Capital Markets & the Modern REIT Era

by Ron M. Donohue

Events in the capital market have heavily influenced the evolution of the modern REIT industry. The following presents one perspective on how the modern REIT industry has evolved and provides some thoughts on where REITs are headed in the next few years. This perspective was developed over six years of REIT analyses and investing using the Hoyt REIT Model, a comprehensive REIT valuation and risk analysis model. That model has reflected the shifting capital market's differential impact on REITs.

The modern, vertically-integrated REIT is a recent phenomenon, with a well-established pedigree. The 1991 offering of Kimco Realty Corporation was the first major offering under a 1986 revision in tax code interpretation that provided for actively managed REITs. This offering paved the way for modern, vertically integrated REITs. The 1992 offering of Taubman Properties launched the public Umbrella Partnership (UPREIT) structure. The UPREIT structure provided real estate developers and owners with a tax protected method for transferring ownership out of relatively illiquid partnership interests. These two offerings legitimized REITs in the eyes of many prominent real estate operators, effectively launching the modern REIT era. Understanding where REITs are likely to go may require at least a brief historical overview of how the capital market helped to drive these offerings.

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CAPITAL MARKET INFLUENCES ON REITS

Excess Supply

In the late 1980s and early 1990s, commercial real estate was clearly in trouble, primarily due to an excess of supply and some reduction in demand. The massive overbuilding of the 1980s was the result of an imbalance in space and capital markets.[1] Essentially, user demand for rental space (space market) was low at a time when institutional

investors and other investors had high interest in placing capital (capital market) in real estate. This capital market imbalance was coupled with massive lending by Savings and Loan administrators with little commercial real estate experience. The result was a capital rich environment, particularly debt capital. As the competition to make loans heated up, underwriting requirements were loosened, and eventually the risks were out of proportion with the return expectations. There was significant commercial mortgage default and many traditional capital sources withdrew from the market.

The logical follow-up to an oversupply of credit is restriction of credit. The restriction was quite pronounced in the late 1980s and early 1990s and was generally labeled a credit crunch. The lack of debt capital had two effects on real estate developers. The first effect was a reduction in construction loans, which brought construction to a near standstill. The slowdown in construction gave space markets an opportunity to absorb the oversupply, but spelled the end for many developers and construction companies. The second major effect was that many developers faced balloon loan payoffs at a time when debt financing was not available. This resulted in a search for alternative sources of capital, and the public equity market provided capital – the REIT format was best suited to provide capital. Without this capital, defaults and bankruptcies would have occurred.

Sources of Capital

Equity REITs also grew rapidly in the 1990s because of the availability of positive spread investments, which many analysts referred to as a "cap rate" arbitrage. They suggested that the value of real estate on Wall Street (securities market) was greater than its value on Main Street (space ownership). For the most part, the assertion was based on first year FFO (Funds From Operations) and debt impacts, rather than long-term cost of capital, leaving the question of arbitrage unanswered. At the same time, traditional lending sources were reducing their debt investments. The result was a shift from real estate's traditional reliance on debt toward greater reliance on equity capital. This was a unique opportunity, and many of the top real estate operators in the country elected REIT status to capitalize on the opportunity.

The REIT industry has grown and evolved significantly since the Kimco offering. The years of 1992 - 1994 were characterized by dozens of initial public offerings. These IPOs provided capital to replace balloon payments on loans, as well as providing capital for positive spread acquisitions. Property markets were recovering just as REITs gained access to a seemingly inexhaustible supply of capital. The result was significant growth, particularly for companies that had access to capital due to management reputation and a story that appealed to investors. As a result, 1995 - 1997 saw a slew of secondary offerings as REITs returned to the equity markets for additional capital.

A dramatic increase in REIT debt offerings was also seen in 1995 - 1997. The best REITs actively sought and secured credit ratings and entered the public debt markets. Previously, REIT access to debt had been through mortgages on single properties or pools of properties, generally secured by an individual property or some portion of the property portfolio. REITs began to use corporate debt, some secured and some unsecured. Many of the strongest REITs shifted entirely to unsecured debt, substantially increasing their capital structure flexibility. The result was competition among suppliers of capital, leading to a decrease in the cost of capital such that debt could be used in making positive spread acquisitions. FFOs grew rapidly as REITs used their cost of capital advantage to dominate acquisition activities.

Regulatory Shift

By the beginning of 1998, REITs had established themselves as the premier buyers of commercial real estate. For example, Starwood Hotels and Resorts Trust used its unique status as a paired-share REIT to successfully beat out Hilton in the competition for ITT Sheraton. The result of this and other transactions was a heightened profile for REITs, which attracted investor interest, a long-time goal of the industry. Unfortunately, the heightened profile also attracted increased government and investor scrutiny, which was probably not a goal of the industry.

Real estate has long been subject to volatility due to the tax code. The REIT is a creature of the tax code, and developments in 1998 reinforced the vulnerability of REIT's unique status. On Groundhog's Day, President Clinton made an announcement concerning the administration's position on REITs. The most well publicized of these announcements outlined the administration's intention to effectively "freeze" the assets of paired-share REITs by prohibiting future acquisitions under the structure. The headlines in the popular press and business publications were less than

complete, leaving the impression that the entire REIT industry was in jeopardy of losing its tax status. Although the change outlined by the administration only applied to five REITs, the entire industry took a hit.

Overbuilding Concerns

At the same time, negative signals were emerging from the space markets. First, there were frequent claims that REITs were overpaying for properties, driving cap rates down to unsustainable levels. In the debate that followed, REITs claimed that the prices made sense given their low cost of capital, while critics suggested that REIT management did not truly understand their cost of capital. This type of debate is not unique to REITs. In every real estate bidding process, the high bidder believes that lower bidders did not recognize the "true" value of the property and the lower bidders think the high bidder overpaid. True to form, private investors complained loudly and often that REITs were overpaying. At the same time, some REIT managers were marketing their companies based on their ability to continue to grow rapidly due to their "permanently" lower cost of capital. Capital flows are cyclical in nature and in the future capital market preferences will shift among various investor groups. Currently, private investors hold the upper hand.

Second, anecdotal evidence of overbuilding in select markets began to creep into REIT analyst reports and the popular press. This led to a perception among some investors that "national markets" were being overbuilt. The term "national markets" is a misnomer, as property markets are fundamentally local in nature, and "national markets" are simply a collection of local markets. Overbuilding in several high profile markets led to concern, despite the fact that in the aggregate (and in most markets) fundamentals were still sound. At the individual market level, the outlook varies substantially. Thorough analysis of the hundreds of local markets in which REITs own properties is a massive task and may not be cost effective or feasible for many investors. This type of analysis makes a great deal of sense in the long-term, but in the short-term, stock market effects may override long-term fundamentals. Momentum investors were not willing to do the required work and moved to "easier" sectors.

SHIFTING STRATEGIES

The double-barreled threat of overpaying and overbuilding led some to paint a picture of REITs as growing solely for the sake of growth, without regard for underlying real estate fundamentals. This picture brought back investors' memories of the mortgage REITs of the 1970s, despite claims that the REIT market had seen fundamental change. While today's REIT industry is very different from the past in structure and size, it still remains a small market segment. Many investors view REITs as a group without segmenting by quality of real estate, management, and risk profile. The result is that the REIT industry remains very susceptible to negative news, particularly in the short-term. Investor perception is key, and just as investor perception that real estate was "hot" led to the run up in REIT prices in previous years, the perception that markets had "cooled" led to a significant price decline in 1998.

As the competition to make loans heated up, underwriting requirements were loosened, and eventually the risks were out of proportion with the return expectations. There was significant commercial mortgage default and many traditional capital sources withdrew from the market.

As part of this general decline, the capital market shifted its attention away from real estate, partially because of the REITs and partially because of the blow-up in CMBS. The broader market's strength and perceived growth prospects also contributed to the shift. In this environment, equity offerings slowed dramatically, with few companies willing to sell at the low prices prevailing in the marketplace. Capital needs continued, and REITs shifted to offering preferred equity at attractive rates. When the Asian economic turmoil rocked world markets, there was a flight to quality that drove up the required yield on REIT preferred offerings and further increased the spread between REITs and Treasuries.

All of these factors combined to create a disconnect between real estate fundamentals and REIT pricing. REIT analysts have made the case for the disconnect, using data about real estate fundamentals and REIT performance to suggest that investors should move into REITs. REIT total returns were off 16.9 percent in 1998 versus a gain of 27 percent for the S&P 500.[2] In 1998, occupancy was up five percent and rental rates were up 10 percent.[3] The average REIT enjoyed 13 percent FFO growth.[4] Despite the solid fundamentals and continuing

growth prospects, REITs as a group went from trading at a 20 percent premium to Net Asset Value (NAV) to trading at a five percent discount to NAV. Clearly, investors were influenced by something other than space market fundamentals, most likely the strength and growth prospects of the broader market.

Commercial real estate has undergone dramatic change in the past decade. Securitization of real estate equity and debt has increased enormously, and is expected to do so for the foreseeable future. This provides a tremendous opportunity for those who understand the underlying factors that influence the risk and return characteristics of these instruments. Institutional investors have flooded the market, with average REIT institutional ownership growing from 38.1 percent in third quarter 1993 to 52.2 percent by third quarter 1997.[5] History suggests that the flood of institutional money will eventually drive prices beyond warranted values, and that may have been the case in 1997 as REITs traded at significant NAV premiums. Institutional investment in REITs has leveled off and the market is poised for the next stage in its evolution.

THE FUTURE

The future of the REIT market has been a subject of considerable debate. Industry leaders such as Sam Zell have suggested massive growth and massive consolidation. Peter Linneman, CRE, has echoed Zell's predictions, drawing from the economic history of other capital intensive industries to support his theory that consolidation is inevitable.[6] Under this theory, the REIT industry will consolidate to very large national REITs, with the existing smaller companies driven to consolidate by the cost of capital advantages enjoyed by the large firms. Kerry Vandell offers a different perspective on the character of growth, suggesting that while there will be some consolidation, regional specialists will still have a place in the industry.[7] In terms of the scale of growth, researchers have pointed to the relatively small percentage of investable assets currently under REIT control and suggested that as much as 50 percent of those assets may eventually come under REIT control.[8] While there is considerable skepticism about the 50 percent estimate, the general concept of REITs expanding their market share is widely accepted.

Although there has been some debate over the character and scale of future growth in the REIT industry, there seems to be general agreement that growth is coming. The question is the form and quality of the growth. The investor's biggest fear is growth for the sake of growth, which was one of the major dimensions of the last real estate collapse. From the investor's point of view, when economies of scale diminish, so should growth in scale. Smart managers will grow when growth makes sense, pull back when it does not, and position themselves and their portfolios for the next boom.

Investors will do well to differentiate between REITs with a strategic approach that allows them to shift their tactics as the market evolves and those that have inflexible approaches. Doing so requires segmenting REITs and understanding the differences among them in terms of capital structure, management, and real estate. The overall pattern offers a risk profile that can be used in diversifying a REIT portfolio.

Although there are significant differences among REITs, there are some general trends that are likely to impact the general performance of REITs going forward. These trends are driven by many factors, especially capital market behavior and investor perceptions.

The most striking trend is a shift in the balance among the different areas for growing income and FFO. There are four areas in which REITs can grow income and FFO; the reliance on these areas is a key indicator of overall REIT strategy. The four areas are 1). growth in the existing portfolio; 2). new acquisitions; 3). development; and 4). operating efficiencies. From 1992 to mid-year 1998, investors and analysts seemed to favor acquisitions, especially positive spread acquisitions, as a growth mechanism. As a result, the vast majority of REITs relied heavily on acquisitions for portfolio and income growth.

In the early stage of the positive spread acquisition business, the focus of analysis was on whether or not the acquisition was immediately FFO-accretive. As markets tightened, investors and analysts scrutinized acquisitions more carefully, considering business focus, strategic fit, price paid, and long-term prospects in analyzing acquisitions. High profile acquisitions (or attempted acquisitions) of non-traditional assets such as casinos and cold storage facilities raised questions about business focus. Capital flows were restricted for this and other reasons and acquisitions declined dramatically.

Lacking acquisition to fuel growth, many REITs have begun to focus on operating efficiencies. This

is a logical step, given the new realities of the capital market. Faced with a need for capital and limited access to traditional sources of capital, the alternatives are to use existing capital more efficiently or find new sources of capital. Shrewd REIT managers are doing both.

Joint-ventures with institutional investors and real estate operating companies are emerging as a major new source of capital and avenue of growth for REITs. In some cases, REITs are working with institutional investors to acquire and manage assets, with the REIT providing the investment expertise and the institutional investor providing the capital. In other cases, either the REIT or the institutional investor contributes properties, with the REIT assuming the management responsibilities and capturing fee income. Joint-ventures will continue to increase in importance, as will scrutiny of the "hidden" leverage in these off-balance sheet transactions. REITs will need to address the alignment of interest problems inherent in joint-venture structures.

The new profile of the politically correct REIT reveals a company working to consolidate the gains it made through positive spread acquisitions. It will do so by reducing costs, generating income through innovative programs (like Simon Brand Ventures), and consolidating with other companies to spread fixed costs over a wider base. Business energies will be focused on maximizing the return from the existing portfolio rather than on making the next deal. All of these ideas make sense from a long-term investment perspective. In short, REITs will be solidifying their positions and operations.

These strategies are unlikely to result in the kind of explosive growth that characterized the positive spread acquisition era, but they are likely to result in steady six- to eight-percent growth over the next few years. Long-term investors will benefit and the market will recover, with investors and REITs hopefully having learned from the experience. At some point, economies of scale will offer less marginal benefit and rents and occupancies will stabilize, necessitating finding other ways of growing.

Use of leverage will flatten out, with debt to market cap ratios flattening out as prices recover and companies increase total debt moderately. Investors and analysts will move from their current fixation with the ratio of total debt to market capitalization and expand their analyses to include debt coverage, character of debt, and duration. FFO payout ratios will continue to decline, at least partially because dividend increases are not being fully rewarded in market pricing.

Although there has been some debate over the character and scale of future growth in the REIT industry, there seems to be general agreement that growth is coming. The question is the form and quality of the growth. . . . Smart managers will grow when growth makes sense, pull back when it does not, and position themselves and their portfolios for the next boom.

The likely future of the industry is a segmentation into "haves" and "have nots." "Haves" will concentrate on maximizing shareholders value, minimizing conflicts of interest, and improving the long-term performance of their portfolio. "Have nots" will not do so. They will focus on short term FFO fixes, protect management rather than shareholder values, and grow for the sake of growth. Over time, investors will recognize the characteristics of the "haves" and the "have nots" and segment the mar ket accordingly. REI

NOTES

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