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US REITs- REIT Structure and Bond Covenants Attenuate Credit Risk

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May 15, 2014

"By God, gentlemen, I believe we've found it—the Fountain of Funding!"

US REITs- Credit Risk

1. REITs: Historical Perspective and Performance
2. Rating Methodology and Covenants
3. REIT Outlook: Stable

1 REITs: Historical Perspective and Performance

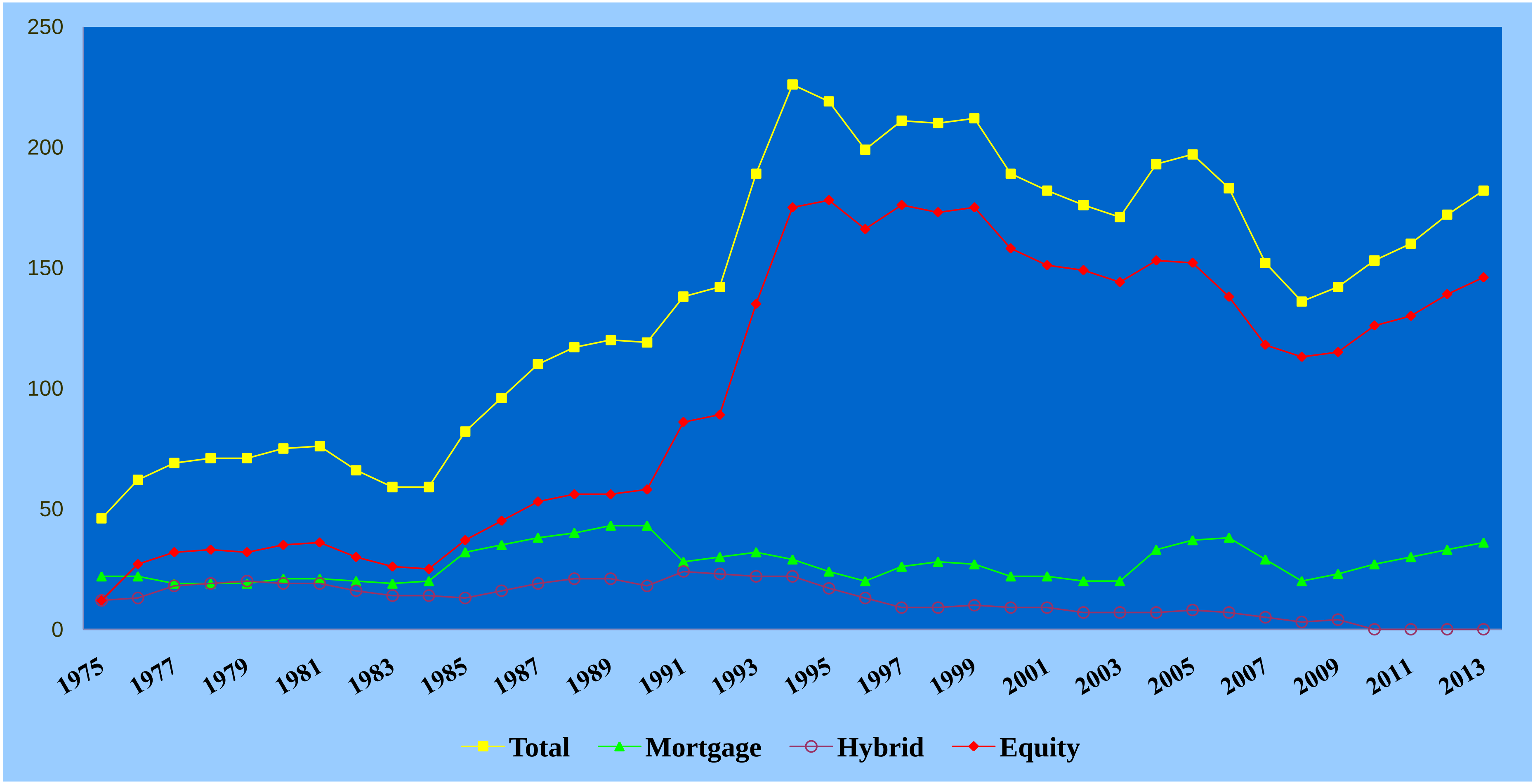
REITs- Definition

- A corporation (trust) that owns real estate and passes its income and losses through to its investors without the entity incurring income tax
- A “Mutual Fund” for real estate – allows real estate companies to access the public markets
- Ownership Rules:
  - Must have a minimum of 100 shareholders-- with no more than 50 percent of its shares held by five or fewer individuals
  - 75% of REIT’s assets must be invested in cash, government securities and real estate
- Income Rules:
  - 75% of REIT’s income must be from real estate sources - rents, reimbursements, etc.
  - Pay at least 90 percent of its taxable income in the form of shareholder dividends each year; as a result, REITs may not generally retain their earnings
  - Less than 30% of gross income can be sales of real property held less than 2 years (originally was 4 years) – anti-churning rule

REITs - HISTORY

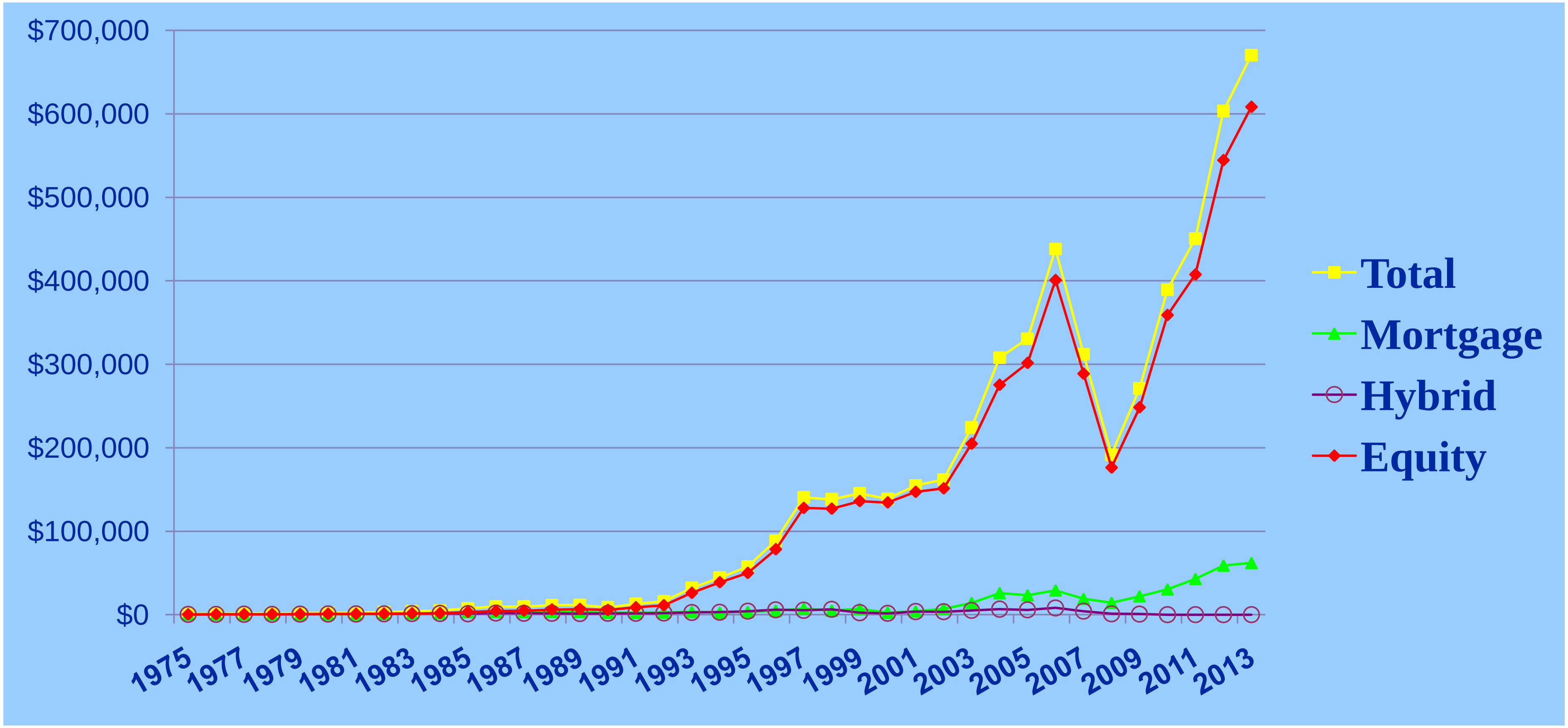
1960	Formed by an act of Congress
1960’s	Passive Equity REITS
1969 – 1976	Mortgage REITS
1970’s/1980’s	Ignored due to Limited Partnerships
1985	A few Real Estate Operating Companies
1986	Tax Equity & Fiscal Responsibility Act Allowed Active Management
1991	Kimco REIT started new ERA
1992	Taubman created and UPREIT coined
1992 – 1998	Real Estate Operating Companies Explode
1998	Real Estate Capital Markets Pull Back
1998 – 1999	REIT Stock Values Retrench; M&A Activity
1999 - Present	Mega REITs, Operating Companies

Growth in Number of REITs
(1975 – 2013)



Source: NAREIT at YE13

Growth of REIT Market Capitalization
(1975 – 2013)

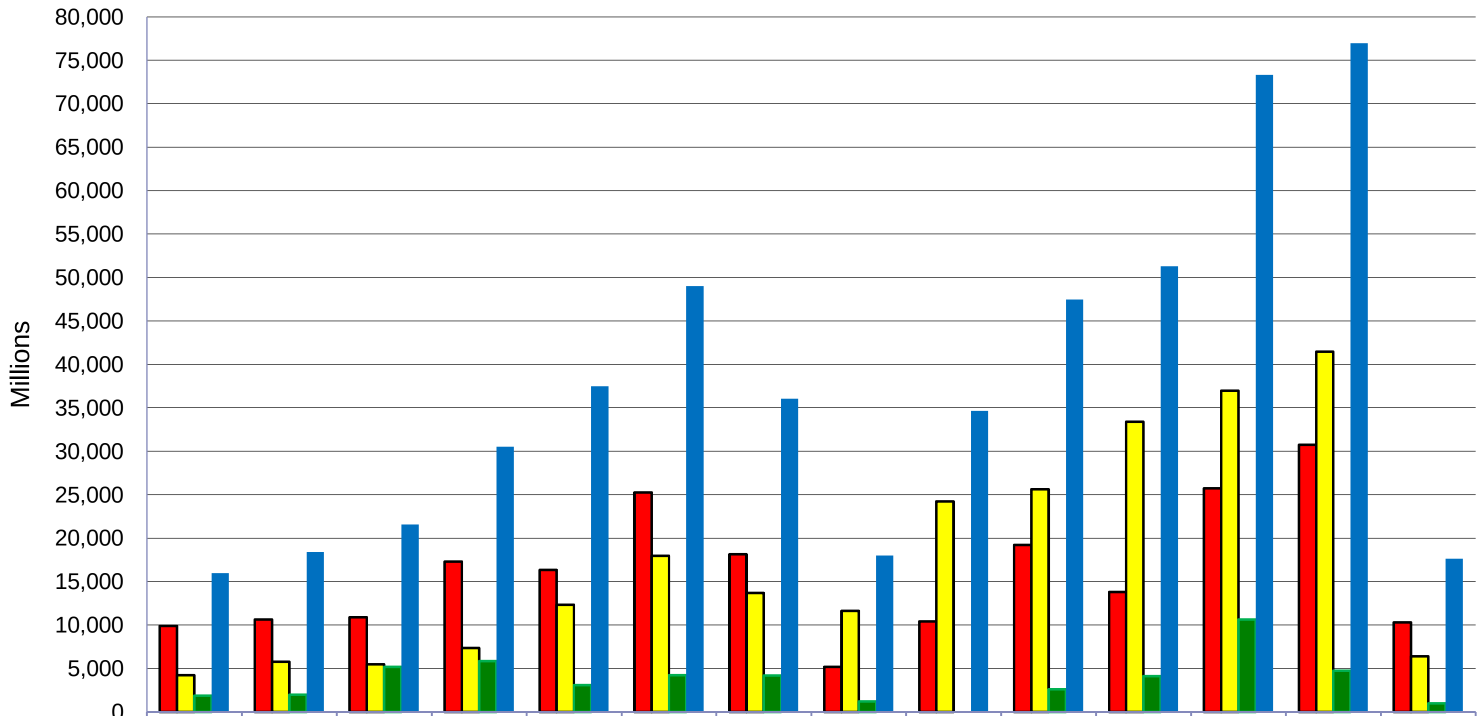


Source: NAREIT (in U.S. $ Millions) as of YE2013

Note: FTSE NAREIT Hybrid REIT Index was discontinued on 12/17/10.

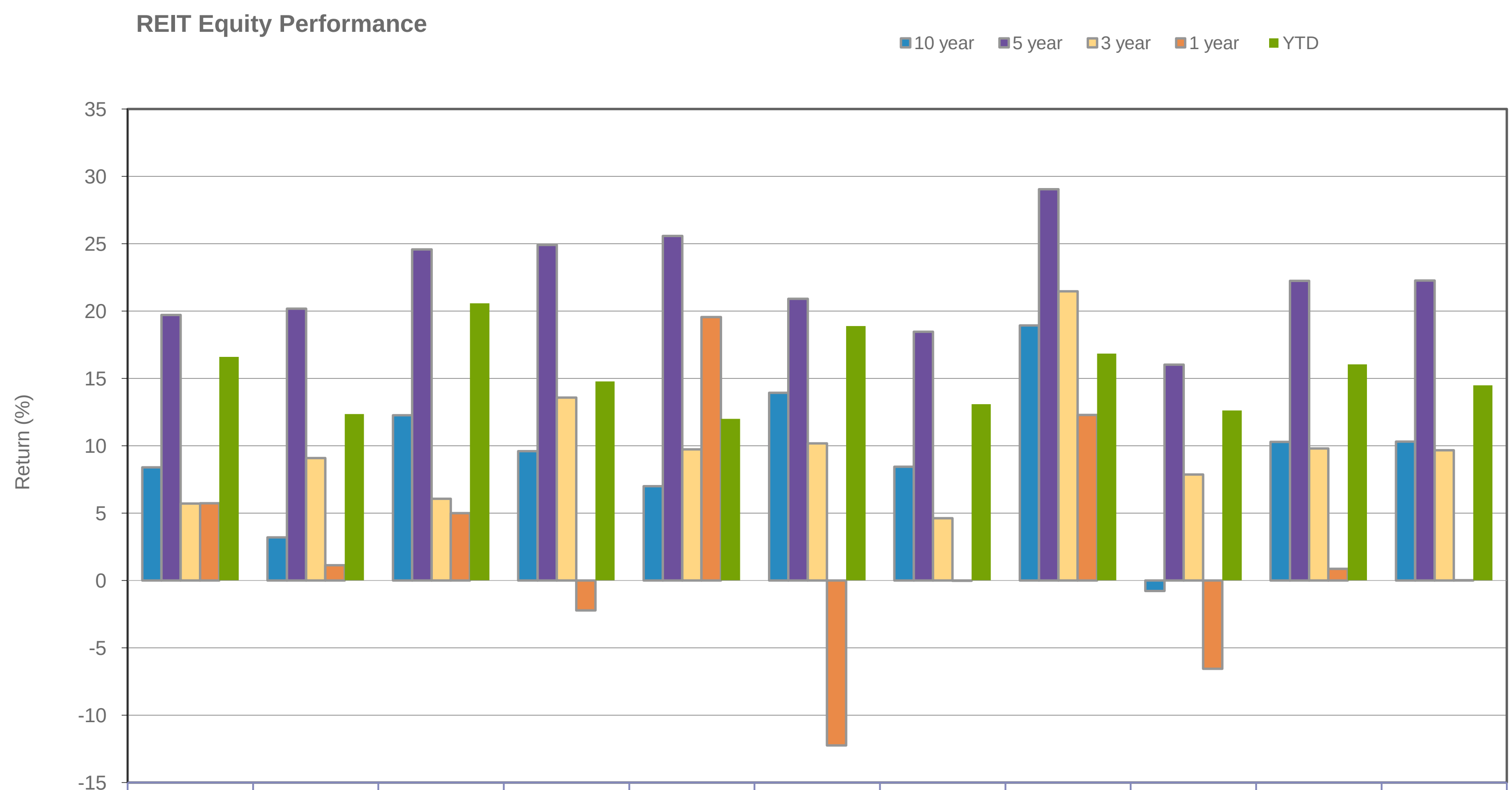
Sources of Financing – Debt and Equity

Sources of Financing--Debt & Equity



	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014 YTD
Unsecured Debt	9,895	10,638	10,894	17,306	16,330	25,261	18,155	5,173	10,422	19,230	13,790	25,730	30,739	10,304
Common Equity	4,204	5,785	5,471	7,338	12,310	17,966	13,674	11,623	24,234	25,604	33,382	36,965	41,463	6,379
Preferred Equity	1,878	1,991	5,192	5,858	3,095	4,239	4,202	1,195	0	2,617	4,108	10,631	4,755	963
Total	15,977	18,414	21,557	30,502	37,492	49,018	36,031	17,991	34,656	47,451	51,280	73,326	76,957	17,646

Source: NAREIT 4/30/2014



	Office	Industrial	Multifamily	Retail (malls, sc,outlet)	Lodging	Health Care	Diversified	Self Storage	Mtg REITs	Equity REITs	All REITs
10 year	8.41	3.19	12.27	9.61	7.01	13.93	8.45	18.94	-0.77	10.3	10.31
5 year	19.7	20.2	24.6	24.9	25.6	20.9	18.5	29.0	16.0	22.3	22.3
3 year	5.7	9.1	6.1	13.6	9.7	10.2	4.6	21.5	7.9	9.8	9.7
1 year	5.7	1.1	5.0	-2.2	19.6	-12.3	0.0	12.3	-6.6	0.9	0.0
YTD	16.6	12.4	20.6	14.8	12.0	18.9	13.1	16.8	12.6	16.1	14.5

Source: FTSE NAREIT YTD through 5/12/14; 1,3 5 & 10-yr Compound Annual Total Returns through April 30, 2014

REIT Performance versus Public Equity Securities Markets

	REITs	DJIA	NASDAQ	RUSSELL 2000
2014 (YTD)	+14.1%	+0.7%	-0.88	-2.2%
2013	+3.2%	+26.5%	+38.3%	+38.8%
2012	+20.1%	+7.3%	+15.9%	+16.4%
2011	+7.3%	+5.5%	-1.8%	-4.2%
2010	+27.6%	+11.0%	+16.9%	+26.9%
2009	+27.5%	+18.8%	+43.9%	+27.2%
2008	-37.3%	-33.8%	-40.5%	-33.8%
2007	-17.8%	+6.4%	+9.8%	-1.6%
2006	+34.4%	+16.3%	+9.5%	+18.4%
2005	+8.3%	-0.6%	+1.4%	+4.6%
2004	+30.4%	+3.2%	+8.6%	+18.3%
2003	+38.5%	+25.3%	+50.0%	+47.3%
2002	+5.2%	-16.8%	-31.5%	-20.5%
2001	+15.5%	-7.1%	-21.1%	+2.5%
2000	+25.9%	-6.2%	-39.3%	-3.0%
1999	-6.5%	+25.2%	+85.6%	+21.3%
1998	-18.8%	+18.0%	+40.1%	-2.4%

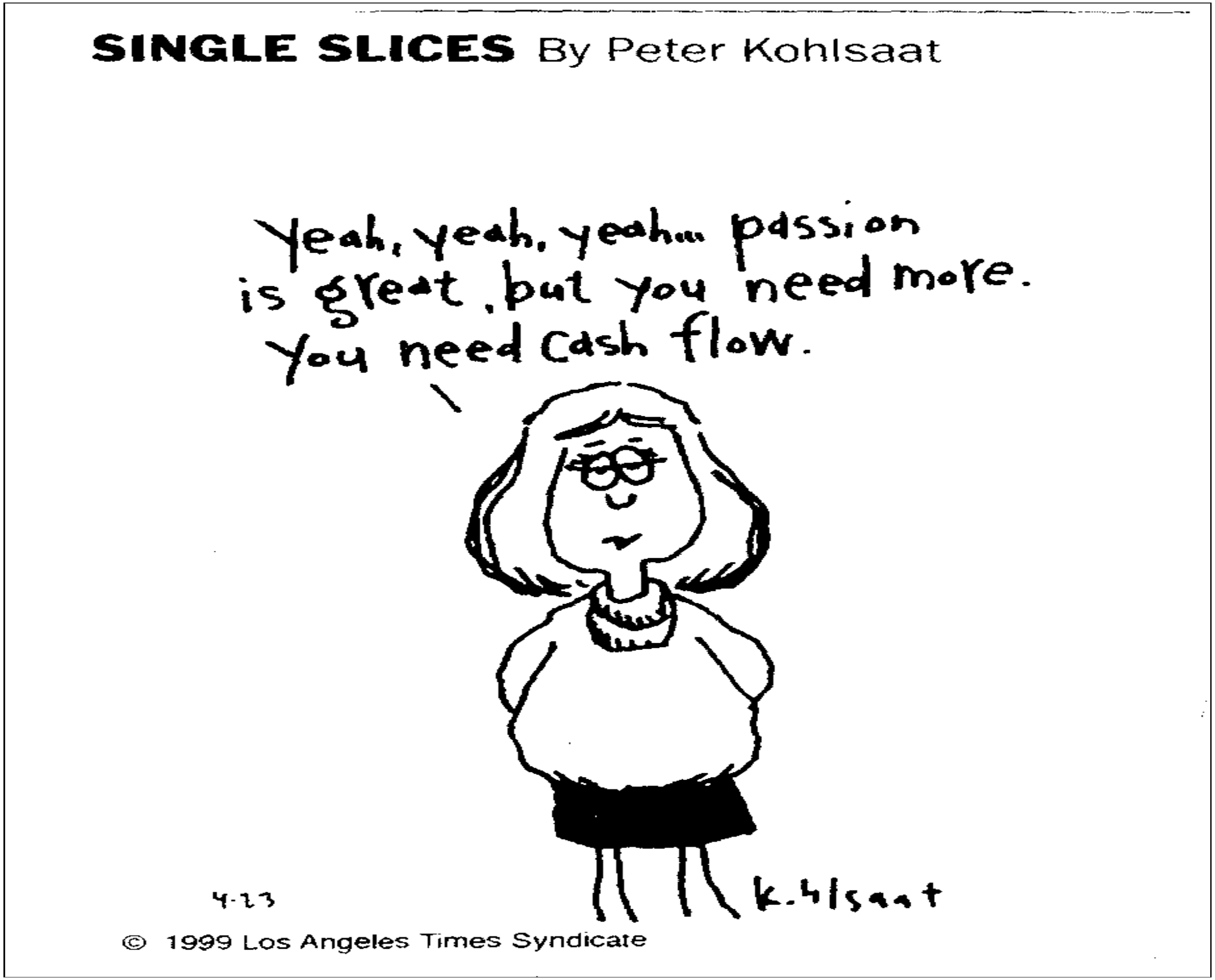
Source: NAREIT; Total return data; FTSE NAREIT US Real Estate Index as of May 12, 2014

REITs vs. Other Equity Investments

How REITs differ from other equity investments?

- Hard assets; easy to understand business premise
- Investors willing to accept lower real estate type returns as hedge against stock market
- Cash flow “protected” by leases
- Pay high dividends (formerly 7%, now approx 4-5%)
- Dividend payout ratios approx. 60%-70% of cash flow
- Low leverage, averaging 40% of capitalization
- Interest coverage is high, at least 2 to 1
- Trade at approximately net asset value +/-

2 Rating Methodology and Covenants


SINGLE SLICES By Peter Kohlsaat
Yeah, yeah, yeah... passion is great, but you need more. You need cash flow.
4-23
K.hlsaat
© 1999 Los Angeles Times Syndicate

REIT/REOC Rating Drivers

- » Achievement of strong sector leadership
- » Steady earnings growth, with stability
- » Portfolio diversification by tenant, industry and geography
- » Capacity to fund at least recurring capex with retained cash – post-dividends
- » Reduction in JVs and funds/fee-generating structures, which often create weaker transparency, complexity, management difficulties and earnings volatility
- » Moderate financial leverage and maintenance of a robust unencumbered asset pool

Quantitative Approach

Ratios that Moody's focuses on:

» Fixed Charge Coverage

» Total Debt/Gross Assets

» Total Debt + Preferred Equity/Gross Assets

» Secured Debt/Gross Assets

» Secured Debt/Total Debt

» Net debt/EBITDA

» Unencumbered Gross Assets/Gross Assets

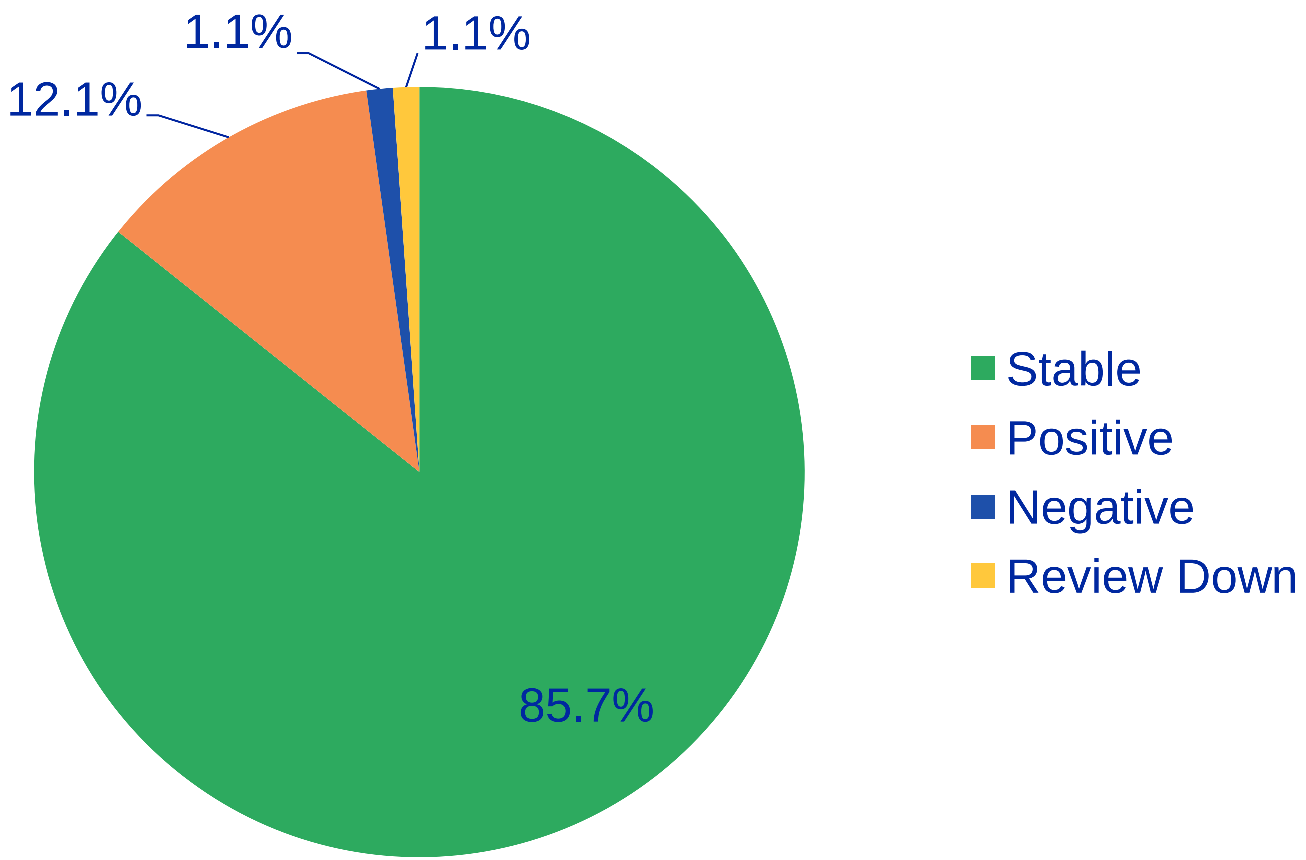
» Unencumbered Gross Assets/Total Unsecured Debt

» Total Unsecured Debt/Unencumbered NOI

Outlooks for Ratings and Market Fundamentals

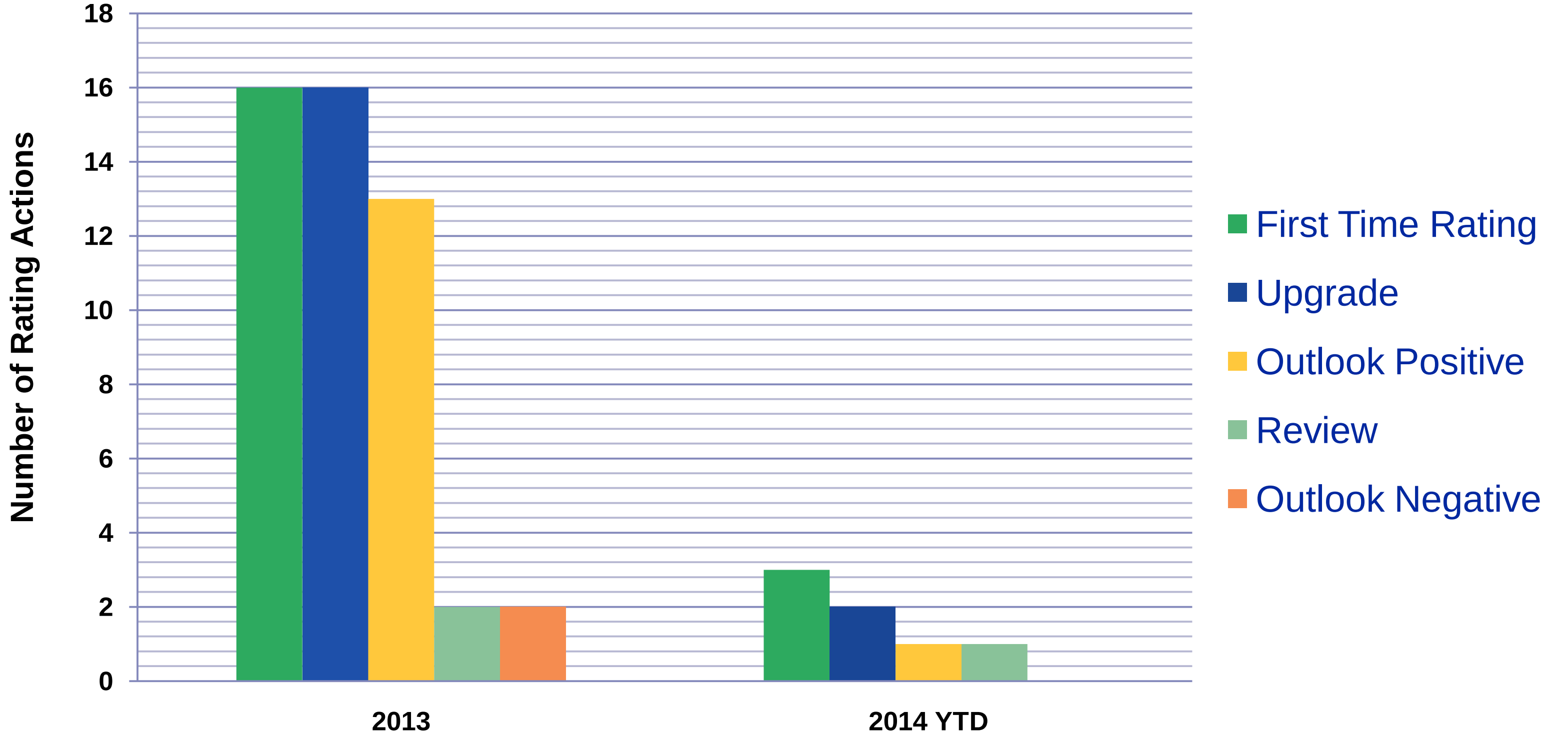
Sector	Ratings	Market Fundamentals
Retail	Stable	Stable
Office	Stable	Stable
Industrial	Stable	Stable
Multifamily	Stable	Stable
Healthcare	Stable	Stable
Lodging	Stable	Stable

Rating Outlooks – U.S. Rated REITs



YTD March 20, 2014

Rating Actions – U.S. Rated REITs

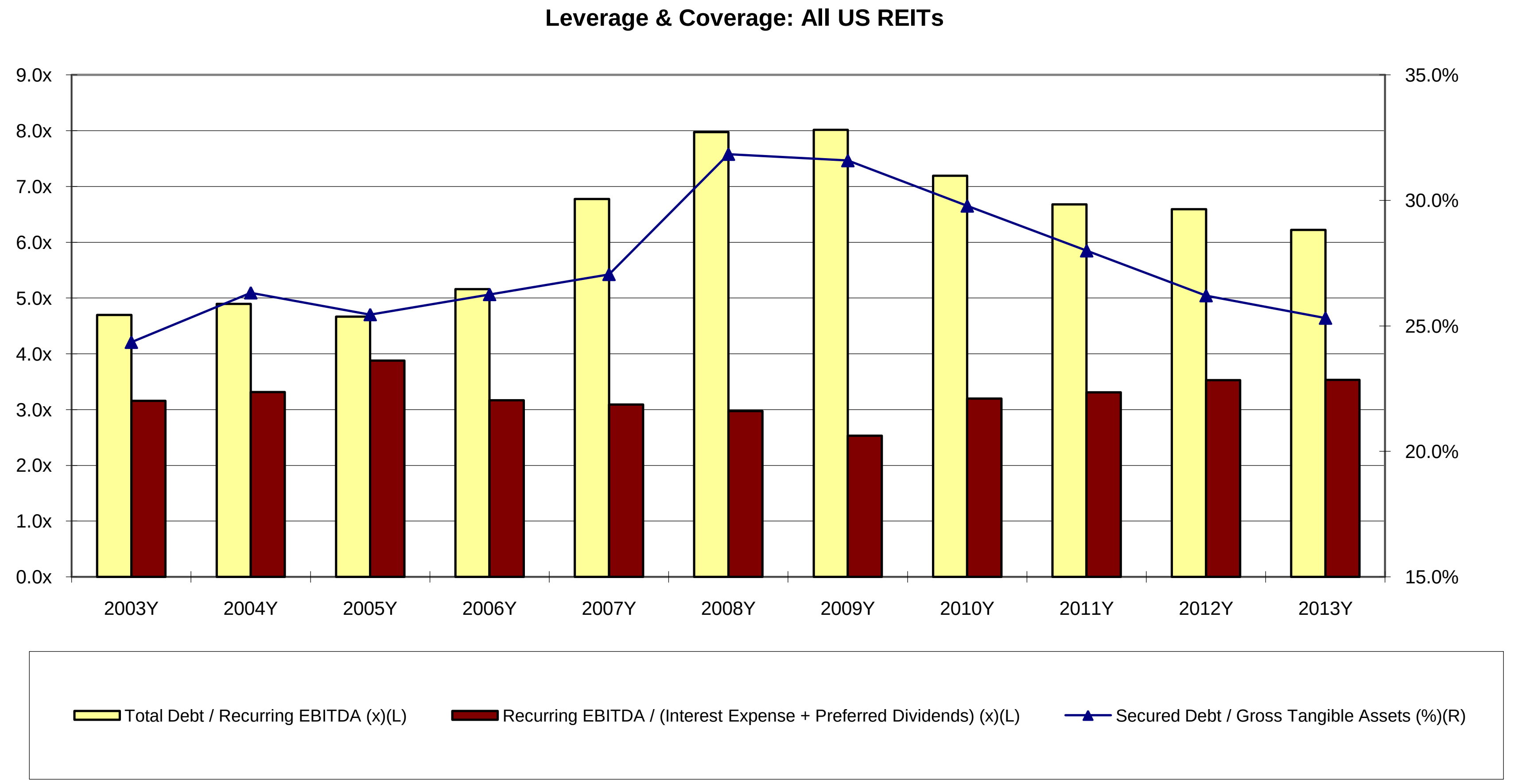


Includes rating actions for U.S. Issuers as of March 20, 2014

REIT Bond Covenants Reduce Risk

- Investment grade senior unsecured debt contains the "standard" REIT covenants that act as a governor– in bonds since mid-90's (definitions of "assets" modified during Recession somewhat):
  - Debt <60% of total assets
  - Secured debt <40% of total assets
  - Unencumbered assets >150% unsecured debt
  - Coverage ratio >1.5x
- REITs can increase leverage up to covenant levels, thereby increasing the risk profile
- During Recession, some REITs re-equitized to remain in compliance with covenants
- The 20-year running default rate for REITs that have issued debt with this covenant package is 0%
- GGP was only equity REIT to go bankrupt during Recession- good portfolio/poor balance sheet management, but investors were repaid. REIT bonds backed by standard covenants survived the cycle without defaulting (GGP/Rouse bonds lacked the unencumbered asset coverage test)
- HCP put the REIT covenants in their bonds when they issued $2.4 billion of bonds in 2011 to fund acquisition of HCR ManorCare

REIT Metrics - 2003-2013



Source: SNL Financial as of December 31, 2013. Includes 238 REITs.

Sample Scorecard from REIT Methodology

Simon Property Group, Inc.										
As of March 31, 2014										
Rating Drivers [1]	**Aa**	**A**	**Baa**	**Ba**	**B**	**Caa**	**Ca**	**Implied Score**	**Adjusted Score**	**Trend**
Liquidity & Funding								Mid A	Mid A	Neutral
Liquidity Coverage		Excellent								
Debt Maturities		10.8%								
FFO Payout		52.5%								
Amount of Unencumbered Assets			74.8%							
Leverage & Capital Structure								Low Baa	Low Baa	Neutral
Debt + Preferred/Gross Assets				57.2%						
Net Debt/EBITDA			5.9x							
Secured Debt/Gross Assets				26.8%						
Access to Capital	Superior									
Market Positioning & Asset Quality								Mid Aa	Mid Aa	Neutral
Franchise/ Brand Name	Superior									
Gross Assets	$51.3									
Diversity-location/tenant/industry/economic	Superior									
Development % Gross Assets	0.9%									
Asset Quality	Superior									
Cash Flow & Earnings								High Baa	Mid A	Neutral
EBITDA/Revenues		72.5%								
EBITDA Margin Volatility			3.4%							
Fixed Charge Coverage		3.4x								
JV/Fund Business % Revenues				19.9%						
Overall Assessment										
Implied Score								Low A		
Adjusted Score									Mid A	
[1] Metrics include unconsolidated joint ventures										

3 REIT Outlook: Stable

Sector Strengths

- Platforms are stronger than ever: US REITs, particularly investment grade, continue to expand in size, scope and diversity while culling older, less productive assets
- Many REITs have adopted a “back to basics” business strategy through simplified business models, which provides increased transparency
- Liquidity is strong: manageable, near-term debt maturities, ample bank line capacity, large unencumbered asset pools, and access to all capital market quadrants
- Financial flexibility due to balance sheet strength
- Improving operating fundamentals - tracking the U.S. economy as it continues to grow - despite U.S. fiscal drama
- Balance sheets: support growth, but also protect in downturn
- Positive internal growth: increasing occupancies and rents with low new supply
- External growth: acquisitions, redevelopment and selective new development
- Asset type (real property) supports liquidity in distress and boosts bondholder recoveries

Sector Challenges

» Little capacity for cash retention with REITs, especially after accounting for capital expenditures

» Leveraged joint ventures and fee-generation platforms such as investment funds can create complexities, risks and earnings volatility

» Widening risk premia and sharper refinancing difficulties for secondary-quality individual properties, property types and locations of secondary quality

» Consumer sentiment and jobs: affect most sectors

» Higher interest rates– rating holding over short term; potential longer-term issue

» International expansion activities are a moderate risk- generally through JVs and funds

REIT Trends 2009-2014

REITs continued to do the “right” things in 2009-14:

- » Focus on internal (“organic”) growth
- » Sell mature and non-core assets
- » Selectively issue equity
- » Repay/refinance debt
- » Joint venture with institutional investors for value-added transactions

Sector Trends

- Liquidity is strong
- All capital market quadrants available
- Financial flexibility
- Property operating fundamentals are improving
- Rising interest rates will impact fixed charge coverage
- Competitive acquisition market
- Redevelopment/Development (mostly outlets) becoming a driver of growth
- Execution risk related to new markets, new property types, international expansion and new structures

Sector Trends

- Multifamily mergers: Mid-America and Colonial, Essex and BRE, Equity Residential/AvalonBay and Archstone
- Single-tenant net lease corporate acquisitions: American Realty Capital Properties, Inc. (ARCP) leading the charge
- Spinoffs: Simon Property Group, ARCP, Vornado, Westfield
- Investment grade REITs platforms: strong balance sheets, well positioned for interest rate increases
- Simplification of business models enhances transparency

The First Developer

"Someday I hope to have a whole complex of caves."

Trends: What's Next?

- More Spin-offs? (like Simon, ARCP, Vornado, Westfield)
- Succession planning
- Additional bifurcation between strong and weak
- European markets as yet untapped
- M&A – recent:
  - Kite/Inland
  - ARCP closed CapLease and Cole

Appendix: Property Outlooks

1. **Retail**
2. **Office**
3. **Industrial**
4. **Multifamily**
5. **Healthcare**
6. **Lodging**
7. **Specialty REITs**

Retail

Strengths

- Improving fixed charge coverage
  - Operating metrics – occupancy, lease spreads, rent growth, sales PSF - improving in all sub-sectors
  - Dominant landlords regaining pricing power
- Continual new store openings
  - Fresh retail concepts
  - Retailers exploiting opportunities to capture attractive stores in quality locations despite monthly fluctuations in retail sales
  - National retailers becoming more interested in leasing “B” properties
- Restrained development (and mostly redevelopment, except for outlet sub-sector)

Challenges

- “B” and “C” properties still struggling
- Constantly looming internet effect; most retailers and landlords have “omnichannel” strategies to integrate Internet with bricks & mortar store activity

Office

Strengths

- Real estate fundamentals are improving
- Leasing activity is gaining momentum. Tech- and energy-driven markets remain strong; Washington D.C. continues to be soft.
- Development remains at low levels for most REIT office developers
- Asset sales (capital recycling) is a growing source of funding

Challenges

- Labor market indicators and business confidence still tentative
- Development is becoming a key driver of growth given aggressive competition for high-quality office assets; to date, office REITs have employed a healthy balance of funding with equity
- Focus on efficient space usage is creating additional organic supply, and possible obsolescence of older assets

Industrial

Strengths

- Broad based improvement in market fundamentals
  - Room for further occupancy gains but expected to level off after 2014
  - Main focus will be pushing rental rates higher (still below 2008 peak levels)
  - Tenant improvement costs are modest
- Low levels of new construction; focus generally on build-to-suit
- High retention levels, owing to tenant needs for value-added services

Challenges

- Speculative development is picking up in key markets
- Somewhat weak credit metrics – specifically net debt to EBITDA and fixed charge coverage
- JVs and fund businesses still key growth drivers, especially for international strategies
- PMI (Purchasing Managers Index) score is 54.9 (as of April 2014), up from 53.7 in March and compared with 12-month average of 54.4 indicating strength; however, number ranged from 50 to 57 over past 12 months.

Multifamily

Strengths

- » Rental growth decelerating though still solid
- » Declining home ownership supports rental demand
- » Unsecured borrowing model dominates

Challenges

- » GSEs’ future uncertain
- » Supply significant in some markets
- » Weak job market recovery

Healthcare

Strengths

- Most platforms benefiting from scale
- Greater property type diversification and defensive characteristics of property types
- Demographic trends – aging baby boomers, higher life expectancy rates – support demand
- Healthcare reform increasing demand for MOBs
- Development remains modest across most sub-sectors

Challenges

- RIDEA structures, which entail operating risk, are increasing
- Large-scale growth by some REITs; concern over ever-larger transactions to maintain growth rate
- Increase supply in senior housing
- Government reimbursement risk and margin pressure for SNFs
- Tenant/Operator concentrations
- Assets highly specialized

Lodging

Strengths

- Operating fundamentals remain strong
  - Improving transient demand and group demand
  - Rates (versus occupancy) are driving RevPAR growth
- Supply/demand balance remains favorable in most markets; new supply significantly below long-term industry trends
- Development remains modest; financing for new construction is still limited

Challenges

- Sluggish recovery impacting business travel and shorter-term groups
- Modest employment growth affecting leisure segment

Specialty REITs

» Technology Infrastructure
  – Strong operating performance
  – Supply/demand characteristics favorable
  – Significant investor interest

» Self-Storage
  – Resilient cash flows through economic cycles; supply remains constrained but low barriers to entry make susceptible to overbuilding long term
  – Competitive nature of this operating intensive business favors large-scale companies; REIT's vast platforms are providing them with increasing advantage
  – The pace of same store NOI growth is slowing down (tough comps, 2013 saw close to 10% growth)

» Corrections
  – Solid operating performance for private correctional companies
  – Federal and state facilities operating at or above capacity
  – Uncertainty surrounding the potential cancellation of contracts
  – Lack of alternative use

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