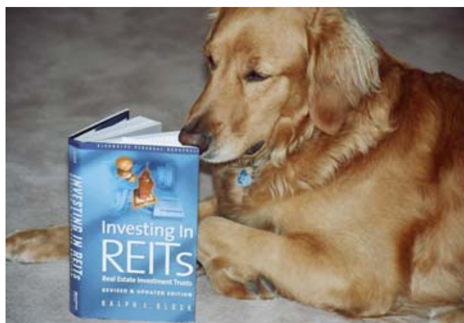
# "The Essential REIT"

## July 19, 2006




*"The best way to become acquainted with a subject is to write a book about it." – Benjamin Disraeli*

*"An author is a fool who, not content with boring those he lives with, insists on boring future generations." – Charles de Montesquieu*

*"Writing is like prostitution. First one writes for the love of doing it, then for a few friends, and, in the end, for the money." – Moliere*

## REITs 101: A Mid-Term Quiz.

We're just past the mid-point of 2006, and REIT stocks continue to perform quite well – indeed, beyond our most optimistic expectations. In an effort, therefore, to fend off complacency, I am asking each of you to take a mid-term quiz. As the right answers to many of the test questions below may be debated until Mr. Netanyahu is invited to Mr. Bin Laden's birthday party, I will seek to defend my belief in the "correct" answers with ample (perhaps more than ample) discussion. Nevertheless, as I have donned my corduroy jacket with appropriately patched sleeves and thus assumed the self-appointed role of REIT professor, your score will be affected by my peculiar REIT biases. All questions are "true" or "false." You will have 50 minutes – and anyone caught looking at his or her neighbor's examination paper will be forced to watch 22 reruns of American Idol within a 24-hour period.

*1. Successful investing in REITs requires substantial knowledge of commercial real estate markets.*

**False.** Of course a basic familiarity with commercial real estate and its markets, locations and cycles is always good to have when investing in REIT stocks; furthermore, REIT investment professionals, devoted as they are to outperforming their benchmarks, must be very familiar with commercial real estate markets, rent and occupancy levels, near term market prospects and all sorts of other commercial real estate minutiae. Nevertheless, none of this deep real estate knowledge is truly necessary to the non-dedicated REIT investor. Instead, many other issues are much more relevant when selecting the best REITs to invest in on a long-term basis.

Most important is the REIT's management team, which is at least as important to a REIT's long-term prospects as its real estate. Is management creating value for shareholders, and how is it doing so? Does it have property development skills, and is it making judicious use of them? How is it managing the properties? How good is it at allocating precious capital, *i.e.*, is it selling stock at high prices and buying it in at low prices, taking on debt at the right time, acquiring and selling properties at attractive prices, or creating joint ventures, when appropriate,

to generate fee income? How does it limit risk? Does management focus on markets it knows well, where it will have a competitive advantage, or is it merely on a quest to expand its empire? How is it managing the balance sheet for maximum safety and flexibility? Does it underpromise and over deliver?

These are not easy questions to answer, and homework is often required. Perhaps a good place to start is to compare a REIT's 5-year record of total returns vs. its peer group. A time period of that duration will tend to filter out most of the positive or negative effects of cyclical property markets, and allows us to focus on the job that management has done. It's sort of like playing duplicate bridge, where the inept don't have luck to hide behind. Other issues to look at include potential conflicts of interest and the extent of executive and director share ownership (the latter providing "skin in the game"), all of which will hopefully align managements' interests with those of its outside investors.

*2. Investors should invest in REITs on a permanent basis, and should ignore market calls to "get in – or get out – of REITs" by those who really don't understand the asset class or from sell-siders to "overweight" or "underweight" them.*

**True**. All right, this question was a freebie. I won't spend much time on it, and will merely jot down a few bits of information in support of the correct answer. First of all, REITs *deserve* a permanent place in an investment portfolio due to their strong and consistent performance over many years. For the 30, 20, 15, 10 and 5 years ending July 13, 2006, equity REITs, according to NAREIT data, have delivered average annual total returns of 15.6%, 12.1%, 14.7%, 15.1% and 19.4%, respectively. And they have done this with consistency; in only 6 of the 33 years since 1972 have REIT stocks limped across the finish line with negative total returns. We won't get returns this good going forward, but 8-9% shouldn't be too difficult a hurdle.

Correlations with other asset classes have been very low. For the 10 years ending May 2006, REITs' correlations with other asset classes have been lower than Sammy's mood when we take a trip out of town, *e.g.*, 0.29 for the S&P 500, 0.38 for S&P Utilities, 0.63 for the Russell 2000 Value index, and 0.33 for domestic high-yield corporate bonds.[1] And, don't forget those Ibbotson studies that provide a powerful argument for placing REITs in a long-term diversified investment portfolio.

A final, and perhaps the most important, point: Years of experience have taught us that, despite the extent to which we have persuaded ourselves that we are brilliant investors, none of us – not even W.E.B. himself – is able to forecast which asset class will perform best over the next 3 months, 13 months or 30 months. Deciding how REIT stocks will perform vs. other asset classes is a fool's game, of interest only to short-term traders whose time horizons are often shorter than the minutes of fame allocated to each of us by Andy Warhol. Buy good REITs, and own them; rebalance your portfolio from time to time. Ignore market buzz and noise. Sell them when we all live underground in caves, or when shopping has gone permanently out of style.

*3. REIT investors should focus on those commercial real estate sectors that are expected to perform best.*

**False.** This question, of course, is similar to the prior one. The basic problem preventing REIT investors from successfully and consistently making sector bets is that it just cannot be done – at least on a regular and consistent basis. Four correct decisions must be made to successfully "time" REIT sectors: (a) determining when a commercial real estate sector will begin to outperform its peers, (b) deciding when REIT investors will discover this truth (REIT stocks may already have anticipated these improving or deteriorating sector prospects, or they may fail to do so for months and months); and (c) and (d) – making decisions and determinations when (a) and (b) above are on the cusp of reversal.

Furthermore, there are just too many variables that can wreak havoc upon the best laid plans of mice and men, not to mention portfolio managers; these include unexpected changes in interest rates, employment growth shocks, cyclical changes in the US economy, geopolitical issues, cap rate changes, and a score of other factors affecting the health of commercial real estate markets and prices, as well as cash flow growth prospects for owners. *Bottom line*: Over long time periods, the various real estate sectors will tend to perform in line with one

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[1] Source: NAREIT's Chart book, found at, www.nareit.com.

another; accordingly, it's wise for the conservative investor to be well diversified across all commercial real estate sectors, letting gunslingers like Ken Heebner make those big sector bets.

*4. As is the situation with other equities, using P/E or P/FFO multiples is a great way to measure the relative values of individual REIT stocks.*

**False**. REIT investors will be fooled regularly when looking at relative earnings multiples among REITs, and even among REITs focusing on the same real estate sector. REIT stocks tend to trade on the basis of estimated Net Asset Values (NAVs), give or take an appropriate premium or discount, along with other factors such as management quality, balance sheet strength, value-creation capabilities and such.

Suppose Junkmall REIT owns a package of retail properties of poor quality, with non-existent growth prospects, weak occupancy rates, and situated in low-barrier-to-entry markets; assume the average cap rate for its assets is 8%. Compare this with Trophymall REIT, which owns a package of the most productive malls in the best locations in America, bearing less risk and greater growth prospects, and who's properties are valued at a 5% cap rate.

Perhaps we observe that Junkmall REIT's stock trades at a P/FFO multiple of 13x, and Trophymall's stock trades at a multiple of 18x. Does this make Junkmall's stock cheap relative to Trophymall's? No way. And what about the balance sheet? All else being equal, nobody except a nutcase would pay as high a multiple for a REIT with an over levered or broken balance sheet as one with a solid and flexible balance sheet. Think of P/E or P/FFO multiples as inverted cap rates. Investors will, quite properly, accept a much lower cap rate (or assign a much higher multiple of FFO/AFFO) to a REIT with great assets, solid growth prospects, modest risk, and stable and predictable cash flows. Often an 18x multiple will be cheap, while 13x will be expensive. Using multiples to value REIT stocks can sometimes be helpful in a broad-based valuation model, but should never be used without adult supervision – and other valuation metrics are much more important.

*5. REIT stocks, despite bearing higher than average dividend yields and being heavy borrowers, are extremely sensitive to interest rate changes.*

**False**. All right, this one is *really* controversial. However, up until the time that REIT stocks (and proxies such as the IYR) became playpens for the fast-money crowd, REIT shares hadn't had much of a correlation with interest rates or bonds. Indeed, the 10-year correlation chart provided by NAREIT (as discussed in Q. 2 above) suggests that equity REITs have had almost no correlation with investment grade bond prices. The correlation with the Merrill Lynch Govt/Corporate Bond index is just 0.04, while the correlation with the Merrill Lynch Mortgage index is actually negative, at -0.01.[2]

How can this be? The obvious answer is that, just as interest rates alone do not determine real estate cap rates, there are powerful factors that drive REIT stock prices besides interest rates. One of these, of course, is the prospects for growth in real estate owners' cash flows. Why are apartment cap rates so low? It's the growth rate, stupid. Why have cap rates moved upwards recently only for triple-net lease properties and, to a lesser extent, fully occupied strip centers? Little or no cash flow growth for those types of assets. So, while rising interest rates will exert downward pressure on REIT stocks' trading multiples (and make new borrowings, or debt rolled over, more expensive), a large offset will be the higher anticipated free cash flow resulting from a strong economy (which normally accompanies rising interest rates) that will be capped in determining a REIT's fair market value.

Of course, over the short term, the fears of runaway interest rates will impact short-term trading patterns of REIT stocks, and the hedgies and traders will short the hell out of IYR shares (or the REIT stocks themselves) in an attempt to capture these short-term trading gains. However, unless rising interest rates come with a low-growth scenario ("stagflation" is, in Harry Potter parlance, the "he-who-must-not-be named"), this offset will often be observed, and can confound those who expect a clear negative correlation between interest rates and REIT stock prices. In other words, neither commercial real estate nor REIT equities are mere bond proxies.

[2] Nevertheless, I expect that future correlations will be somewhat higher, for reasons discussed in Essential REITs past.

A final point.[3] Many investors value equities on the basis of discounted dividend or cash flow growth models, with the discount rate being a key input. When interest rates rise, the assigned discount rate will often rise as well. REITs, however, are different from other equities, as something like 50% of one's investment return from REITs will come from the current dividend, leaving only 50% of the expected return to come from future cash flows that will be discounted at a greater rate when interest rates rise. Accordingly, for those using these models, rising interest rates will negatively affect valuations of non-REIT equities (where more of the return is expected to come from growth in future cash flows) more than would be the case for REIT stocks – thus arguably making the latter somewhat more defensive than other asset classes in rising interest rate environments.

*6. Dividend yields are a poor way to invest in REIT stocks.*

**True.** All right, as we need a breather, I have inserted this slam-dunk question. Sure, much of the attraction in REIT stocks is the dividend yield. But let's be honest: We can do much better than equity REITs if Yield – and Yield *alone* – is what makes us happy. If all we want is yield, we can buy bonds and preferred stocks of all shapes and sizes, as well as other securities where yield is pretty much all – or almost all – that you'll get, *i.e.*, master LPs, gas pipelines, and oil tankers, not to mention royalty trusts.

But the stocks of most equity REITs are, first and foremost, *total return* investments. As noted above, only something like 50% of one's expected total return will come from the dividend yield, and that's just 4.2% currently. If your jones is simply yield, you can do a lot better outside of REIT world and, often, with less risk. Today there are REIT stocks that have cracked the 3% barrier, *e.g.*, Avalon Bay, Public Storage, and SL Green, yet their stocks appear to be attractive on a total return basis. Looking primarily at a REIT's dividend yield isn't going to get you sent to the local psychiatric hospital for further observation, but it's no way to manage a REIT portfolio.

*7. NAV estimates are largely inaccurate – and, since REITs are now primarily operating businesses, they are no more useful in REIT evaluation than book value is for tech or consumer staple stocks.*

**False**. Green Street Advisors has published reports showing a strong correlation between the NAV growth for a REIT and its stock performance over time. This shouldn't be surprising. Owning and operating commercial real estate is both a capital intensive endeavor and a slow-growth business, and thus the estimated market value of a REIT's assets, particularly as they *can* be readily valued, will be of major importance to investors.

"But," you say, "NAV analysis is done haphazardly and without much care by most of those who do it." True; and determining a good NAV for many of today's REITs, which own different quality assets in many locations, including a number of them in joint venture format, is time-intensive. In the investment world today, sell-sider analysts who make investment recommendations aren't supposed to even have contact with their firm's investment banking guys, and must therefore pay their own way. They just don't have the time to do NAV analysis properly.

But, just as a good lathe in my clumsy hands won't even create an attractive stick, yet will create an awesome table in the hands of a skilled craftsman, those who can do NAV analysis properly provide a wonderful service for REIT investors. Unfortunately, only Green Street Advisors and some institutional buyers are able to do it right; and, most investors cannot get the information from the latter, while a subscription to Green Street's services ain't exactly cheap.

It's too bad, really. Barry Vinocur used to publish consensus NAV estimates which he gathered from both sell-siders and buy-siders; while it was far from perfect, it was at least available to subscribers at a reasonable price. Unfortunately, this service is no longer available. However, Anatole Pevnev is gathering NAV estimates and presenting them on his new and interesting website, REIT Café. See www.reitcafe.com. Hopefully, over time, more NAV estimates will be available with which to stock Anatole's compilations. So the current status is this: Although NAVs are very important to REIT investors, accurate NAV estimates remain generally unavailable to

[3] This concept was introduced to me many years ago by a good friend and very smart real estate guy, Michael Dowd. I apologize to him if I have mis-characterized his thoughts on this matter.

anyone other than institutional investors. Perhaps this will change under a new “fair value accounting” regime, but that’s a topic for another issue of The Essential REIT.

*8. Here’s a contemporary quiz question: War in the Middle East is terrible news for REIT stocks.*

**False**. The loss of lives and increased insecurity resulting from the current Mideast conflict are very bad news indeed, as is the upward pressure on oil prices resulting from it. However, the worst likely effects resulting from loonies firing rockets into Israel and Israel’s reactions will be a slowing economy due to spiking energy prices and possibly a greater reluctance to spend and invest due to the heightened uncertainties.

While these conditions may cause demand for space to abate modestly, they will also cause interest rates to top out sooner than expected as Mr. Bernanke and crew focus more on slower economic growth and less on inflation. After all, to the extent that inflation is caused by rising prices for commodities with inelastic demand, such will act as a stealth tax hike. And concerns over the health of the market for single family homes, coupled with geopolitical concerns, are likely to turn consumers more cautious. Will the Fed continue to boost interest rates in the face of this tax hike doppelganger, while consumer confidence continues to recede? Don’t bet on it.

As long as the US economy can avoid a (still unlikely) recession, commercial real estate owners will benefit from a slow-growth economy. We get lower interest rates (and its corollary, relief from interest rate-induced upward pressure on cap rates), enough job growth to provide stable occupancy rates, increased caution by developers and, due to slower global growth rates and higher investment risks, less competition from other asset classes such as equities (domestic and foreign), junk bonds and commodities. Both commercial real estate and equity REITs should fare reasonably well in such a slow-growth environment.

*9. A significant benefit of REIT investing is that REITs cannot retain much earnings with which to grow the business.*

**True** – although the “correct” answer may be subject to debate. So hear me out. First, REITs can, if they really want to, retain a very significant portion of their free cash flows. We need look no further than Public Storage or PS Business Parks to see what can be done with intelligent use of preferred stock rather than debt on the balance sheet.

But, more importantly, Corporate America’s track record with respect to the effective investment of retained earnings at rates of return in excess of their cost of capital leaves much to be desired. Companies able to play with their shareholders’ money often “diworsify” (to use a well-known Peter Lynchism), they make lousy investments, they buy in stock at high prices (often merely offsetting the dilution caused by option grants), and they build empires. I would suggest that many, if not most, intelligent equity investors would prefer their companies to pay out more of their earnings to shareholders.

But we don’t have that issue in REITdom. REIT laws require that 90% of pre-tax net income be distributed to shareholders; this is a *good* thing for most REITs, most of the time. REIT organizations, forced as they are to pay most of their current income to their shareholders, face a form of opportunity triage – only the very best opportunities can be funded. And this, of course, is more conducive to better investment returns, which of course redounds to the benefit of REIT shareholders.

Another point: This regime allows only those REITs who have shown that they can successfully deploy new capital to raise it. They may have to pay out a substantial portion of their cash flow, then bring it back again in the form of stock secondaries, but at least the discipline imposed by the market is at work – those REITs that are serial value-destroyers won’t be able to continue to raise fresh equity. And, of course, many REITs have developed a new business model that, sometimes aided by the judicious use of a joint venture program, allows them to continually recycle their assets without having to ever go back to the equity markets. All in all, while I wouldn’t mind a handful of REITs reinvesting most of “my” free cash flow (*e.g.*, Kimco), I want most of them to share the wealth via substantial dividend payments – and, after all, isn’t commercial real estate largely about current cash flows?

*10. Mortgage REITs are risky, volatile and unpredictable, and thus should always be shunned by REIT investors.*

**False.** I wouldn't have answered this question this way a year ago, but, like the old dog that I am, I try to learn new tricks from time to time. First, I continue to believe that, generally speaking, mortgage REITs (sometimes affectionately known as MREITs) aren't lovable creatures that can confidently be taken home to Mom; indeed, like muriatic acid, if not approached carefully and with a great deal of respect, they can corrode one's net worth.

Why? Let me count the ways: They use tons of debt leverage to finance their investments; their profits are very sensitive to changes in interest rates (short-term and/or long-term) and interest rate spreads; their dividends have been less predictable, with the track records of many littered with unexpected dividend cuts; their stocks often trade at substantial (and unwarranted) premiums to book value; and the business models of a large number of them are incomprehensible to all but quant jocks with PhD's in mathematics from M.I.T. Over the past 10, 15, 20 and 30 years, equity REITs have delivered much better average annual total returns than MREITs, despite the latter's much higher dividend yields.

And yet I have recently come to believe that the right people, with sufficient skill and good business judgment, can build a good business that focuses on lending upon the security of commercial real estate. Yes, the business and investment risks are apt to be higher than merely owning quality commercial real estate. However, if the strategy is sound and management is sufficiently incentivized and executes well, there is nothing inherent in real estate lending that would prevent an investor from diversifying a bit by looking for a few good MREITs. This has been a good business for many companies, not necessarily REITs, over the years.

An MREIT known as Gramercy Capital (GKK) induced me to take another look at these creatures. Although still a young company, and not run entirely independently (it's affiliated with SL Green), this REIT has performed well since barreling out of the starting gate in 2004 (it will celebrate its 2-year anniversary as a public REIT on July 28). Its strengths suggest criteria that those investors willing to accept somewhat higher risks may want to utilize in MREIT selection:

Gramercy can boast of an experienced management team; it has a strategy that emphasizes value creation through finding its own investment opportunities and underwriting them conservatively; it manages risk effectively, *e.g.*, it keeps mezzanine loans at a modest level (only 14% of all debt investments at March 31); it limits its exposure to changes in interest rates; and the company is well-diversified by property type and geographical location. In short, I believe that Gramercy is in the process of building a good business, and one that shouldn't necessarily be shunned by REIT investors just because it makes real estate loans rather than buying it. But be careful; MREITs are a very different animal from equity REITs, and bear significantly higher (and different) risks. Here there be dragons!

All right, what was your test score? Due to the subjectivity of the "right" answers, the grading system is generous:

80-100%: You're in real trouble – a Ralph Block clone
60-70%: Congratulations – you really know your REITs!
40-50%: You're REIT-knowledgeable, not yet warped by my strange theories
20-30%: We need to have a face-to-face debate; Sammy can be referee
Under 20%: No room for debate; buy REIT mutual funds and ETFs and go play golf

Your humble servant,
Ralph (Block)

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