REITs: Clear advantages over private real estate

Lowell Bolken, CFA
Associate Portfolio Manager
Real Estate Securities

Joseph Betlej, CFA
Vice President & Portfolio Manager
Real Estate Securities

Real estate investment trusts (REITs) have grown up. The public REIT structure as we know it began growing in the 1980s and matured through the 1990s. The "new way" to invest in real estate has moved beyond "alternative investment" and boasts professional management teams, liquidity, access to capital and global companies.

REITs should now be considered the "better way" to invest in real estate.

The REITs of the 2000s are now experiencing their second recession. The 2001 recession, the first real test for the modern REIT, was a more traditional "V"-shaped economic cycle. The latest recession, officially commencing in December 2007, has been characterized as financial-services driven, a less common occurrence since the Great Depression.

In 2008 and early 2009, REITs suffered substantial price declines, largely due to withdrawal of capital and then its increased cost. As 2009 played out, however, REITs began to distinguish themselves from their private market competitors as their stock prices rebounded from their depths despite a steepening decline in real estate fundamentals. How? Liquidity played a part, with the public markets essentially re-pricing commercial real estate on a daily basis through REIT stock prices. One could argue that REITs have served as a leading indicator of commercial real estate valuations. Indeed, they have led private valuations both on the downside and on the rebound in this current cycle (see chart below).

However, we see a greater fundamental dynamic in the value of public REITs. The public format for

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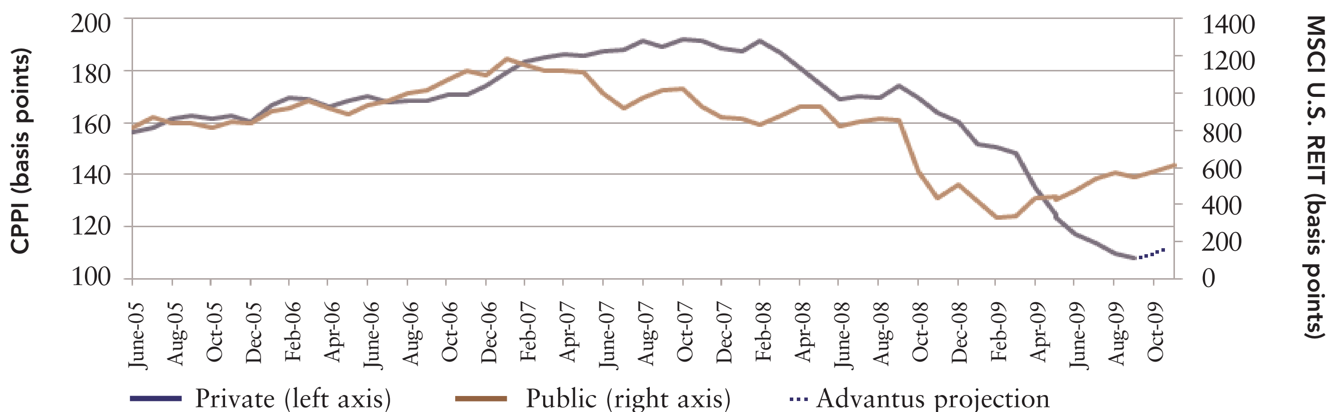
- REITs raised $25 billion through stock offerings in 2009—funds generally not available to private real estate owners—to solve multiple issues related to liquidity and capital.
- The ability to house talented professionals with multiple real estate skill sets creates synergies and efficiencies is a key part of the value proposition for a well-managed REIT.
- Many leasing brokers favor REIT properties based on their balance sheet strength and willingness to invest in their properties. In contrast, many private real estate players whose buildings could now be worth less than their debt are at a competitive disadvantage.

Performance: REITs vs. Private Real Estate



Source: Moody's CPPI through 10/09; MSCI U.S. REIT Index through 12/09 (Bloomberg)

ownership of real estate has benefits in declining fundamental markets, largely due to access to capital and benefits of the REIT platform.

Capital Was King—And Still Is

The health of commercial real estate has historically been dependent upon domestic labor trends. Employment stability serves as a foundation, while job growth provides fuel for demand expansion. Commercial real estate houses its tenants' employees and businesses – in offices, regional malls, industrial facilities, etc. The prospects for future hiring forces companies to make decisions on whether to expand (or contract) leased space (office and industrial properties). Job creation accompanied with wage inflation encourages household formation (apartments) and consumer spending (in retail centers).

The free and easy capital of 2006-07 clearly overshadowed the effect of job formation, as liberal underwriting criteria drove real estate values up. The primary driver was the profitability of lending in commercial mortgage-backed securities conduits, whose high loan-to-value loans and other questionable underwriting criteria rationalized larger amounts of debt flowing into the sector. Mathematically, this pushed valuations higher as capital flooded the system (see chart below). This surge of liquidity overwhelmed commercial real estate fundamentals. We now know that this was unsustainable, but the re-pricing and deleveraging that began in 2007 served to push the pendulum so far in the reverse direction that it eventually forced a liquidity squeeze.

It was in this liquidity squeeze that REITs were forced into damage control. At the time, REIT balance sheets were in line historically and conservative relative to their private competitors. However, refunding risk for shorter-term maturities reached a true "doomsday" status. The banks and life insurance companies that were significant commercial real estate lenders were themselves frantic in their quest for survival. Already greatly exposed to commercial real estate, these institutions were rushing to limit this exposure, or at the very least mitigate the risk of funding obligations outstanding. As it turns out, REITs possessed the equivalent of a magic bullet that addressed both of those needs: access to the public equity market.

Armed with strong sponsorship, REITs raised $25 billion in common equity in 2009. We refer to this as a magic bullet because it solved multiple issues. First and foremost, a portion of the proceeds could immediately be used to pay off near-term maturing debt and reduce revolving credit line balances. (Also note that many REITs reduced their dividend and/or paid out a portion in common stock, in a further effort to preserve cash.) While this addressed near term financial pressure, it also assuaged REIT lenders, who now could more accurately gauge REIT credit worthiness. REITs graded very well, as evidenced by the number of institutions that stepped up to refinance existing mortgages and extend short-term credit lines.

Finally, the REITs' fresh equity opened the door for other capital alternatives, particularly a rebirth of the

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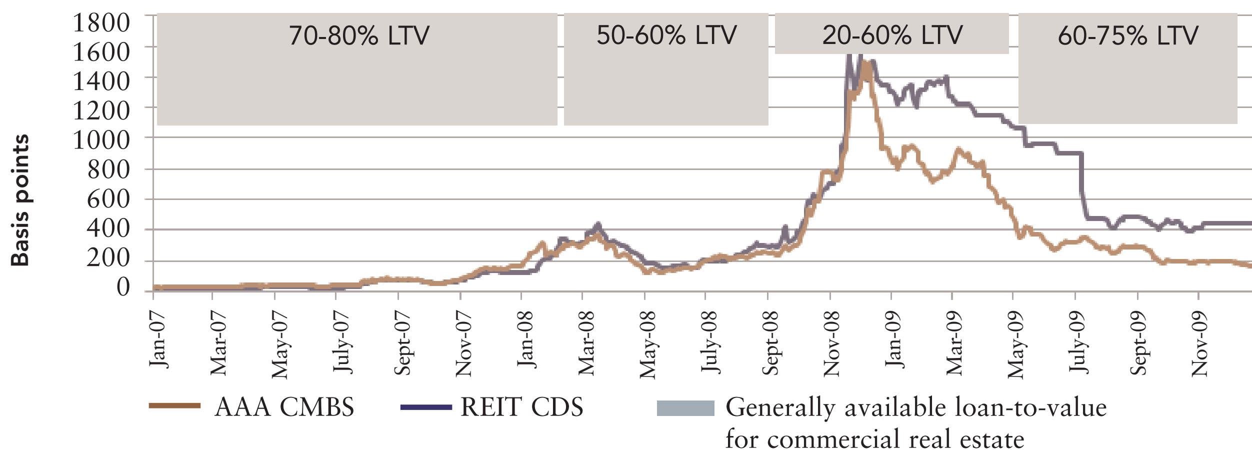
Commercial Real Estate Debt Spreads vs. Underwriting Criteria



Source: Bloomberg, Barclay's Live, Advantus

public unsecured bond markets. Past efforts in establishing investment-grade credit ratings paid off; REITs were able to issue $11 billion of unsecured debt in 2009. Much of this new debt capital was used to pay off short dated debt maturities and lines of credit.

This track record of success magnified the stock market's overreaction to the early 2009 liquidity squeeze, which drove REIT indices to a cycle low on March 6, 2009. By demonstrating their survival instincts, REITs regained investor interest and confidence, and funds flowed back into the sector. From its nadir on March 6 through the end of 2009, funds flow—and not fundamental recovery—was the major driver for the 124 percent total return for the MSCI U.S. REIT Index, versus 66 percent for the Standard & Poor's 500 Index over the same period.

Platform Adds Value

One must recognize, however, the long-term enhancement of the REIT platform. Many REITs wisely used the period of growth from 2003 to 2007 to invest in infrastructure. REITs that grew to large national or global entities benefited from economies of scale, allowing for greater investment in accounting, administrative and other operating infrastructure improvements. This drove the average general and administrative overhead cost to lower relative levels. This has become a huge advantage in terms of property management, leasing and general revenue enhancement when applied to a large portfolio. Investor confidence in this operating platform played a part in raising $36 billion in debt and equity in the public markets despite deteriorating fundamentals.

To put this in perspective, recall that many REITs began as small organizations often founded by an individual or family. At some point, a more formal corporate management structure was incorporated. Specialized financial and management talent were recruited, who then introduced and developed state-of-art financial planning and management systems. This, in turn, facilitated REIT growth to a new level, as expanded sources of capital and more efficient means of deployment allowed for unprecedented volumes of acquisition and development. Currently, 13 REITs are represented in the S&P 500, and 23 are in the S&P MidCap 400, attesting to company quality.

The acquisition and development engine is a good example of this transformation. This structure was not created on the fly, as may have occurred in the more formative years of the REIT industry. This effort required a collective base of disciplines, often referred to as a "platform."

As an example, consider a sophisticated commercial real estate development. Initially, a team of acquisition and finance personnel would have been required to source, finance and close the purchase of land. From that point, leasing, property management and development staff would take the reins to design, budget and determine the feasibility of the proposed development. Once ground is broken, the construction staff has the most visible role, but the leasing staff is just as diligent in seeking leases to build the revenue stream for the project. At the point of occupancy, the property management team takes center stage, addressing the day-to-day demands of the property and tenants. The finance team would arrange construction financing as well as determine a long-term capitalization strategy for the asset.

At every stage, and throughout the life of the investment, the responsibilities of each discipline may overlap. The synergies created by having talented professionals all "under one roof" to optimize the investment is a valuable asset in and of itself. Platform flexibility is a key long-term asset for a REIT, because revenue drivers can offset each other throughout cycles. Property management and leasing capabilities can add more value in the current stage of the cycle than development, for instance. This "platform" is a key part of the value proposition that is created in a well-run REIT.

Finding value in apartments

Perhaps the sector that most illustrates the benefit of a platform is apartments. The REIT players in this sector grew through acquisition and development, but value creation is also dependent upon operating execution. Historically, the rental property model was decentralized, using an on-site property manager as a revenue collector, leasing agent, maintenance scheduler and arbiter of rent levels. This is becoming a vestige of the past. A robust internet web site that accomplishes the first three of the above tasks is now standard among REITs, meeting the needs of the modern day renter.

The final task, pricing appropriate rental rates, has distinguished REITs among its competition. Following the lead of other industries, software programs

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specifically designed for apartment revenue management came of age during the most recent cycle. "Lease Rent Optimizer" (LRO) became the catch phrase for the industry. The model has evolved to a centralized LRO engine that daily, if not hourly, objectively sets rents based on a predetermined occupancy goal. If a REIT had set an objective to maintain a 95 percent occupancy level, rates would be either lowered (if occupancy dipped) or increased (if occupancy swelled) to achieve the highest level of cash flow. Anecdotally, REIT officers have estimated that revenue increased by as much as 1.5 percent with full installation. Similar software approaches are also used by REITs in other sectors, such as self-storage and hotels. These systems are not cheap to develop and are dependent on the benefits of scale that are afforded to REITs due to their size.

Effective financial management

Another test for the REIT platform in this financial services-driven downturn has been the need to rationalize operations. Due to the abrupt pullback by lending institutions and weakening fundamentals, REITs were forced to manage expenses, cutting non-essential spending in order to hoard cash. Though this occurred across industries, many REITs were in the midst of financing developments, redevelopments or recent acquisitions. REITs had to balance replacing, extending or refinancing financial commitments in place, while at the same time avoiding draconian lay-offs that would impede recovery once the markets recovered.

Maintaining professional relationships may have played an important role in the financing efforts. REITs were able to extend short-term credit lines (usually held by a syndicate of banks) and renegotiate or refinance mortgage loans (usually held by life insurance companies). This could not have been achieved as effectively in such a challenging environment without capable finance professionals who have cultivated long term relationships with the lending community, and indeed that was the case.

A similar effect can be found in leasing, where REITs are poised to take market share from their peers. We have heard several firsthand accounts of leasing brokers favoring REIT properties for their clients based on their balance sheet strength and willingness to invest in their properties. No doubt, these "leasing reps" have their clients' interests in mind when it comes to financing tenant improvements and property maintenance. Not surprisingly, timely commission checks may also have played a part. However, these are difficult decisions for many private real estate players whose buildings could now be worth less than their debt.

REITs were also successful in rationalizing their platforms to adjust to the falling rent environment. This is important; a leaner operation allows for aggressive lease packages at a time when competition is likely in a weaker position. As the table below indicates (using multi-family REITs as an example), expenses were dialed down to offset revenue reduction. Also, after peaking in 2007, general and administrative overhead as a percent of revenue has now come down to 2004 levels. Yet, we have found that many critical development and leasing professionals were retained to restart the engine when the economics permit. Private or smaller competitors may not enjoy this luxury.

Multi-family REIT Performance, 3Q 2009

	Same Store Occupancy		Same Store vs. 2Q 2009		
REIT	**2009**	**2008**	**Revenue**	**Expense**	**NOI**
AEC	94.6%	95.8%	-2.5%	-2.9%	-2.2%
AIV	94.8%	95.0%	-2.9%	1.1%	-5.4%
AVB	96.0%	96.2%	-4.8%	3.2%	-8.5%
BRE	94.7%	94.9%	-5.6%	-0.2%	-7.9%
CPT	93.7%	94.9%	-1.3%	1.7%	-7.0%
EQR	93.7%	94.0%	-3.9%	-0.6%	-5.8%
ESS	97.0%	96.3%	-4.7%	1.8%	-8.0%
HME	95.1%	95.0%	-0.2%	0.2%	-0.5%
MAA	96.0%	95.3%	-1.7%	-1.3%	-2.1%
PPS	94.5%	95.2%	-6.0%	-1.0%	-10.0%
UDR	95.6%	95.1%	-3.0%	-1.6%	-2.7%
Avg.	95.1%	95.2%	-3.3%	0.0%	-5.5%

Note the maintenance of 95 percent occupancy. Though doing so appeared to negatively affect revenue, expense discipline offset this to a degree. Learning the lesson from previous downturns that lost tenants are costly to re-attain, the REITs should be well positioned to push rents in the up-cycle. *Sources: Company reports, Advantus*

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2010: Not Without Challenges

Though we highlighted employment as a key metric earlier, there are other challenges facing this sector:

Higher cost of capital: Despite an advantage versus their competition, interest rates have been rising and may face greater upward pressure in the face of growing U.S. government deficit-related borrowing demands.

Weak fundamentals: Commercial real estate fundamental recovery historically lags the broader economy, and recent results for the REITs are indicative of that. Though poised to outperform the industry, REITs will continue the battle to retain occupancy and rent levels in 2010.

Unpredictable state and local government budgets: The concerns here are operating budgets, which are poised to come under significant pressure in 2010 as tax receipts are on a precariously downward trend nearly across the board. Commercial real estate unfortunately wears a large bull's-eye for property tax or fee increases. Also, state and local governments are large employers and significant commercial tenants. Up to this point, REIT exposure to governments has been a positive in contrast to the private sector, which has suffered job losses. This may be the year the shoe drops for the public sector.

The REIT Structure—Up For the Challenge

With fourth quarter earnings around the corner, we anticipate REIT fundamentals will be weak given the lag to the economy. Nonetheless, we are optimistic about REITs and believe they will continue to demonstrate results superior to private real estate.

First, based on our analysis of individual REITs and discussions with company management teams, we anticipate that many will return to the 100 percent cash dividend payout model, having survived a major test to their capital structure. Some have already announced an increase in 2010 dividends, and we expect more to follow suit.

Second, we see many REITs that are well positioned to go on the offensive, as a large tide of under-capitalized and foreclosed properties will be forced into the market. These distressed transactions have been widely anticipated, but largely absent because the owners (banks, life insurance companies and commercial mortgage-backed securities special servicers) have not been forced to adjust to reality. REITs with access to capital who make strategic purchases in key locations will benefit.

Finally, we like REITs as operators with improved efficiencies. This attracts institutional capital to the sector, particularly in an environment where current return alternatives are low. It also positions the sector for outsized cash flow generation once the cycle matures, as margins increase exponentially once revenue growth gains traction.

Finding the Gems is Key

Though better positioned as a group than private real estate, not all REITs will thrive. Investors will need to look at REITs one-by-one. At Advantus, our investment professionals have worked in the real estate industry as well as the capital markets. Such a "dual perspective" and a bottom-up, fundamental research process focusing on individual companies can help identify REITs that are positioned to perform well in this environment.

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400 Robert Street North, St. Paul, MN 55101-2098
www.advantuscapital.com | 1.800.665.6005

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