

REITs: Smooth Sailing in Choppy Waters?

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Written during mid-2010, Conning's "REITs Navigate Their Perfect Storm" highlighted the sector's ability to survive the credit crisis and concurrent correction in the commercial real estate market. Since that initial publication, REITs have continued to strengthen their balance sheets and extend debt maturity schedules through opportunistic access of the capital markets. The recent weakness resulting from Europe's financial crisis has left the REIT sector with valuations that provide an attractive entry point, or opportunity to add to existing position, for those investors with a longer-term perspective.

Solid Fundamentals Position REITs Positively

With Europe's financial woes and the threat of contagion garnering the majority of the market's current focus, the financial sector has led overall corporate spreads wider. It has under-performed significantly versus the industrial and utility sectors. REITs have clearly been hurt by their association within the financial sector, yet benefit in comparison to other financial subsectors from their ownership by the "relatively stable hands" of insurance companies. Meanwhile, the much higher-beta and day-trading names that populate the banking and insurance sectors are often owned and traded by the "fast-money/hedge fund" community.

The lack of a credible solution to Europe's crisis has certainly contributed to the market's current "risk-off" sentiment. However, Conning believes that the REIT sector's solid credit fundamentals will ultimately prove too attractive to ignore, likely drawing significant investor capital when the market reverses sentiment and shifts into a "risk-on" mode. In the event that the U.S. economy falters and does not deliver the slow growth expectations most anticipate, the REIT sector is much better positioned now than it was entering the previous financial crisis of 2007-2008.

A Reminder to the Benefits of REIT Bonds

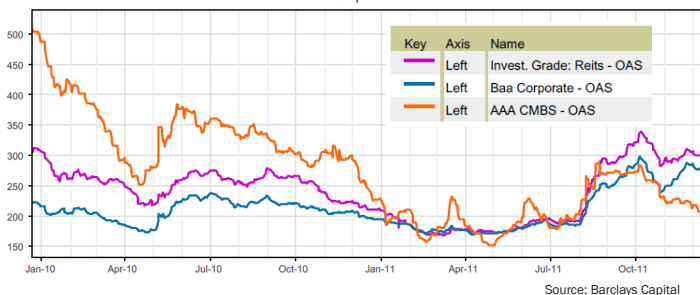
Let's review the case for investing in REIT bonds. In order to qualify as a REIT, at least 90% of taxable income must be paid to shareholders as a dividend. The inability to retain a majority of cash flow cause REITs to depend on capital market access to help finance operations and address debt maturities. While the requirement to return significant cash flow to shareholders should make a bondholder shudder, several intricacies of REIT bonds provide safeguards to help mitigate risk.

Corporate debt – Bonds issued by REITs are similar to bonds issued by any other corporation, with the added benefit of strong covenant protection (see below). The bondholder has recourse to the REIT itself, as compared to a CMBS investor whose recourse is back to specific properties securing underlying mortgages.

Organic entities – A REIT bond should not be viewed purely as an investment in commercial real estate. It's structure as a corporation enables bondholders to benefit from the organic nature of the REIT and management team. For example, REITs can manage liquidity profiles by accessing the capital markets as well as buying and selling properties. In contrast, CMBS investors depend entirely upon the performance of a specific pool of assets for ultimate repayment.

High quality properties – REITs generally own high quality properties in desirable locations. Not only did this enable properties owned by REITs to outperform the broader market throughout the recent economic downturn, but these properties are also more readily financeable.

REIT Spread



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Unique 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:

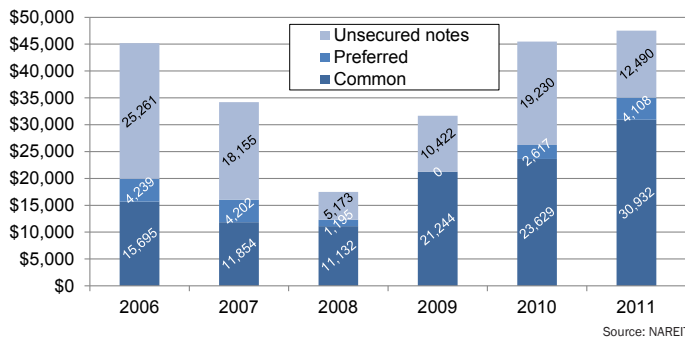
- Maximum total debt to total assets <60%
- Maximum secured debt to total assets <40%
- Minimum EBITDA to interest coverage >1.5x
- Minimum unencumbered asset to unsecured debt >150%

The standard REIT covenant package protects a bondholder by limiting leverage and providing a safety net via the unencumbered asset to unsecured debt covenant (UAUD covenant) of 150%. An unencumbered asset is typically a property not secured by a mortgage. The UAUD covenant ensures bondholders are protected by the flexibility of a pool of unencumbered properties that, in a liquidity pinch, REITs can use to generate cash via secured mortgages or outright sales.

Low default probability and high recovery values – There have been no defaults of REIT bonds issued with a standard covenant package since at least the early 1990s. General Growth Properties/Rouse did default on its bonds, but these contained a nonstandard covenant package with no UAUD covenant. Conning believes the UAUD covenant would likely result in recovery values materially higher than typical unsecured corporate debt in the event of a default on bonds.

Balance sheet recapitalization

A variety of capital markets have been open to REITs, allowing companies to continue to recapitalize balance sheets. The following chart from the REIT industry’s trade organization, NAREIT (National Association of Real Estate Investment Trusts), highlights offerings of secondary equity, unsecured notes and preferred stock:

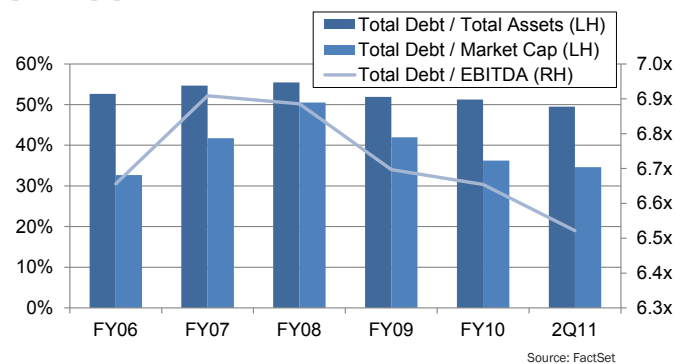


Receptivity of the capital markets has benefited financial flexibility for REITs, chiefly through improving leverage metrics and extending upcoming debt maturity schedules. For example, Conning calculates total debt to assets reached

a high of nearly 56% in FY08 before declining to 50% by 2Q11. Even more pronounced, total debt to market capitalization peaked at 51% in FY08 before dropping to 35% in 2Q11, reflective of the recovery in REIT equity valuations and secondary issuance. Likewise, total debt to EBITDA, a metric that now receives much more attention from the rating firms, was down half a turn from the peak a few years ago to 6.5x at 2Q11. Management teams have demonstrated a bias toward more modest leverage, and this will likely continue for some time. Although the industry is expected to remain predominately BBB rated for the foreseeable future, many companies have stated a desire to achieve modestly higher credit ratings.

In addition to the public capital markets, banks continue to prove willing lenders to REITs, providing unsecured term loans and renewing credit facilities. An important source of liquidity to REITs, credit facilities are being renewed on favorable terms that frequently increase borrowing capacity.

REIT liquidity is certainly improved compared to pre-credit crisis with companies in a much better position to address upcoming capital requirements. Notable differences when compared to several years ago include better laddered debt maturity schedules, ample availability under credit facilities, significantly less exposure to puttable convertible notes, and more modest capital requirements associated with development pipelines.



Operating Fundamentals Turning the Corner

REIT operating fundamentals are stabilizing or improving, depending on the subsector. Again, it is important to remember that REITs generally own high quality properties in desirable markets, factors which have contributed to their outperformance compared to the overall commercial real estate. Fundamentals follow the general health of the economy, lagged due to ongoing rollover of property leases. Fundamentals are supported by moderate job creation and very little new construction activity, which should prove favorable longer term. A double dip recession, if it were to materialize, would certainly weigh on fundamentals and cause a reversal in these positive trends.

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Apartment fundamentals are extremely strong with nearly full occupancy, rising rental rates, favorable demographics and manageable new supply. Retail, industrial and central business district office fundamentals are continuing to recover. Suburban office remains weak and many REITs are actually opting to reduce exposure to this subsector via asset dispositions.

Preferred stock – A yieldy alternative

REITs have issued over \$4B of preferred stock in 2011, a level that is now consistent with that of pre-credit crisis levels. Access to the preferred market is positive for REITs as it provides an additional source of capital, and one that can be permanent within the capital structure. REIT preferred stock is issued in perpetuity, usually containing a 5-year call at the option of the REIT.

Conning has historically been cautious on REIT preferred stock as the securities lacked the financial covenant protection of bonds and did not have change of control protection. In the event of an acquisition, this could potentially result in a preferred holder being further subordinated in the capital structure, enduring both credit degradation and price deterioration. However, recent preferred issuance is coming with much improved privatization protection, which alleviates this concern.

Preferred stock is being issued with coupons ranging from 6% to 9%, depending on credit quality. While a good deal of issuance is not rated and the secondary market is more limited than bonds, investors can purchase preferred securities from issuers with solid BBB ratings. This provides an opportunity to move down in the REIT capital structure of an investment grade rated REIT at an attractive spread pick up over unsecured debt issued by the same entity. Preferred stock receives the same capital treatment as unsecured debt by the NAIC.

Conclusion

REIT balance sheets and financial flexibility continue to improve as management teams operate with lower leverage and proactively address upcoming capital requirements. Operating performance has stabilized, even improving in certain instances, and that trend should persist provided the economy registers modest growth.

Despite the macro uncertainties, Conning's thesis on the sector remains unchanged – REIT bonds continue to offer the benefits of diversification from more traditional financial credits. Many attributes of the bonds offer attractive risk/reward characteristics for investors with a BBB tolerance, longer term investment horizon. Investors with higher risk tolerance might consider opportunistically moving down in the REIT capital structure into preferred stock to obtain higher yields. ♦

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