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Viewpoint

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Real Estate Resiliency: the 'REIT Model' Proves its Mettle

Real Estate Investment Trusts (REITs) have not only survived one of the worst real estate downturns in modern history, but have actually been thriving during the past several years. How is this possible, given the depths and persistence of the housing and commercial property market meltdown? In our view, this resiliency can be attributed to a number of attributes, which PIMCO collectively refers to as "the REIT model."

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The evolution of REITs

First, a bit of historical perspective: REITs have their roots in a series of legislative actions (some going back to Massachusetts in the 1800s) designed to open up passive real estate investing to the broader public. The REIT structures allowed thousands of investors to pool their funds together and buy professionally managed real estate – for example, a number of apartments – adding diversification for their portfolios.

Key to the development of the REIT sector was the establishment of REITs as pass-through vehicles – there would be no taxation at the corporate level, with income taxes being the responsibility of the individual unit holder. In turn, the REIT would be required to pay out 90% of available earnings annually in the form of dividends. As the sector matured, we saw the dawning of the modern era for REITs in the late 1970s and especially the 1980s as management of REIT portfolios shifted from external managers to managers affiliated with the REIT, along with the emergence of many of the most well-known and largest REITs we see today.

The emergence of the modern REIT was also marked by a shift in the sources of debt financing for property acquisitions and development away from the traditional model (which consisted of mortgage borrowing against specific properties) to the unsecured debt model that characterizes most large REIT corporations today (issuing unsecured debt that does not involve mortgage borrowing against a specific property).

Given the long-lived nature of the real estate assets underlying the REITs, the most natural investor for the REIT unsecured debt would prove to be insurance companies – investors with long-lived liabilities, many of which were already invested heavily in commercial real estate through their traditional underwriting of property-level mortgages for REITs, and other owners of commercial real estate assets.

The REIT model emerges

While insurance companies were familiar with REITs (and many of their properties and portfolios), they were also comfortable with the property-level covenants typically associated with commercial mortgages: limits on encumbrances, minimum debt service coverage, etc. Accordingly, when a handful of the larger U.S. insurance companies began to look at REIT unsecured debt – i.e. debt issued by property-owning REITS not backed by any specific asset owned by the REIT – they also asked for the same type of covenants that were associated with property-level mortgages. In time, these requirements, what the investors required for a bond issue to pass muster with insurance buyers, began to coalesce into a standard REIT covenant package that typically included certain limits (or "stops") on debt incurrence and limits on unencumbered assets (assets without mortgages).

For example:

- A limitation of total debt incurrence, typically no more than 60% of total assets, though sometimes 65%.
- A limitation on secured (mortgage) debt incurrence; typically 40% of total assets, though sometimes 45%.
- A fixed charge coverage covenant that prohibits further debt incurrence if the fixed charge coverage ratio (interest payments plus preferred dividends typically) is less than 1.5x (the company has earned 1.5 times its fixed costs).
- A requirement that the ratio of unencumbered assets (assets without mortgages) to unsecured debt be maintained at 150% or better.

This covenant package, essentially unique in investment-grade space and more typical of the high yield area, has become essentially de rigueur for REITs that issue unsecured debt. While a number of REITs have tried issuing without the associated package, especially in "bubble" periods, few have succeeded in the face of the inevitable pushback from a firmly established buyer base.

Together with a number of other key factors – including the long-lived nature of REIT leases and the generally higher quality of underlying assets for publicly traded REITs compared those in the private real estate market – the covenant package makes up the basis for what we at PIMCO view as the "REIT model" of fixed income real estate investing.

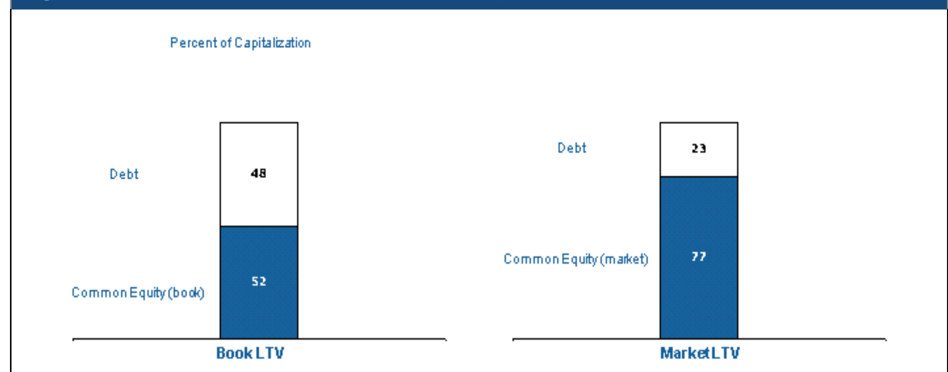
The impact of the REIT Model

Taken together, the covenant package and other elements of the REIT model provided the requisite breathing room that allowed REITs to weather the worst downturn in commercial real estate (CRE) in the last 70 years with only a single REIT filing for bankruptcy protection – one that did not have the REIT covenant package.

As mentioned earlier, by providing a "stop" on debt incurrence, restrictions in the covenant package helps ensure that REITs have much lower debt-to-market value ratios than those typically seen in commercial real estate, which is a leverage-intensive business.

This lower debt provides something of a common "cushion" for REITS. For example, essentially for a REIT like the example shown in Figure 1, a 52% decline in market value would have been required before the unsecured debt became effectively impaired – something that did not occur in a CRE market generally characterized by 35% to 40% declines in market value peak to trough. In the

Figure 1: Effect of the Covenants on REITs: example



Sample for illustrative purposes only.
Source: Company SEC filings as of 3 July, 2012
Debt and common equity shown as a percentage of the total cap structure.

case of this example, this cushion also translates into a lower loan-to-value (LTV) ratio on a market basis, as the market price of equity generally exceeds the book price.

The generally higher-quality nature of the REIT portfolios relative to other private market real estate portfolios helped ensure that: 1) the overall impact of the downturn was muted, as mediocre properties saw vacancies and rent reduction much worse than those that hit class A (the highest quality property class) and other strategically-located REIT properties, and 2) the REIT portfolios generally rebounded faster, as tenants looked to take advantage of the downturn to move into higher-quality facilities.

The fact that commercial leases typically extend for long periods of time helped prevent a deep deterioration in rents for the office and industrial sectors – two areas hit hard by job losses. In fact, some REITs actually saw year-over-year mark-to-market increases in rents for parts of their portfolios as leases from a decade ago were renewed at higher rates.

Collectively, these factors appear to have helped convince debt and equity REIT market investors looking at REIT valuations in 2009 that the REIT model itself was fundamentally sound and valuations were actually attractive when viewed relative to the overall decline in the broader CRE market, as represented by the NCREIF Property Index.

In March of 2009, a series of REITs led by Simon Property Group and soon followed by other key names like KIMCO and Equity Residential were able to successfully generate capital by issuing both debt and equity. While the price to do so in terms of equity dilution and bond coupons was high, the message seemed clear – the REIT model was attractive and might help these companies survive the downturn.

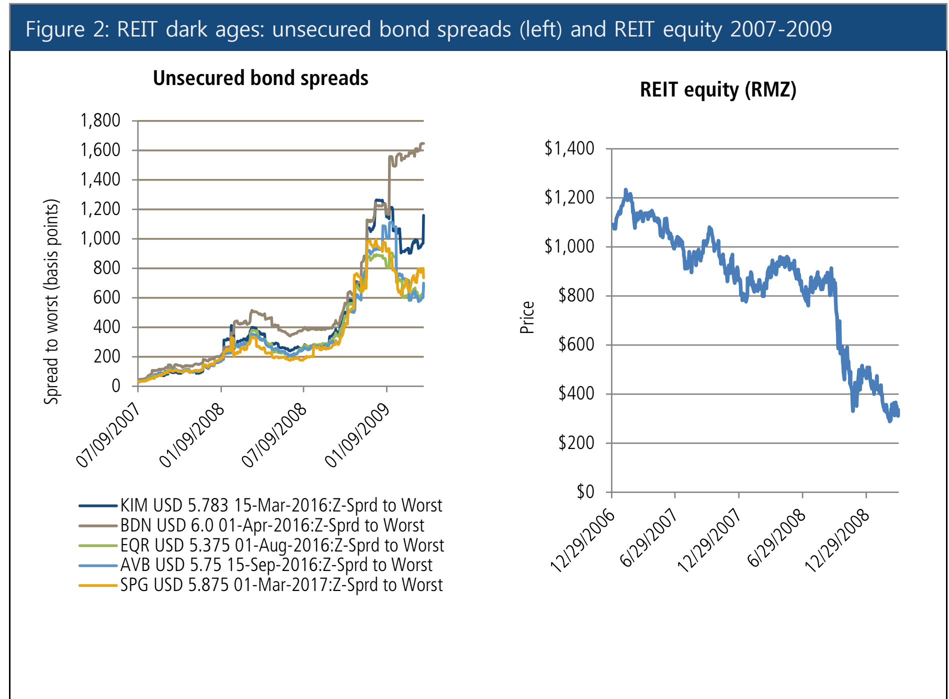
Ruin and redemption

In the early months of 2009 the real estate market plummeted and the REIT sector came under pressure that had not been seen in the modern era. REIT equities were decimated, with various REIT indexes down 70% to 80% and individual equities losing as much as 95% of their value from the highs of early 2007– the height of the real estate bubble. Simultaneously, the spreads on REIT unsecured bonds and credit default swaps (CDS) – the best measure of how the

market perceives credit risk of an individual issuer – blew out by 800 to 900 bps (see Figure 2).

At the time, a prudent investor would certainly have been quite justified in asking: Is the REIT model for publicly-traded real estate investing still viable? Can it survive in the wake of the meltdown of the underlying commercial real estate market itself?

Figure 2: REIT dark ages: unsecured bond spreads (left) and REIT equity 2007-2009

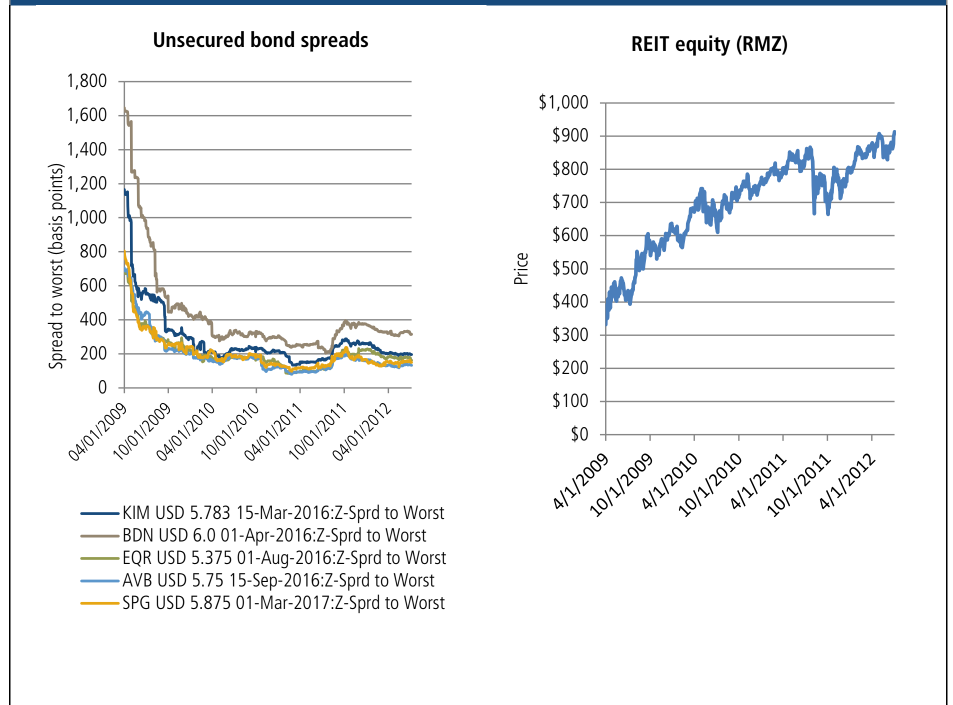


Source: Barclays Capital and Bloomberg as of 3 July 2012
Left chart, **unsecured bond spreads for illustrative purposes only**, based on a representative sample of available REIT bonds with a wide range of credit quality, liquidity and sector representations. The sample was chosen to represent the diverse REIT unsecured bond market. Right chart, REIT equity market is represented by MSCI U.S. REIT Index (RMZ). The index represents approximately 85% of the U.S. REIT universe.

Now, flash forward to the present day.

Not only have REITs survived the recession so far, but two segments of the REIT market in particular have recorded strong performance from 2009 to 2012 (see Figure 3). Equity REITs, which own and manage properties and issue shares to investors to generate working capital, posted strong performance during the "Great REIT Revival" period (see chart on right). And REIT-issued unsecured debt has been one of the best-performing areas of the entire investment-grade credit market (spreads are shown in left chart).

Figure 3: REIT Revival: unsecured bond spreads (left) and REIT equity 2009-2012



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Implications for the future

In our view, the "Great REIT Revival" has been nothing short of remarkable, especially in the context of where things stood in early 2009. REIT-issued bonds have tightened considerably, and now trade fairly vs. other investment-grade bonds, based on historical norms.

It remains to be seen whether the resurgence that began in 2009 has run its course or will continue. Regardless, PIMCO continues to view the REIT model favorably – especially property-owning REITs that issue unsecured debt.

We believe low default rates and relatively high recovery rates, driven largely by the REIT covenant package, make the sector attractive over the long term – particularly for buy-and-hold investors (there will always be a degree of volatility and illiquidity associated with REITs) looking for exposure to commercial real estate.

Past performance is not a guarantee or a reliable indicator of future results. All investments contain risk and may lose value. REITs are subject to risk, such as poor performance by the manager, adverse changes to tax laws or failure to qualify for tax-free pass-through of income. Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk; investments may be worth more or less than the original cost when redeemed. References to specific securities and their issuers are for illustrative purposes only and are not intended and should not be interpreted as recommendations to purchase or sell such securities. PIMCO may or may not own the securities referenced and, if such securities are owned, no representation is being made that such securities will continue to be held.

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The MSCI US REIT Index is a free float-adjusted market capitalization weighted index that is comprised of equity REITs that are included in the MSCI US Investable Market 2500 Index, with the exception of specialty equity REITs that do not generate a majority of their revenue and income from real estate rental and leasing operations. The index represents approximately 85% of the US REIT universe. It is not possible to invest directly in an unmanaged index.

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