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MARSH MERCER KROLL
GUY CARPENTER OLIVER WYMAN

Recapitalization & recovery in the REIT market Back to the 90's

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As we enter the third decade of the modern era of real estate investment trusts (REITs), it appears that the REIT industry is in the beginning of a significant growth stage. Despite unprecedented volatility within the last 24 months, REITs have staged an impressive rebound in the face of widespread concern about their survivability. The industry has raised substantial new equity, albeit at the expense of diluting existing shareholders' value, and it is poised to capitalize on a period many believe will present the best investment opportunities seen in the past 20 years. Of course, for those who have followed REITs since the modern era began (generally considered the early 1990s), this may seem like a repeat performance. While it is still unclear how this REIT rebound will ultimately play out, it is important to note that there are significant differences between this cycle and the REIT cycle of the 1990s.

The market forces that created the volatility within the REIT industry over the last 24 months were of a completely different variety than the forces that dragged REITs into a bear market in 1990. In the late 1980s and early 1990s, overconfident developers, investors, and managers of real estate caused an overheated environment, and massive overbuilding ensued. Investors became concerned that the pipeline of new construction, coupled with already soft real estate fundamentals, would result in poor operating performance. The office sector was a prime example of the excess. According to Torto Wheaton, a provider of commercial real estate research, the office market vacancy rate going into 1990 was about 19%, compared to 2007, when the vacancy rate was about 12%. The rate in 1990 was over 400 basis points above the average rate for the 20 years since 1990, while the 2007 rate was approximately 150 basis points below the average. Looking back, it is clear that the writing was on the wall for real estate to pull back in the 1990s, while in 2007 the signal was not as strong and market supply was more closely aligned with demand.

This time around, real estate fundamentals did not become overextended because of aggressive growth in the real estate industry. Instead, the capital markets shut off REITs' ability to access capital as a result of external shocks, such as the collapse of Lehman Brothers and AIG; the rapid deterioration of the housing market; and the slowdown in global trade. This in turn led investors to zero in on balance sheets, liquidity, and capital availability. Further, investors became highly risk averse, causing a dramatic repricing of risk in all investment vehicles. Of course,

this is not to say that REITs did not bear some of the blame for their own undoing. A number of factors played a role in REITs' exposure to the credit crisis. Specifically, the REITs reliance on short-term financing vehicles coupled with property-level debt led to leverage levels that exceeded loan covenants when valuations took a nosedive. Also, the rapid expansion into markets where management had little previous experience, the reliance on income from cyclical sources such as development fees, and complex structures with investment partners all contributed to investors' dramatic exodus from the sector.

While the aftermath was similar in both of the periods researched, the factors that led to the significant share price declines were different. REITs played a role in both, but investors that were only paying attention to the real estate lessons of the early 1990s likely missed the new warning signs of the most recent downturn.

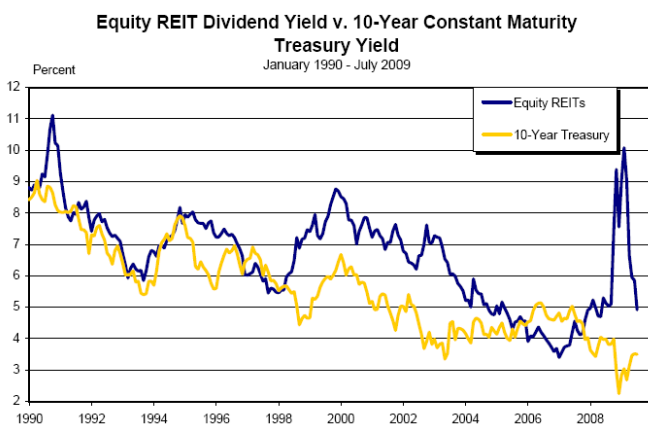
Valuation Drivers

In addition to the impact of financial and real estate markets on REIT share prices, the valuation indicators also provide insight about how REITs have performed over the past 24 months compared to the early 1990s. Several factors are typically considered in order to evaluate the absolute and relative attractiveness of REITs: dividend yields to 10-year Treasury yields, average real estate cap rates to 10-year Treasury yields, share prices to net asset values, and FFO multiples.



Equity REIT Dividend Yield to 10-year Treasury

Yield: The chart below illustrates the historical movement between these two yields, and a couple of observations can be drawn. Investors have required an average yield premium of 106 basis points over the 10-year Treasury yield. In early 2007, however, the REIT dividend yield was a full 100 basis points below the risk-free Treasury yield, indicating that investors had come to view REITs as either an extremely safe source of income or a high-growth vehicle poised for strong future gains. Whatever the reason, just after the dividend yield reached its low point, the credit crisis – and the REIT correction – began. Going forward, tracking the yield premium of REITs against the 10-year Treasury yield could prove to be a good predictor of the overall valuation of REITs.

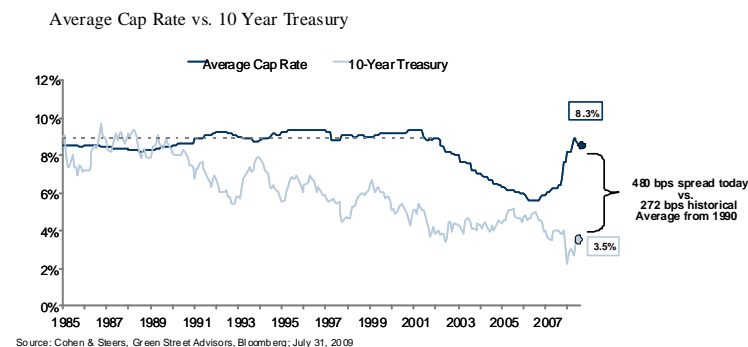


Source: NAREIT

Average Real Estate Cap Rate to 10-year Treasury

Yield: In addition to reviewing the REIT dividend yield to the 10-year Treasury, it is also relevant to compare average real estate cap rates by year to the 10-year Treasury yield to get a sense of the overall real estate environment. The cap rate is a measure of the operating income of a property compared to the property's value. The interest rate environment heading into the downturn of 1990 was materially different from that of 2007, making it difficult to interpret the data based on these spot dates;

however, the long-term trend is helpful for understanding the current environment. As the following chart reflects, the 10-year Treasury in 1990 was between 8.25% and 8.5%, while at the start of 2007 the yield was 4.85% and trended down to nearly 4% by the end of the year. The average cap rate in 1990 was within the range of interest rates, around 8.25%, thus there was no measurable spread. As the Treasury yield drifted down over the next 17 years, the average cap rate remained fairly constant and averaged 8.9%. This led to an expansion of the spread during most of the 1990s and early 2000s, with the largest spreads as wide as 500 basis points in 2001. In 2002, the average cap rate began to drop, and by mid-2007 the spread between the two yields had compressed to a 20-year low of 59 basis points. The average spread over the 20-year period was 272 basis points. While the downward drift of cap rates was warranted because it dovetailed with the risk-free rate, it is clear from the evaporation of the risk premium typically required by investors that real estate pricing became overheated. Further, when taken in conjunction with the REIT dividend yield and its relationship to the 10-year Treasury yield, the data seems to paint a clear picture that REITs had run ahead of fundamentals going into 2007.

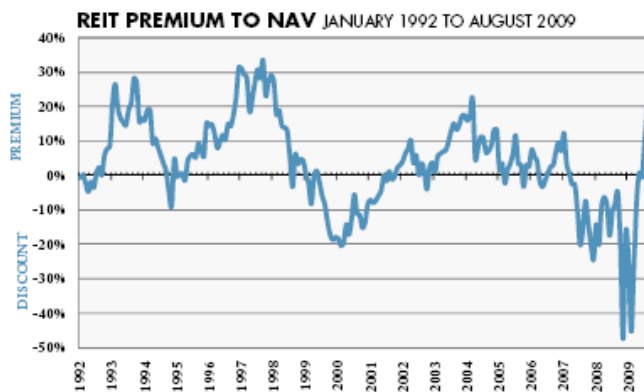


Share Price to Net Asset Value (NAV):

Although the process of determining the underlying asset value of REITs can be subjective and complex, the premium or discount of a REIT's share price to its NAV offers insight about investors' perception of the REIT



industry. The chart below reflects estimates by Green Street Advisors about the value of REIT shares to the value of the underlying assets. While this chart shows historical data points, all of the data points are reflective of Green Street Advisors' view at the corresponding time. Based on these estimates, it is clear that heading into 2007, REITs were overvalued compared to their underlying assets. Taken as a standalone measurement, this is not necessarily a concern since it is reasonable to believe that REITs have intrinsic value that is not reflected in the underlying assets. However, when other measurements are factored in, such as dividend yield as outlined above, NAV lends additional support to the idea that REITs were overvalued heading into the recent downturn.



Source: AEW and Green Street Advisors

Funds from Operations Multiple (FFO): The most telling valuation metric is possibly the FFO multiple for all REITs. FFO, the industry's supplemental performance measure, differs from net income primarily by excluding depreciation and amortization of real estate assets, and gains and losses from most property sales. According to the National Association of Real Estate Investment Trusts (NAREIT), REIT multiples reached 20-year highs at 18.6x in 2007. This compares to the average multiple in 1994 of 10.25x and the average multiple since then of 11.24x. Real estate is not viewed as a high-growth industry,

yet the multiple in 2007 implied that investors believed that the industry could sustain the rapid growth experienced since 2005. In fact, as the multiple was continuing to trend upward, the S&P 500 multiple was beginning to show downward movement, indicating potential economic weakness on the horizon. This should have also indicated upcoming weakness for the commercial real estate market.

During the most recent downturn, REITs dropped to a multiple of 6.68x in the first quarter of 2009, which was a low not seen over the last 20 years. The upside correction that occurred since first quarter of 2009 brought the multiple to just over 10x, which is closer to the historical average. Given that the near-term outlook for commercial real estate fundamentals is weak, we expect the multiple to generally trail the 20-year average until the property markets bottom.

Hindsight is always 20/20, and while it is easy to compare measurements today that seem to suggest that real estate – and REITs in particular – were overvalued heading into 2007, we must keep in mind that real estate had outperformed most other asset classes for nearly two decades. Throughout this time period, property markets were generally stable and the residential real estate debacle had not yet completely engulfed the economy. Finally, the Federal Reserve kept interest rates low, as reflected in the historically low 10-year Treasury yields, which provided an extremely cheap and abundant source of capital for the commercial real estate market and resulted in lower return requirements. Each of these factors contributed to masking the escalating valuation of REIT shares.

REITs Respond

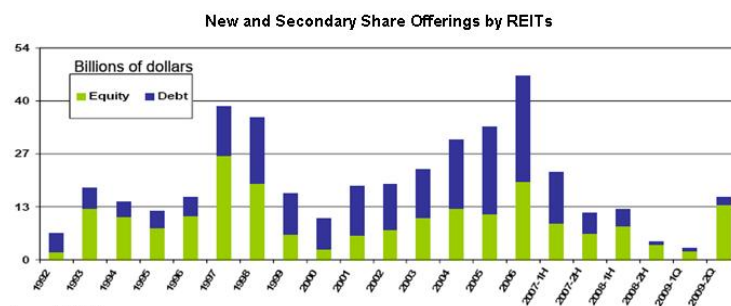
As highlighted earlier, the market overindulgences that disrupted the REIT parties in the late 1980s and over the past 24 months were fundamentally different; however, the REIT response during both periods has been relatively similar but because of the evolution of REITs, some priorities have changed. Before



comparing the two responses, it is helpful to look at a few issues REITs overcame during the early 1990s. At that time, REITs were still a relatively new investment vehicle and were fighting to command attention from both institutional and retail investors. In order to attract those investors, structural changes were implemented in the late 1980s and as those changes came to fruition, investor receptivity increased. No longer were investors concerned about conflicts of interest between REITs and their advisory committees. Further, REIT management teams performed well during the preceding bull market, and uncertainty over their experience and capabilities diminished. Investors were beginning to view management teams in a whole new light. Their narrower focus, compared to private market investors', on geography or property type fueled the belief that a sharpshooter approach would create synergies and access to opportunities that private investors could not match. Today, REITs are regarded as having superior management teams because of their targeted focus, and the alignment with shareholders is strong because insider share ownership is high. The inclusion of REITs in the S&P 500 Index proves that REITs have become accepted as an investment vehicle, and average daily trading volume within the industry is between \$3 billion and \$4 billion. REITs no longer have to fight for a seat at the table, which is an important difference between the two time periods.

REITs have addressed the current crisis in a number of ways that are similar to those tactics used in the early 1990s. A number of REITs have raised equity, made dividend cuts, attempted asset sales, obtained unsecured lines of credit, or slashed headcounts. However, the strategy that has had the biggest impact to date has been the equity raise. Over the last year, a considerable number of REITs have successfully issued new shares to raise equity, and as depicted on the chart below, over \$15 billion has been raised in over 60 secondary offerings in 2009 for equity REITs. This compares to the same strategy REITs employed in the early 1990s, when in 1993 nearly \$4.0 billion

was raised by existing equity REITs and in 1994 another \$3.9 billion in follow-on offerings were made. The total amount raised in 1993, both new and secondary offerings for equity and debt REITs, was more than the combined amount raised in nearly 15 years and helped increase the size of the industry by nearly 70% according to NAREIT.



Source: NAREIT

The impact of the equity injections in the early 1990s certainly helped REITs post strong returns in the short term and strengthened their balance sheets for the long term. The impact of the injection of equity on the financial condition of the REITs in today's market has resulted in a similar pattern, with a strong uptick in share price and an apparent reduction in debt loads. REITs have seemingly regained stability, and with the media headlines generally proclaiming that the recession is over, REITs appear to be a good way to ride the impending recovery.

A closer analysis of recent performance reinforces the broader picture. Soaring stock prices have minimized the expected dilution from the equity raises. Prior to issuance of new equity, the amount of the equity raised represented a 23% dilution based on the market cap of the companies at that time. After the issuance, the equity injections resulted in only a 3.4% dilution to shareholders due to the dramatic share price increase. Further, REITs issuing equity enjoyed a 5.4% one-day price gain the day following the offering, and have since outperformed the greater REIT index by an average of 4.5% through July. Clearly REITs and their shareholders have been rewarded.



However, the REIT market is not all rosy, and despite the positive reception thus far, concerns remain – specifically regarding overall debt. In comparing the before and after debt ratios of the REITs issuing equity this year, the overall debt-to-asset value before issuance was approximately 62% and after the issuance is 53%, as reported by NAREIT. While a step in the right direction, this is still well above the target debt load of REITs (around 30% to 40%), and will likely rise again because of the high probability that the full impact of declining property fundamentals has not yet been priced into REITs. Over the next year, the debt ratio will likely crawl back up over 60%, as NOIs continue to deteriorate – potentially by as much as 15% – which may lead to downward pressure on share prices.

It remains to be seen how much more equity REITs will raise over the near term in the face of declining fundamentals. During the equity raise boom of the early 1990s, investors waited until it appeared that fundamentals had bottomed out before injecting fresh equity, but this time around, early movers appear to be rushing in to take advantage of a possible rebound in the real estate markets. Real estate lags the economy, and with no clear evidence that the economy has hit bottom, it is certainly too early to call a bottom of the real estate market. Further, after the two years of new equity issues in the early 1990s, the REIT market experienced a two-year period in which it trailed the broader markets.

Outlook – Challenges & Opportunities

Despite the recent uptick that REITs received in the market, challenges still lie ahead. Near-term concerns over balance sheet health were somewhat alleviated with the \$15 billion in equity issuance during 2009, but anxiety still surrounds the capitalization health of some of companies. Going forward, companies wanting to raise more equity without diluting shareholders' interests will face a delicate balancing act. Stock price increases have offset shareholder dilution thus far, but if REITs turn

back to the equity markets, the concern remains. Even though this real estate downturn has been touted as a result of the debt and capital markets, and not born out of oversupply (as in years past, as highlighted previously), a supply problem could arise if the housing market and consumer spending markets come back smaller than before. We believe that generally the recent share price increases represent a near-term high for the industry and that over the next year, absent significant changes in US and global economic growth projections, REIT shares will likely show little appreciation.

The near-term focus will be on those factors that could cause further deterioration in valuations. As a result, we expect that individual company valuations, real estate fundamentals, and FFO growth – and not necessarily sector positioning or overriding themes – will be the drivers of performance. Many REITs have portfolios of high-quality assets with good management teams in ideal locations, and should outperform when the economy rebounds. The rising tide has lifted all boats during the recent run-up, but not all REITs deserved the bounce and we expect some turbulence over the next 12 months. In general, we expect FFOs to remain flat over the next year as REITs struggle to maintain operating performance because of the strong headwinds from poor real estate market fundamentals. We do not expect the REIT market as a whole to consistently outperform the broader equity market and fixed income market as it had done for the past 20 years, but we do expect there to be pockets of opportunity. Skilled investors with access to robust capital market and property market data will be in a better position to capitalize on those opportunities – it will truly be a stock picker's market.

In addition to external pressures on REITs, governance concerns could weigh on the industry over the near term. While REITs have generally come to be viewed as exhibiting strong alignment of interest with shareholders, the use of private funds sponsored by public REITs may test this view in the



years ahead. Over the past 5 to 10 years, a number of the largest REITs have created separate private funds that provide another avenue by which institutional investors can gain access to a REIT's management capabilities. During the capital wave that engulfed REITs over the last decade, these vehicles have generally coexisted in harmony and represented disparate strategies. Little internal conflict existed regarding how to allocate resources, since deals were abundant and share prices were soaring. As an example of the structure: Some REITs became almost exclusively reliant on development as a means to generate fees and high-appreciation returns for shareholders. These REITs would also sponsor a private institutional fund that would invest in more stable investments with a focus on current yield, and possibly act as a takeout vehicle for the public REIT's development projects. The public REIT would generate fees by charging the private fund for access to human capital and expertise, as well as receive a return on invested capital in the private fund. Now, because real estate investment opportunities are scarce and are likely to remain so over the near term, the question will be whether REITs can satisfy investors that there are enough opportunities to drive returns in both the public REIT and private fund without internal conflicts. With opportunities in short supply it is conceivable that the clear lines once established to define strategies will be blurred in the hunt to place capital. As the markets move forward and opportunities remain scarce, and with investors ever more attuned to governance and corporate transparency, it may be difficult for REITs to convince investors that these two investment conduits can coexist without internal conflicts of interest.

As we look beyond the challenges that lie ahead, opportunities exist that could lead to strong growth for the REITs industry. Potentially the greatest opportunity for growth will result from the pending meltdown in the commercial mortgage market. With estimates projecting over \$1.2 trillion in commercial real estate loans coming due in the next four years, it is expected that some properties will be brought to the

market by borrowers unable to secure additional financing or loan extensions. Capital for commercial real estate will remain tight, and with many institutional investors sidelined for the time being, REITs with balance sheet strength will be in a position to take advantage of the opportunities. As a majority of this debt is tied up in private real estate assets, REITs may provide a recapitalization solution for the private market, just as they were in the mid-1990s. It should be noted, however, that the wave of defaults has yet to materialize and the federal government is working overtime to create mechanisms that will prevent the anticipated crises. While we believe that ultimately assets will be sold because of duress, the exact size and timing of the opportunity are still unknown.

The US government has created two programs specifically designed to reduce the expected tidal wave of defaults. These two programs are the Term Asset-Backed Securities Loan Facility (TALF) and Public Private Investment Program (PPIP)¹. REITs that own sizable portfolios of only one or two property types are expected to be among the first participants to take advantage of these programs. The programs were created to infuse activity into the CMBS and RMBS markets by providing government financing for the purchase of troubled assets, and to restart the secondary markets to support primary loan originations. Although considerable time has been taken to get the programs up and running in the commercial real estate market, the anticipation of improved liquidity from the programs has provided a boost in prices, and compression of spreads on existing CMBS. This has served to bring down overall borrowing costs, which will benefit the REIT market in the future.

A final opportunity for US REITs may be a return to global investing. Most recently, the hot topic of "going

¹ For more information on the PPIP program, please refer to Mercer's white paper regarding the program.



global” had been put by the wayside as domestic portfolios have been tended to and repaired. However, economists are generally projecting that global growth will outpace that of the US, and we believe that correspondingly there should be great opportunities for investment in global real estate securities. As the global credit markets recover and countries continue to establish and adopt new REIT legislation, investors will continue to benefit from greater regional diversification and the ability to gain access to global markets through a more liquid means than with traditional direct real estate investing. As REITs have strong management teams and a history of success in public markets, there will likely be opportunities for growth – if not from direct property investments, then as capital providers to emerging foreign-based REITs.

While we have learned lessons from the REIT markets of the past, as we move to another point in the market cycle, inevitably new lessons will be learned and old lessons forgotten. It is certain that in the future we will look back on this period to gain insight on strategies implemented to address issues, and the relative success of each strategy. While we can only speculate about how the future will look and the lessons that will be learned, it appears certain that REITs will be major players in the shaping of the real estate industry for years to come.

David Nix

404 442 3259
david.nix@mercer.com



David is a member of Mercer's Manager Research Real Estate Boutique. His primary responsibility is leading the firm's research and analysis of North American based value-added and opportunistic real estate funds for recommendation to Mercer's investment clients. He has over ten years of experience deploying capital in the four quadrants of real estate investing and along the entire risk spectrum.

Michelle Reuter

312 917 9221
michelle.reuter@mercer.com



Michelle Reuter is a member of Mercer's Manager Research Real Estate Boutique. Michelle is responsible for primary research on global and domestic real estate securities investment managers. She provides support and recommendations on investment managers to Mercer's Global Property Manager Ratings Review Committee.

About Mercer's Real Estate Boutique

Mercer's real estate boutique consists of 22 professionals located in the US, UK, Australia and Hong Kong. We have been advising clients on real estate for over 25 years. Our real estate coverage extends to more than 900 strategies from more than 300 managers. For more information, please contact Allison Yager at 404 442-3258 or allison.yager@mercer.com



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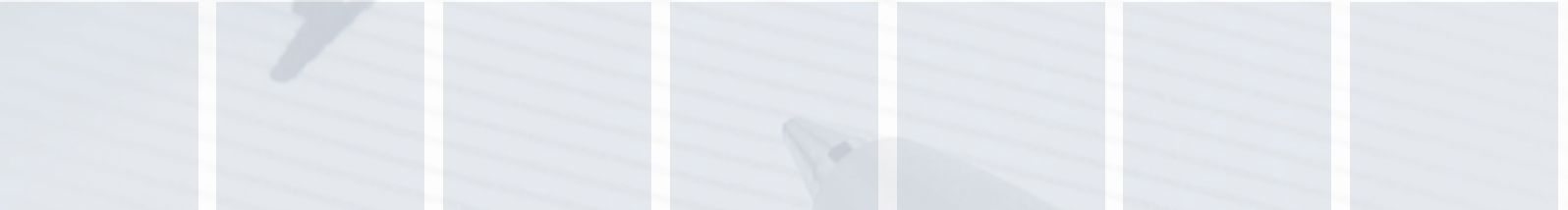
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MARSH MERCER KROLL
GUY CARPENTER OLIVER WYMAN



Mercer
1166 Avenue of the Americas
New York, NY 10036
Tel +1 212 345 7000