



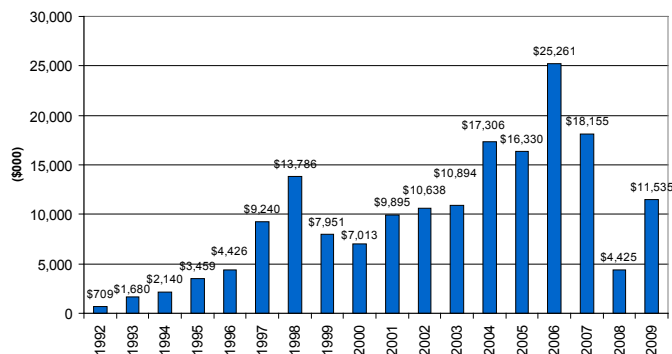
REITs Navigate Their Perfect Storm

Matthew Daly, Director and Research Analyst
David M. Amaral, Director and Trader

The Real Estate Investment Trust (REIT) sector has grown dramatically over the past 15 years, providing incremental yield for income-oriented investors, as well as shorter-term “trading opportunities” for the more total-return focused investor. Even with this growth, REITs remain a relatively small component of the overall corporate market. According to J.P. Morgan, the sector’s public debt outstanding totals \$93.5B, a figure dwarfed by the overall \$3.8 trillion investment-grade market. Despite representing only 4.4% of Barclay’s Corporate Index, REIT bonds offer the benefits of diversification from the more traditional financial credits – banks, brokers and insurance companies. Conning believes there are many attributes of REIT bonds that offer attractive risk/reward characteristics for BBB-tolerant investors.

With the growth of the REIT sector has come a change in its investor base. Unsecured debt issuance began in the early 1990s and was purchased by a select group of large insurance companies who placed the sector in a “buy and hold” niche, seeing it as a way to pick up yield versus similar-rated, but more liquid sectors. Colorfully referred to as the “REIT Mafia,” this buyer group had significant “influence” on not only the deal’s covenant package (see below), but also the size, price and maturity of the transaction. A chart from the REIT industry’s trade organization, NAREIT (National Association of Real Estate Investment Trusts), highlights the growth in issuance for the sector, peaking in 2006 at \$25.3 billion.

Figure 1. Historical REIT Unsecured Debt Issuance / Source: NAREIT

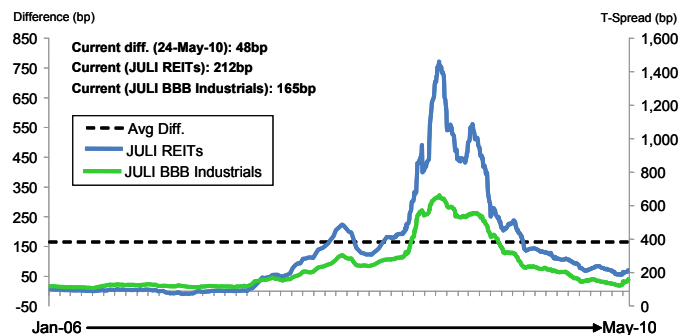


Over the past decade however, REITs have drawn interest from a much wider investor group, including mutual funds, pension funds and hedge funds. As demand has increased, so too has the average size of individual issues, with the vast majority of today’s issuance being index-eligible (>\$250mm). In fact, earlier this year, the “bellwether” name in the REIT sector – Simon Property Group – issued a multi-tranche transaction which included a \$1.1 billion 5-year maturity and a \$1.25 billion 10-year maturity. This is a major increase over deals issued in the early 1990s, when it was very common to see deal sizes in the \$100-200 million range. As the REIT sector’s total debt outstanding has increased, so too have the number of “sell-side” firms actively trading the sector and providing valuable liquidity for market participants.

REIT bond investors continue to be attracted to the sector by generous spreads versus other BBB-rated options. The vast majority of credits

in the REIT universe are rated BBB, as only the above mentioned Simon Property Group and Australia’s Westfield Group, are single A rated entities with actively traded debt. As measured by J.P. Morgan’s JULI indices, the chart below highlights the spread pick-up for REITs versus BBB-rated industrial credits over the past five years.

Figure 2. JULI REITs vs. JULI BBB Industrials / Source: J.P. Morgan



REITs have been tested severely over the past two years by the credit crisis and the correction in the commercial real estate (CRE) market. Following the implosion of Lehman Brothers, investors finished 2008 and entered 2009 concerned about the REIT business model and its ability to access the capital markets. This was exacerbated by the popping of the CRE bubble, with prices down nearly 42% from the October 2007 peak, according to Moody’s/REAL Commercial Property Price Indices. Needless to say, this was a grim time for REIT bondholders, as REIT securities were the worst performers in the investment grade corporate space in 2008, posting a dismal negative excess return of -37.35%.

However, markets improved dramatically during the course of 2009. REITs stood up well to their challenge – successfully accessing multiple forms of capital, meaningfully strengthening balance sheets and improving financial flexibility. According to figures provided by J.P. Morgan, REITs raised debt and equity totaling \$11.5 billion and \$26.9 billion, respectively, in 2009. As a result, REITs posted the second best excess return in the investment grade corporate universe in 2009 at 55.75%. Having demonstrated an ability to navigate the challenges of the past two years successfully, many REITs now find themselves in the catbird seat, well-positioned to overcome any fallout from the CRE space. Let’s look at what makes the sector an attractive option for risk-tolerant investors.

What are REITs?

REITs were created by Congress in 1960 to enable investors to invest in a diversified CRE portfolio. Through a series of legislative and tax law changes, REITs have morphed into their current form as companies that own and actively manage properties (this article is focused on equity rather than mortgage REITs). REITs control an estimated 20% of all CRE in the U.S.

A real estate company elects REIT status in order to avoid taxation at the corporate level. However, in order to qualify as a REIT and get a pass from Uncle Sam, companies must abide by a few rules, as stated in the Internal Revenue Code. The most relevant of these rules for bondholders is the requirement that at least 90% of taxable income

be paid to shareholders as a dividend. Because depreciation reduces taxable income, a REIT can actually retain an estimated 30-40% of cash flow. Nonetheless, the inability to retain the majority of cash flow puts REITs in a position of needing to access capital markets regularly in order to finance operations. Multiple forms of capital are typically available for REITs, including equity, unsecured bonds and mortgaging properties. Selling assets is another option to generate liquidity, although it does not raise new capital.

Why Invest in REIT Bonds?

Investing in REIT bonds defies conventional credit wisdom at first glance – why would one lend to a REIT when most cash flow must be paid as a dividend to shareholders? Doesn't this render REITs highly dependent on the capital markets to help finance operations and repay debt? A deeper dive into the intricacies of REIT bonds reveals several safeguards and inherent credit strengths to help mitigate these risks:

Corporate debt – Bonds issued by REITs are similar to bonds issued by any other corporation, with the added benefit of providing strong covenant protection (see below). The bondholder is in an unsecured position in the capital structure and has recourse back to the REIT itself. This contrasts to a CMBS investor whose position is secured by a specific pool of properties pledged as collateral, but who has no recourse back to a corporation. As a result, the owner of those securitized properties has a put option back to the CMBS investor...hand over the keys and walk away if the economics make sense to do so!

Organic entities – A REIT bond should not be viewed purely as an investment in CRE. Because bondholders have recourse back to the corporation, they benefit from the organic nature of REITs. For example, REITs receive contractual cash flows from a diverse tenant base and benefit from staggered lease expirations. More important, as showcased during the credit crisis, REIT management teams have access to multiple forms of capital that enabled companies to aptly address liquidity concerns. In contrast, CMBS, a static entity, renders the investor entirely dependent on the performance of a specific pool of property for ultimate repayment.

High quality properties – REITs generally own high quality properties in desirable locations. This enabled properties owned by REITs to outperform the broader CRE market throughout the economic downturn.

A unique set of financial covenants – REITs are the only sector in the investment grade corporate universe that issue bonds with meaningful financial covenants. A typical REIT bond contains the following set of financial covenants, referred to as a “standard” covenant package:

- **Maximum total debt to total assets of < 60%**
- **Maximum secured debt to total assets of <40%**
- **Minimum EBITDA to interest coverage of >1.5x**
- **Minimum unencumbered asset to unsecured debt of >150%**

Note: “Standard” covenants calculate asset value based on undepreciated book, although some REITs will calculate asset value capitalizing EBITDA.

The standard REIT covenant package provides a level of protection for bondholders in two key ways. First, REITs can incur only a certain amount of leverage, which ensures a certain degree of creditworthiness. In the event of a leverage buyout, the REIT must continue to live within the bounds of the covenants, thus limiting the amount of debt that can be utilized by the acquirer. As demonstrated by Blackstone's leverage buyout of Equity Office Properties in 2006, bonds must be repaid in order for the usage of significant debt.

Second, bondholders have a safety net via the minimum unencumbered asset to unsecured debt covenant (UAUD covenant) of 150%. An unencumbered asset is a property that is not secured by a mortgage. As a result, the unsecured bondholder has an effective negative pledge on a pool of high quality, unencumbered property that covers unsecured debt by 150%. Assuming the REIT has owned its property for an extended period, the market value of its assets is often greater than the book value on which the covenants are calculated, providing the bondholder with even greater protection.

The beauty of the UAUD covenant is that bondholders are protected by the added flexibility of this pool of unencumbered properties. In a liquidity pinch, REITs can raise proceeds by leveraging the unencumbered properties with secured mortgages. When the bond and equity capital markets were closed to REITs during the credit crisis, companies continued to have access to secured mortgages provided by life insurance companies and pension funds.

Default probability and recovery values – Not a single REIT bond issued with a standard covenant package has defaulted since the modern REIT era began in the early 1990s. General Growth Properties/Rouse did default on its bonds, but these contained a nonstandard covenant package with no UAUD covenant.

In the event that a REIT did indeed default on bonds with a standard covenant package, the UAUD covenant would likely result in recovery values materially higher than typical unsecured corporate debt.

Conclusion

The REIT industry has successfully navigated its perfect storm, opportunistically accessing the capital markets through the issuance of significant amounts of equity and debt in 2009. With debt maturity schedules now extended and the industry's collective balance sheet now strengthened, REITs are much better positioned to overcome obstacles that lay ahead – certainly better positioned than heading into the credit crisis of 2007-2008.

Conning believes REIT bonds offer an attractive risk/reward opportunity for BBB-tolerant investors, as financial covenants contained in REIT bonds are unique in the investment grade corporate space. A REIT's covenant package protects investors by limiting credit profile degradation in the event of acquisitions, reducing default probability and maximizing recovery value in the event of default. The sector's growth, and accompanying improvement in liquidity, has enabled investors to take advantage of attractive spreads versus other BBB-rated corporates. ♦

Matthew Daly, CFA, Director and Research Analyst, joined Conning in 2003. He was previously employed as a credit analyst at Webster Bank, at Brown Brothers Harriman & Co. and also at FleetBoston Financial Group. Mr. Daly is a graduate of Gordon College with a degree in Economics and Business Administration.

David M. Amaral, Director and Trader, joined Conning in 2006. He was previously employed by Citigroup as a fixed income trader, with prior experience as a credit analyst. Mr. Amaral is a graduate of the University of Connecticut with an undergraduate degree in Finance and an MBA.

Asset Management Viewpoint is published by Conning and may not be reproduced or disseminated in any form without the express permission of Conning. This publication is intended only to inform readers about general developments of interest and does not constitute investment advice. While every effort has been made to ensure the accuracy of the information contained herein, Conning does not guarantee such accuracy and cannot be held liable for any errors in or any reliance upon this information. Conning does not guarantee that this publication is complete. Opinions expressed herein are subject to change without notice. Past performance is no indication of future results. Conning is a portfolio company of the funds managed by Aquiline Capital Partners LLC (“Aquiline”), a New York-based private equity firm. Conning has offices in Hartford, New York, Dublin and London.

CONNING, One Financial Plaza, Hartford, CT 06103
860-299-2000, www.conning.com

Copyright 2010
Conning, Inc., All rights reserved.