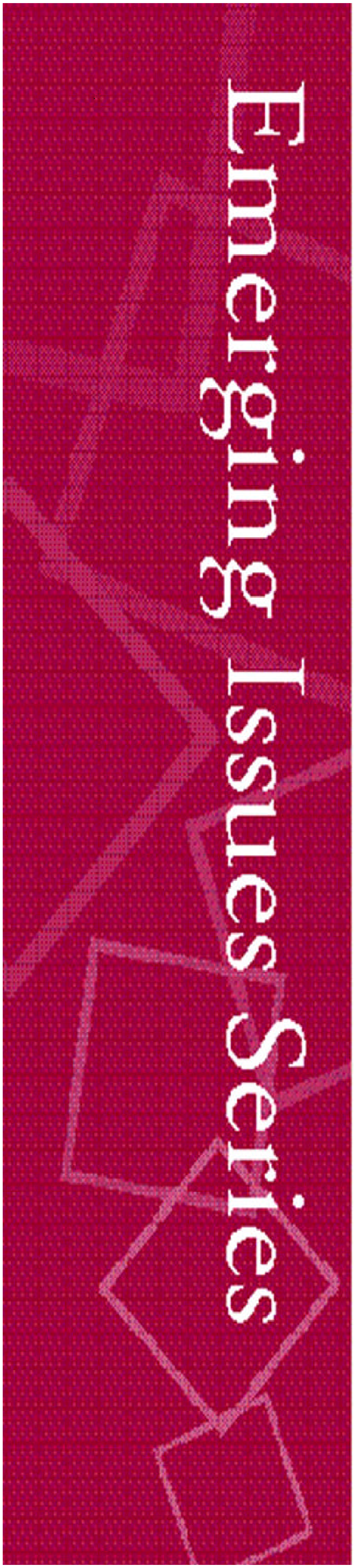
Emerging Issues Series

Points to Consider when Financing REITs

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Points to Consider when Financing REITs

Catharine M. Lemieux and Paul A. Decker[1]

Real estate investment trusts (REITs) have progressed from their infancy as a tax vehicle to an effective way to increase the liquidity, security and performance of real estate investments, especially for small investors. The Federal Reserve System conducted a study of underwriting standards in early 1998 and found that several banks in the sample had rapidly increased their lending to REITs. While there were no substantial safety and soundness concerns with regard to loans currently being extended to REITs, examiners realized that REITs have unique characteristics that lenders need to understand when extending credit. In addition, stock market conditions in the latter half of 1998 greatly reduced REITs' ability to refinance their bank lines in the capital markets. This article discusses risks associated with lending to REITs.

REITs began in the 1960s as a way to provide smaller investors a vehicle to earn the returns from real estate investments normally available only to those with large resources. Provisions of the tax code prior to 1986 made commercial real estate investment tax shelter-oriented. The emphasis was on construction and development rather than developing long-term income generating properties. Initially, REITs could own but not manage property. The Tax Reform Act of 1986 changed the fortunes of REITs as an investment vehicle and forced them to modernize, by reducing the deductibility of interest, lengthening depreciation periods, restricting the use of passive losses, and permitting REITs to manage their own properties. This last provision gave rise to one of the key differences between the REIT of the 1980s and the REIT of the 1990s. The "old" REITs were interested primarily in developing properties for sale, while the "new" REITs intend to hold and manage their properties. They reduced their debt, migrated to public ownership, and changed their focus from tax losses to income generation.

Today's REITs are widely held corporations that are required to invest in real estate and pay at least 95% of all taxable income to shareholders. In 1992, equity market capitalization was less than $20 billion dollars. As of April 30, 1999, it was nearly $145 billion. Today there are over 300 U.S. REITs, 212 of which are publicly traded.

Over 83 percent of all publicly traded REITs are classified as equity REITs, that is, they own real estate assets and their primary source of income comes from the rents earned on that real estate. Most equity REITs specialize in holding particular property types, such as hotels, office buildings, health care facilities, residential properties, industrial properties, or retail properties.

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The National Association of Real Estate Investment Trusts (NAREIT) lists several advantages that present-day, publicly traded REITs offer investors and lenders.

1. As public-traded corporations, they have increased transparency for investors through audited financial statements, compliance with SEC reporting requirements, and compliance with shareholder rights regulations.
2. They are reviewed by ratings agencies, which issue publicly available ratings.
3. Access to equity markets allows publicly traded REITs to operate with less debt. Publicly traded REITs' debt levels average 40% (on a market value basis), compared with 80 percent for the real estate industry overall. The thicker capital cushion helps insulate REITs from market fluctuations.
4. Publicly traded REIT stock allows smaller investors to move in and out of REIT stocks at will, because trading volumes are adequate to ensure liquidity. These advantages are not typically available to individual investors wishing to invest in real estate assets.

However, the REIT structure does present one major disadvantage: the inability to retain capital easily for future growth. Because of this, access to public equity markets has been REITs' lifeblood in recent years. Market access powered REITs' aggressive acquisition of new properties in 1997 and the first half of 1998. Unfortunately, falling share prices during the second half of 1998 slowed acquisitions as the market for equity offerings and debt issuances dried up. An index of REIT stocks put together by NAREIT declined steadily during 1998.[2] A number of factors have been suggested as the cause of decline. Standard and Poor's suggested the following reasons:

- *"High-flying" REITs.* Some REITs had experienced increases in their stock prices due to their aggressive acquisition strategy. This was difficult to sustain in 1998. Additionally, some took advantage of a special structure (paired-shared) to diversify into other businesses. Legislative changes eliminated this organizational structure.
- *Competition from other real estate investors*. Increased liquidity in the real estate sector provided by conventional lenders, Wall Street conduits, and institutional investors served to significantly narrow investment spreads for new acquisitions. Investors became concerned about the price of new property acquisitions.
- *Market instability.* Market fallout from events in Asia caused investors to look for a safe haven in Treasuries. Additionally, the REIT secondary market is relatively small at $47 billion and not as established as the corporate bond market, causing investors to have concerns about liquidity. Statements by some REIT management teams that they were considering taking companies private or permanently abandoning an unsecured financing facility were also problematic.

Investors that remained in the REIT market shifted their focus from REITs that grew through acquisitions to those that focused on managing existing assets.

REIT merger and acquisition (M&A) activity was strong in 1997 and continued in 1998. Prudential Real Estate Investors reported that there were 45 M&A transactions in

[2] "NAREIT Performance Indices," NAREIT Online, http//www.nareit.com.

1998 with a total value in of $34.2 billion, or close to one-fourth of the market capitalization of all public REITs.[3] A survey done by NAREIT in February 1999 found that of the 80 REIT CEOs surveyed, seven out of ten anticipate some sort of involvement with mergers in the next five years.[4] There appear to be five underlying drivers powering these mergers:

1. *Long-term shareholder value and earnings growth.* The past few years have been a period of unusually high profitability among REITs. Unfortunately, given the historical performance of commercial real estate, these returns will be difficult to sustain. REITs have responded to this pressure by aggressively growing their franchises and entering new segments (for example, cold storage). Larger REITs have greater economies of scale, both on the expense side and in their ability to hire specialized management. These economies often allow REITs to add new properties to their portfolio with a minimal increase in costs. Many REITs are looking to consolidation as a means to achieve continued revenue growth through reduced operating expenses.
2. *Maturing commercial real estate markets.* A maturing commercial real estate market implies that many REITs face diminishing growth opportunities in their traditional markets due to increased development costs, more development activity, and rising real estate prices. These factors, along with greater investor selectivity, are forcing REITs to consolidate in order to satisfy market demands for continued revenue growth.
3. *Enhance investor visibility.* Larger REITs need to float larger security and debt issues. Since the market often demands a minimum size before issues can be floated publicly and generate sufficient investor response, larger REITs have greater access to public capital markets. Many REIT managers believe that size also enhances their visibility with investors. More active trading in any debt or equity issues provides increased investor confidence that they will be able to sell their investments at will.
4. *Consolidation as an exit strategy.* Some REITs are using consolidation as an exit strategy, having reached the conclusion that they cannot realize the earnings growth they need to meet market demands. In addition, a trend is developing where private real estate firms are using mergers and acquisitions as a means to go public (Mid-America/Flournoy Development) rather than going through the riskier and more difficult IPO process. Industry experts have indicated that they expect to see more private real estate firms taking this route.
5. *Diversify earnings.* During the recent market turmoil in the latter half of 1998, larger REITs out-performed smaller REITs. Size allows REITs to diversify across regional markets and attain a dominant position in a geographic area. Size also allows REITs to offer related services, such as trash removal or building maintenance, expanding their sources of revenue. Diversifying both geographically and by expanding the sources of income reduces the variability of returns and provides greater assurance

[3] Barry Ziering and William McIntosh. “REIT M&S Outcomes: When to Hold, When to Fold,” Prudential Real Estate Investors Investment Research, Parsippany, NJ, March 1999. http://www.prudential.com/inst/business/prei/itbrz1004.html

[4] “REIT CEOs Forecast More Mergers,” NAREIT press release, March 16, 1999. http://www.nareit.com/press/

that downturns in real estate markets can be weathered.

All of these factors also illustrate why REITs today account for an increasing share of the real estate activity. John Kriz, Managing Director of Real Estate Finance at Moody's Investors Service, explained, "The capital markets have also realized that although REITs still comprise a small proportion of the commercial real estate investment industry, they have a significant impact on the real estate market as a whole. REITs are market leaders, and they will deepen this leadership position over time."[5]

Bank Lending to REITs

Bank loans to REITs are typically moderately sized two-to three-year credit lines that are distributed through the syndication market. Pricing typically is a spread over the London Interbank Offered Rate, ranging from 25 basis points to 200 basis points. Line size as a percent of book value averages approximately 35%, but, on individual credits, can range from 5-90%.

The normal financing pattern for REITs is to finance real estate acquisitions with unsecured credit and then refinance the debt with common or preferred stock offerings or senior notes and subordinated debentures because they lack the ability to retain much cash (95% of income must be distributed to shareholders). The decline in REIT stock prices forced REITs to investigate alternative sources of liquidity, such as asset dispositions, secured financings and joint ventures. The issuance mix of debt versus preferred stock changed from 70% debt in 1997 to 80% in 1998.

Standard and Poor's reports that in 1998 there were 96 multinational and regional banks that participated in rated credit facilities to 76 rated equity REITs. Loans outstanding to REITs have risen rapidly in recent years. The average size of a REIT credit facility increased from $130 million in 1996 and $225 million in 1997 to $300 million in 1998 with some as high as $1.25 billion. In addition to acquiring more debt, REITs began using their unsecured variable-rate bank lines more heavily. Standard and Poor's study of line usage revealed that between the second and third quarter of 1998, usage increased from 42 to 49%. There was also an increase in the number of companies reporting 75% or more line usage, from 12 to 18, which represents over 20 percent of the rated equity REITs in the study.

The increased financing demands for both secured and unsecured credit by REITs will probably continue at least for the near term. The equity market disruptions of 1998 have made many realize the importance of tapping a variety of both public and private funding sources.

Factors to Consider when Lending to REITs

During 1998, the Federal Reserve System study revealed that certain banks had significant exposure to REITs. As a result of that study and a conference of market

[5] Thierry Perrein and John J. Kriz, "US REITs: 1999 Credit Outlook," Moody's Industry Outlook, New York, New York, April 1999, http://www.moodys.com/research

participants and banking regulators held by the Federal Reserve Bank of Chicago in December, several important factors came to light that lenders should consider when extending credit to REITs.

Loans to REITs are real estate credits. Lenders need to follow their risk management policies for commercial real estate credits. They need to know the value of the underlying real estate assets, the trend in property values in that region and for that property type, and the outlook for the sector. Such things as an oversupply in apartment units, growth of online retail, or changes in the Medicare payment system could impact the value of REITs specializing in any of these real estate markets. In addition, lenders should maintain a diverse REIT portfolio and avoid concentrating in any one real estate sector.

Management is the key. Lenders must evaluate management's ability and capacity to successfully operate the entire portfolio of properties and related businesses. A number of REITs are diversifying into non-core real estate businesses (such as cold storage and gambling casinos) as they seek to generate incremental earnings. The concern is that these diversification activities will result in higher leverage while presenting management challenges for which they may have limited or no expertise. When acquiring properties and engaging in new lines of business, management needs to have a coherent investment strategy. It is critical that acquisitions add revenue *and* value. Otherwise, the asset portfolio could be weakened.

Loans are generally short-term and unsecured. Lenders generally expect to be repaid from the proceeds of equity or subordinated debt issues. Therefore, a critical aspect of REIT lending by banks should focus on a REIT's ability to access the capital markets. Events in the second half of 1998 demonstrated how quickly capital markets could provide market discipline to REITs. Moody's reports identified the liquidity squeeze due to falling equity prices as a factor in slowing the growth of the real estate cycle. Several factors influence REITs' access to capital markets.

- *Experience.* Lately markets have been rewarding REITs with strong operating histories and experience and penalizing companies with poorer operating histories and less experience.
- *Legislation.* In late 1998 Congress eliminated the paired-share REIT structure. Many of the rapidly growing REITs had adopted this structure. The success of real estate investment trusts has been strongly influenced by tax and investment legislation.
- *Overall market volatility.* Market volatility in the third quarter of 1999 caused investors to look for safe havens in treasuries, causing the price of business capital to rise. The REIT market is smaller and newer than the corporate bond market and, therefore, more subject to market concerns.
- *Complex structure.* If the market has difficulty determining who is ultimately responsible for a project and the true financial picture, financing will be more costly. Complicated management structures and intricate cash flow channels can obscure the true leverage of the organization. Joint ventures may also fall into this category.
- *Liability structure.* Rating agencies look favorably on a balanced liability structure

but are quick to penalize high leverage. Too much reliance on variable-rate debt exposes the organization to interest rate risk and can lead to a potential mismatch of assets and liabilities. Unencumbered assets allow REITs to qualify for longer-term secured debt, but excessive secured debt causes concerns for unsecured creditors and equity holders. REITs need financial flexibility to weather short-term capital market disruptions. Financing needs in excess of available collateral are penalized by the market.

- *Asset values.* Rating agencies do consider the value of the underlying real estate assets when assigning ratings. A negative outlook for the assets for a particular real estate sector will impact the equity price of REITs investing in these assets.

Lenders dealing with publicly held REITs have the advantage of using the rating agency's rating of the organization. However, the same factors that effect the rating of public REITs also effect the credit quality of privately held REITs. Lenders would do well to consider these same points when evaluating loans to privately held REITs. In any case, ratings alone are not a substitute for careful analysis.

All of these factors relate to evaluating the potential riskiness of the REIT. An estimate of risk is essential to determine the appropriate pricing. Loans to REITs need to be based on both cash flow analysis and collateral values. Assumptions about both need to be stress tested under a variety of economic scenarios. Pricing should reflect the downside vulnerability of any organizations operations.

Summary

If history is any indication, REITs are here to stay. They have endured sweeping tax law changes, plummeting real estate markets, and volatile capital markets. The REIT structure, particularly publicly traded companies, provide some safeguards for investors that do not exist for those investing directly in real estate projects. However, all REITs are not alike. The adoption of a REIT structure will not compensate for bad management, high leverage, or poor market analysis. Loans to REITs are generally unsecured. This means that lenders should be *more*, not less, concerned about cash flow and anything that could impact the ability of the REIT to access long-term capital. The value of the REIT ultimately depends on the value of the underlying real estate assets and, therefore, is subject to all the risks associated with real estate lending. While REIT lending is no more or less risky than lending to other businesses, it requires the same attention to the basics, management ability, and financial performance by lenders familiar with real estate lending.

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