



Homer Hoyt Institute

US REITs- REIT Structure and Bond Covenants Attenuate Credit Risk

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"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

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REITs: Historical Perspective and Performance

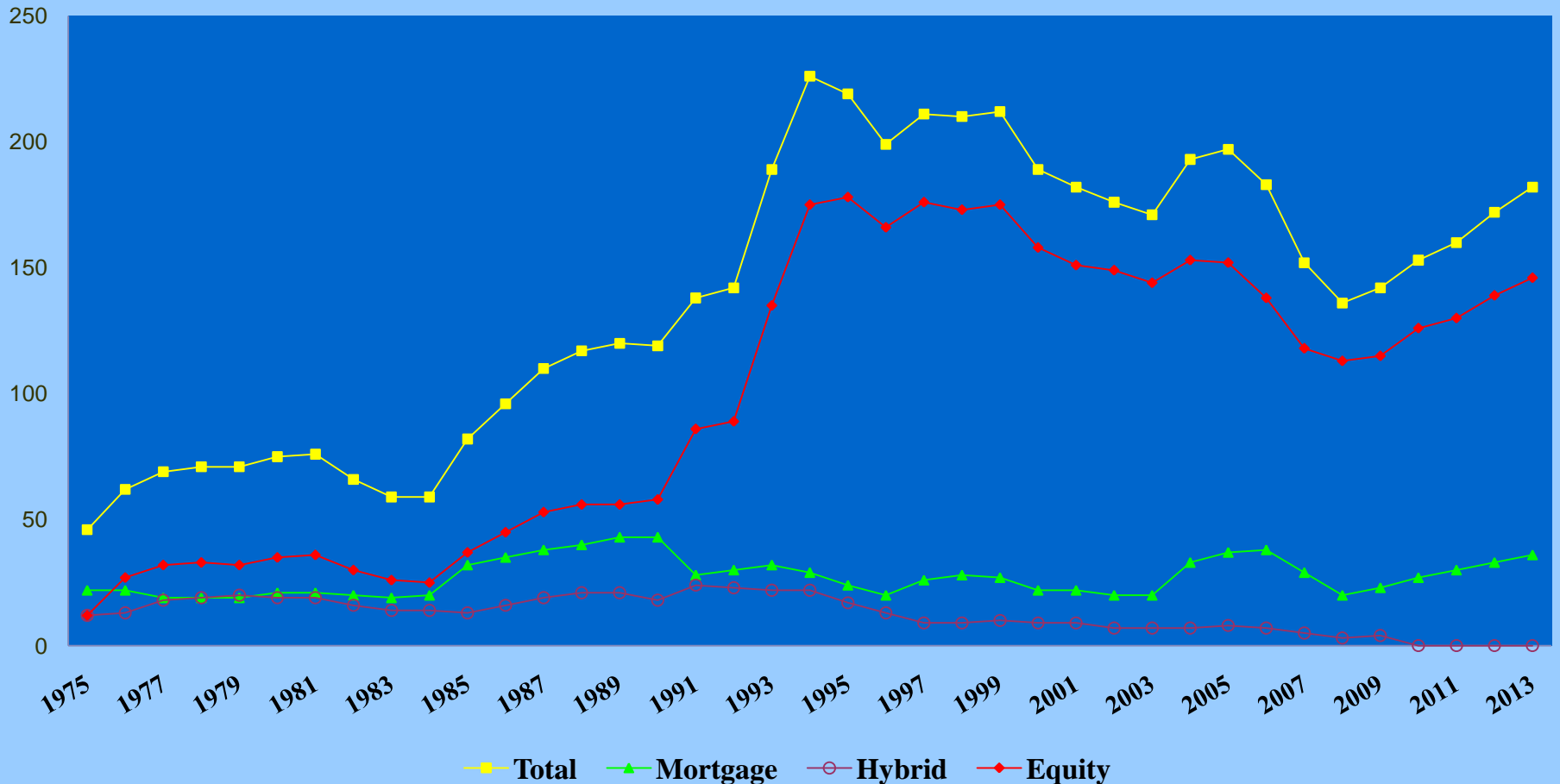
REITs- Definition

- » 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

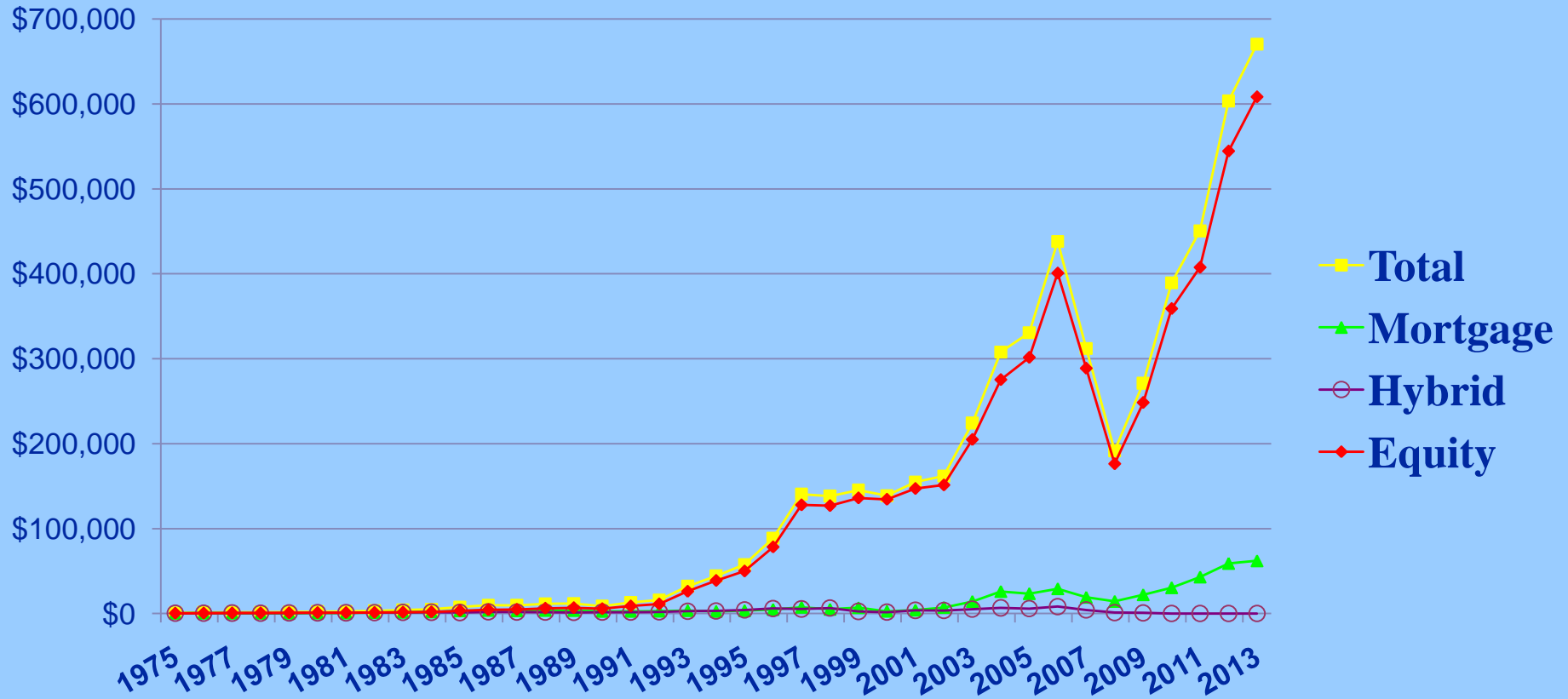
| | |
|----------------|--|
| 1960 | Formed by an act of Congress |
| 1960's | Passive Equity REITS |
| 1969 – 1976 | Mortgage REITS |
| 1970's/1980's | Ignored due to Limited Partnerships |
| 1985 | A few Real Estate Operating Companies |
| 1986 | Tax Equity & Fiscal Responsibility Act Allowed Active 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)

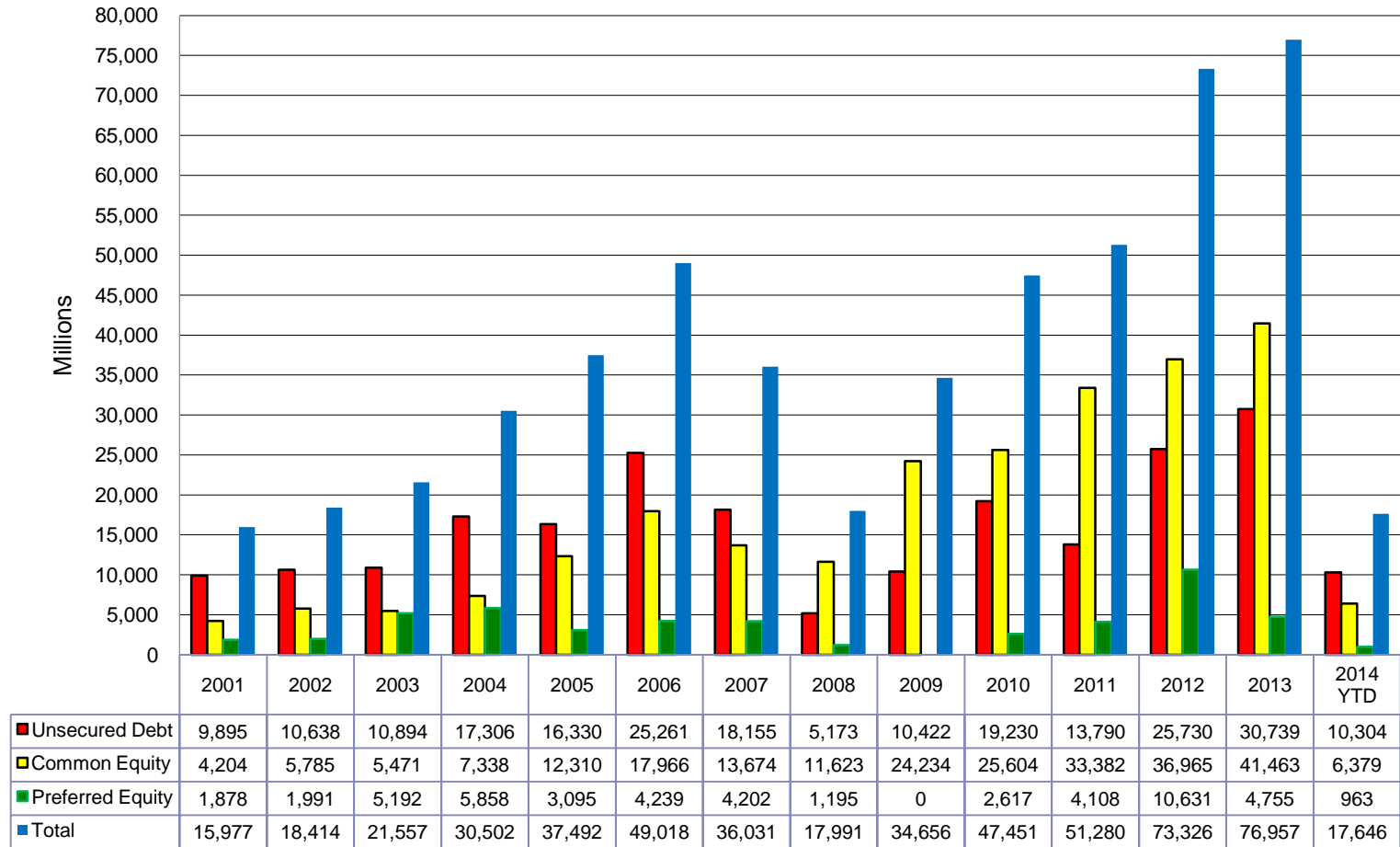


Source: NAREIT (in U.S. \$ Millions) as of YE2013

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

Sources of Financing – Debt and Equity

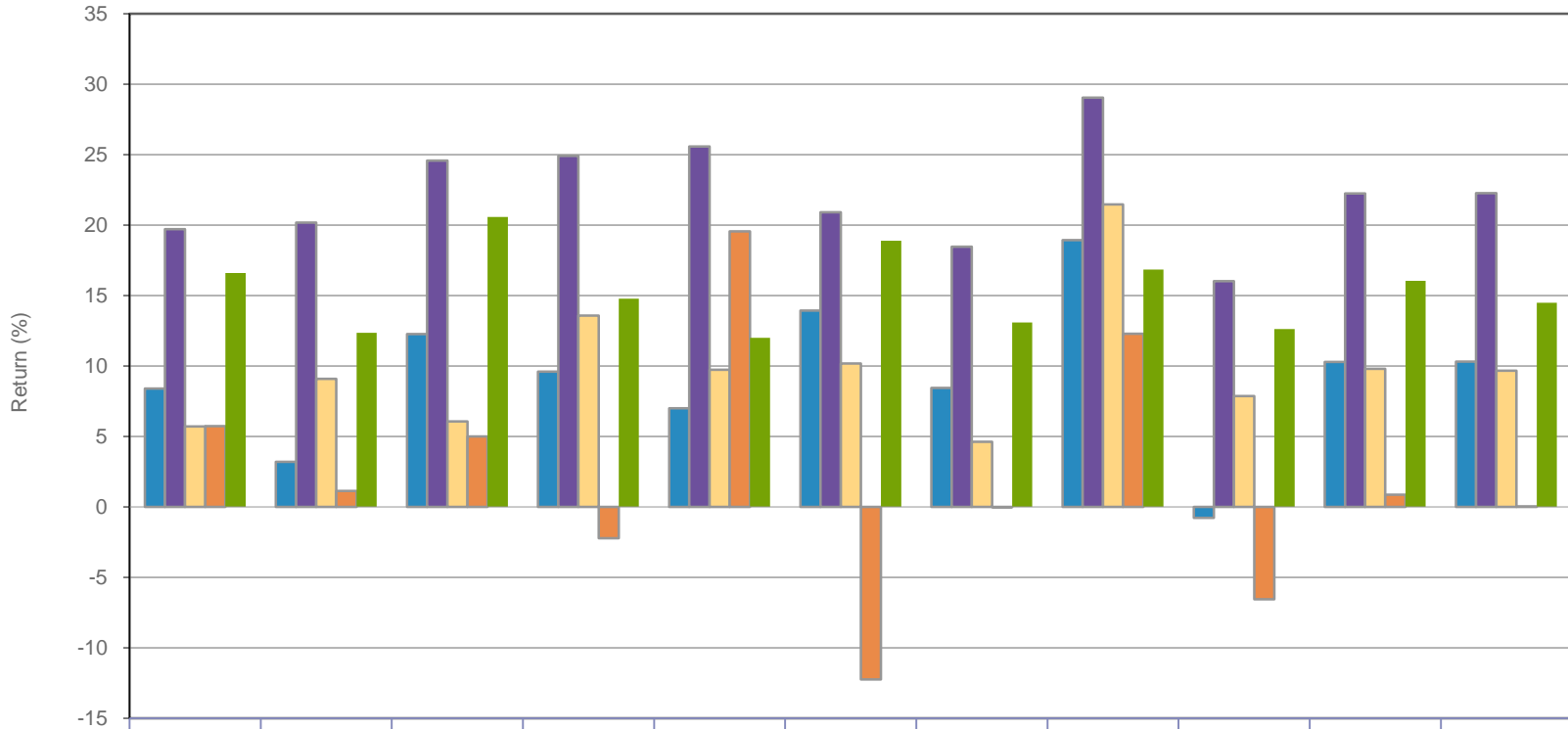
Sources of Financing--Debt & Equity



Source: NAREIT 4/30/2014

REIT Equity Performance

■ 10 year ■ 5 year ■ 3 year ■ 1 year ■ YTD



| | 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

| | <u>REITs</u> | <u>DJIA</u> | <u>NASDAQ</u> | <u>RUSSELL 2000</u> |
|------------|--------------|-------------|---------------|---------------------|
| 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 +/-

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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.k/laat

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

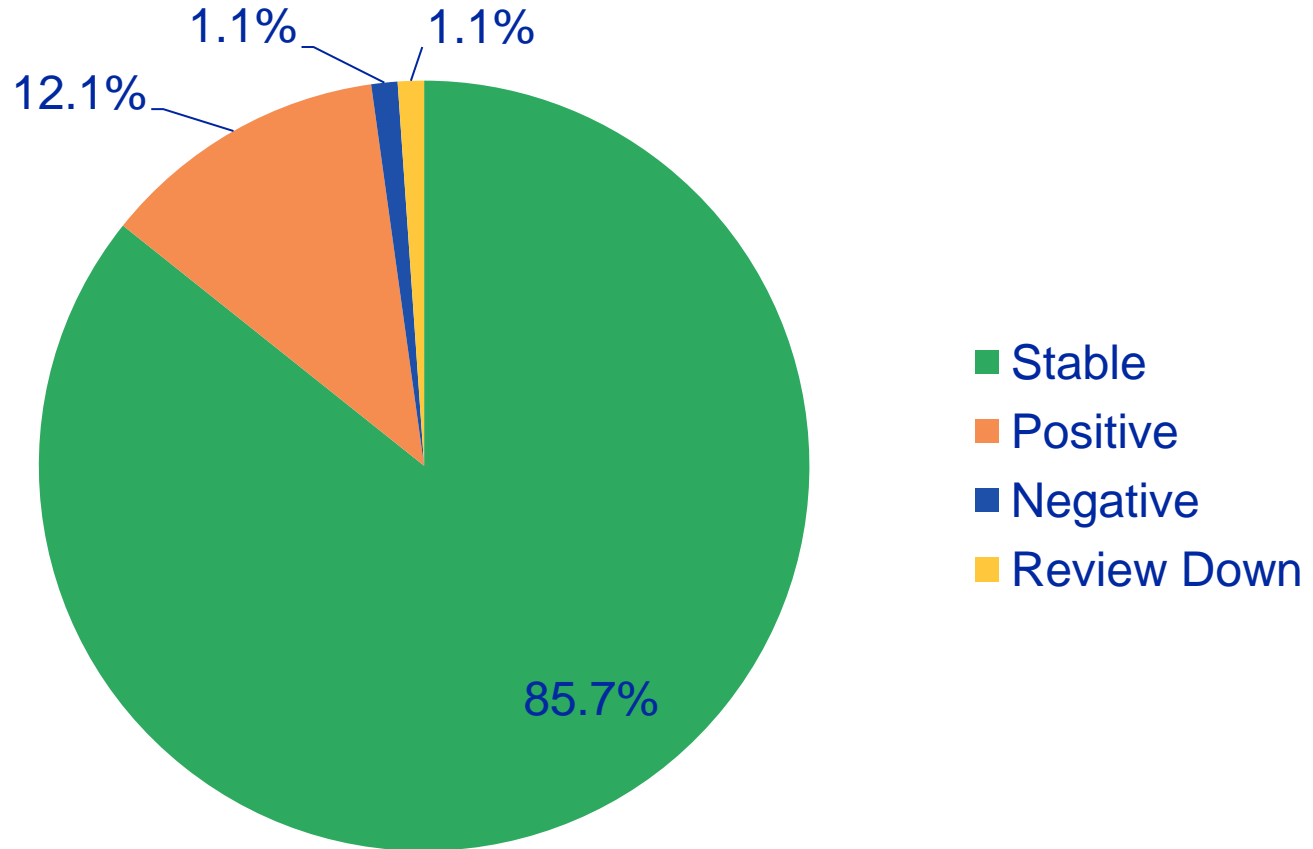
Ratios that Moody's focuses on:

- » 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

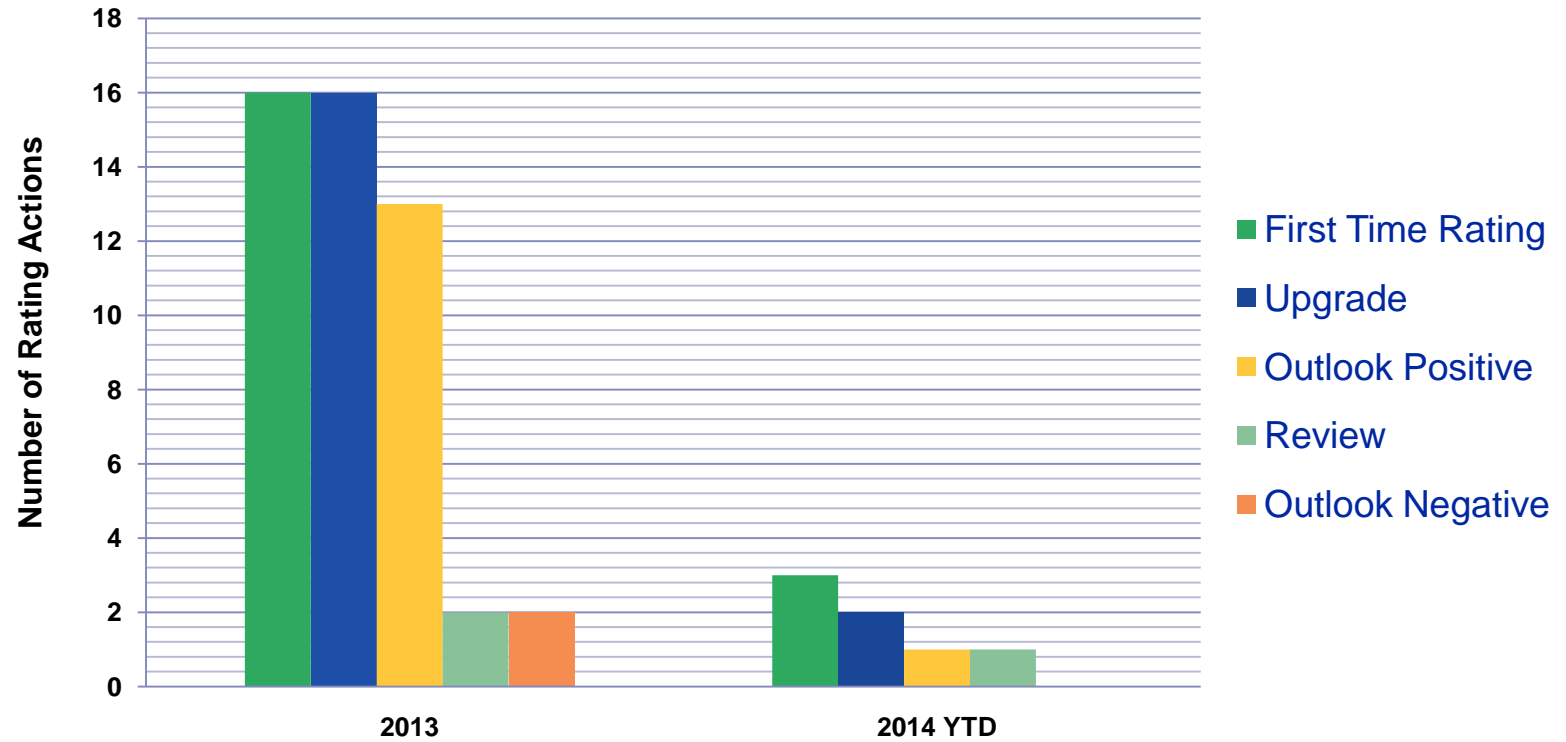
| Sector | Ratings | Market Fundamentals |
|-------------|---------|---------------------|
| Retail | Stable | Stable |
| Office | Stable | Stable |
| Industrial | Stable | Stable |
| Multifamily | Stable | Stable |
| Healthcare | Stable | Stable |
| Lodging | Stable | Stable |

Rating Outlooks – U.S. Rated REITs



YTD March 20, 2014

Rating Actions – U.S. Rated REITs



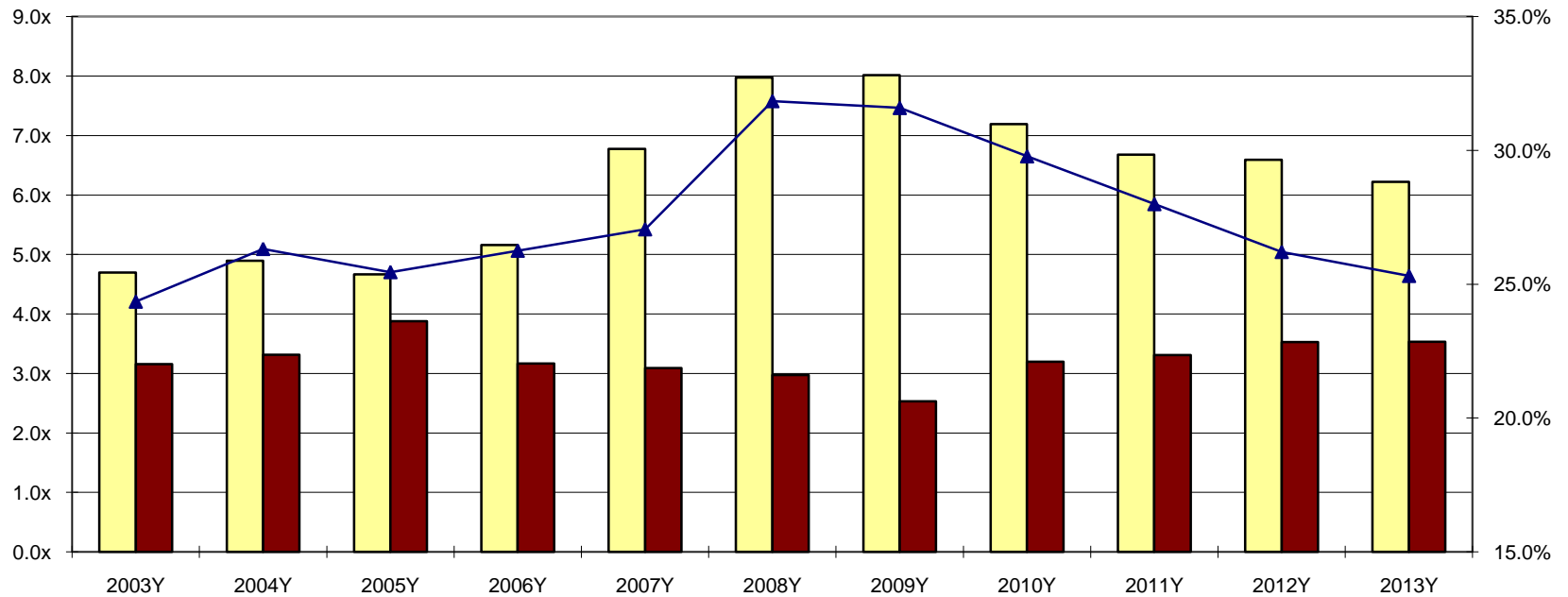
Includes rating actions for U.S. Issuers as of March 20, 2014

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

Leverage & Coverage: All US REITs



█ Total Debt / Recurring EBITDA (x)(L)
 █ Recurring EBITDA / (Interest Expense + Preferred Dividends) (x)(L)
 ▲ Secured Debt / Gross Tangible Assets (%) (R)

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

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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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