce expenses. While both efficiencies and economies of scale cause an increase in FFO per share, these benefits diminish over time when the maximum reduction is realized.

Growth Cylinder 5 –
Generate Non-Rental Revenue



REITs can generate income from sources other than rent to grow FFO per share. These include internal sources such as tenant services and external sources such as third-party property management and financial services. Possible sources of non-rental income include a multitude of real estate services: site selection, tenant representation, property management, facilities management, disposition of excess space, tenant improvements, and construction management. Various property accounting services can also be provided, including accounts receivable and accounts payable administration. Still other services include CAM administration, tax administration, and audits, as well as environmental and regulatory compliance management. Income can be generated by mortgage originations, mortgage servicing, and mortgage securitization.

In fact, tenants, their customers, and visitors to their property could be sold an unlimited array of products and services, including insurance, credit cards, business services, or even electricity. These varied revenue streams create continuing income growth potential. Many REITs have already begun

to generate greater levels of non-rental income as noted in *Figure 3*.

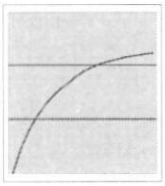
Figure 3

Types of Other Income

REIT	INCOME TYPE	REIT	INCOME TYPE
AEC	Painting Services	GGP	Strategic Investment
AEC	Construction Fees	GGP	Cable Television
AML	Landscaping	MRY	Mineral Royalties
OAS	Laundry	MRY	Cash Management
OAS	Vending	OAS	Cleaning Fees
CRE	Leasing Fees	RA	Maintenance Fees
AML	Investment Advisory	REG	Brokerage
AML	Asset Management	RET	Consulting
AML	Property Management	SPG	Architectural Fees
BFS	Parking Income	SPG	CO-Branding (Credit Cards)
CEI	Lot Sales	SPG	Financial Services (ATM)
CLB	Marketing Commissions	SRW	Engineering
DRE	Telecommunications	UDR	Dividends
FFA	Equipment Leases	HOT	Employee Leasing
GBP	Olympic Revenues		

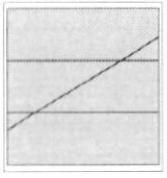
Source: Ron M. Donohue, Ph.D., Hoyt Advisory Services

Growth Cylinder 6 – Sell Properties at a Spread Over the Investment Base and Reinvest



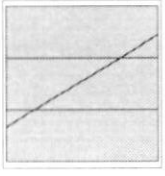
Strategically, as part of a sell-discipline, REITs should dispose of assets to enhance the overall value of the portfolio. If the goal is to continue reinvestment, then the REIT can utilize a 1031 tax-deferred exchange to reinvest the profit, thereby growing FFO per share. This strategy generates new investment capital without raising any new equity or securing any new debt. This revenue source, similar to accretive acquisitions, tends to diminish as the REIT grows.

Growth Cylinder 7 – Generate Retained Earnings



The REIT business model has the inherent capacity to grow FFO per share through retained earnings. This internally generated capital can be used for new acquisitions or to acquire outstanding shares. *Figure 4* demonstrates that the REIT business model can use retained earnings to grow FFO per share by three percent perpetually, regardless of size.

Growth Cylinder 8 – Grow Intellectual Capital



Intellectual capital is, "The sum of everything everybody in a company knows that gives it a competitive edge."[5] A growing knowledge base and expanding set of business relationships can increase productivity throughout the organization. These productivity gains grow FFO per share.

Figure 4

FFO Impact of Cash Flow Reinvestment

Operating cash flow analysis for a typical $1 Billion REIT
(in $millions)

Real Estate Assets	***$1,000.00***	***$1,031.23***
Net Operating Income (@9.50% cap rate)	$95.00	$97.97
less general & adm expenses (@5.50% of NOI)	(5.23)	(5.39)
EBITDA	89.77	92.58
less depreciation expense (75% of investment over 39.5 years)	(18.99)	(19.58)
less interest expense 35% leverage @7.75% interest	(27.13)	(27.97)
Taxable Income	43.65	45.03
less taxes	-	-
less dividends @ 97% of taxable income	(42.34)	(43.68)
plus depreciation expense	18.99	19.58
[Operating] Cash Flow	$20.30	$20.93
FFO (Taxable income plus depreciation)	$62.64	$64.61
Increase in FFO		3.14%
Reinvestment analysis:		
Total new assets (Cash Flow plus debt @ 35%)	$31.23	

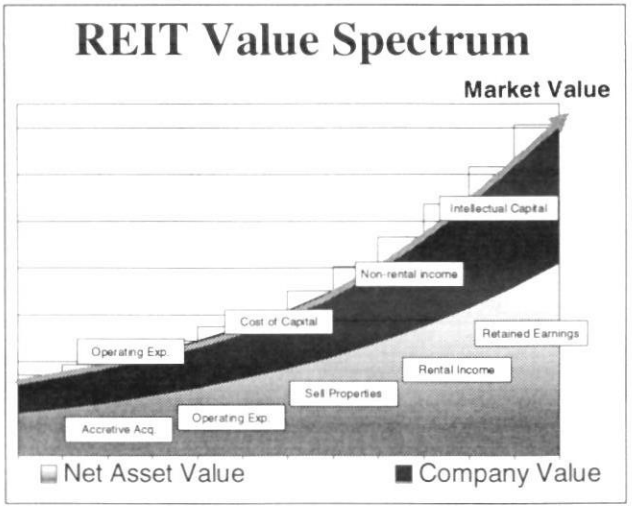
New products and services for customers grow out of this intangible asset. The creative nature of intellectual capital is the catalyst for increasing the utility of space, which not only increases income, but improves the quality and durability of the rental income stream.

Cultivating intellectual capital is the key to continuous improvement resulting in best practices and increasing income. Theoretically, with no boundaries on intellectual capital, there is no limit on growing FFO.

THE REIT VALUE SPECTRUM

Increasing FFO per share leads to growth in net asset value (NAV) and/or growth in the company's value. *Figure 5* illustrates this concept of two primary components of market value, reflecting the REIT Value Spectrum.

Figure 5



Net Asset Value Drivers

Five strategies that primarily drive the increase in net asset value include:

- **Accretive acquisitions**—This is simply the direct addition to net asset value.
- **Increasing rental income**—Though not reflected on the balance sheet, NAV is increased based on the "IRV" formula where **I**ncome divided by **R**ate equals **V**alue.
- **Increased retained earnings**—This is the reinvestment of internally generated funds which increases total assets.
- **Sell properties at a premium and reinvest**—Though no increase in assets is reflected on the balance sheet (original asset basis retained), net asset value grows (based on IRV) due to an increase in the total income stream.
- **Reduce operating expenses (at the property level)**—Lower property expenses increase total net operating income and thus net asset value (based on IRV).

While these drivers of FFO growth most directly impact and grow the NAV component of a REIT's total market value, the other cylinders of the FFO growth engine most directly impact and grow the value of the company.

Company Value Drivers

Four strategies that primarily drive the increase in company value include:

- **Lower the cost of capital**—This aspect of capital management most directly impacts the growth in a company's value by reducing a key raw material cost at the operating level, increasing FFO per share.
- **Generate non-rental income**—By targeting existing tenants, the REIT is able to grow revenues from its existing customer base, increasing the bottom line with a corresponding increase in the company's value.
- **Increase intellectual capital**—Growing FFO is a key result of the application of creative ideas that accrue to the benefit of the REIT and increase the value of the company.
- **Reduce operating expenses (at the company level)**—Lower expenses increase total net income for the REIT and increase the value of the company.

Implications for Growth

Each set of strategies includes some growth drivers whose potential diminish as the REIT portfolio grows and others that can generate unlimited growth opportunities. Those drivers which decrease in impact over time as the REIT grows—accretive acquisitions, selling at a premium and reinvesting, reducing operating expenses (at company and property levels), and lowering the cost of capital—provide particularly strong growth accelerators in the earlier phases of a REIT's life cycle. Those drivers which do not have an inherent limit—increasing rental income, increasing retained earnings, generating non-rental income, and increasing intellectual capital—offer the REIT long-term growth potential without restriction.

As the REIT industry evolves to the long-term growth REIT model, analysts have voiced concern that the REIT will look more like an operating company and thus incur the same level of risk found in operating companies. We disagree. It is true that the four strategies driving the growth in REIT company value are similar to the growth drivers of any operating company. However, a REIT has an entirely different risk profile. Unlike the typical operating company, a REIT has an effective floor on earnings. Its long-term assets are productive and generate some level of return, even if operations cease. An operating company is unable to generate any return on its fixed assets (other than through a liquidation sale) if its operations cease. Therefore, it is unlikely that the market value of a REIT would fall and remain below net asset value. This provides a significant, built-in cushion.

CONCLUSION

We have attempted to present an argument for the sustainability of REIT FFO per share growth. We have identified eight broad strategies, or cylinders for growth, reflecting on the different impact each has on FFO per share. Though the impact of these growth cylinders varies based on REIT size, the real bottom line is that the new growth REIT must maximize output of each growth cylinder throughout its life.

We recognize there is considerable uncertainty as to what the future holds for REIT growth engines. Despite the fact that the V-8 engine may give way to a nuclear engine, some time-tested principles still hold true. The changing environment simply requires REIT management to use any and all available resources to create an increase in value for their shareholders. If they do so, FFO per share growth can and will continue. REI

NOTES

1. Mueller, Glen R., "REITs' Growth Cycles: Is Bigger Better? Or

a New Challenge?", Legg Mason Wood Walker, Inc. Real Estate Research Group, February 6, 1998.
2. Lenzner, Robert and Shook, Carrie, "The Unstoppable REIT Juggernaut," *Forbes*, December 29, 1997. Page 68+.
3. Lenzner, Robert and Shook, Carrie, page 68+.
4. Mueller, Glen R., "REITs' Growth Cycles: Is Bigger Better? Or a New Challenge?", Legg Mason Wood Walker, Inc. Real Estate Research Group, February 6, 1998.
5. Stewart, Thomas A., *Intellectual Capital: The New Wealth of Organizations*. Doubleday, 1997.

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