IS THE REIT PARTY OVER?

By Patricia L. Kirk

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After three years of rising valuations, record-low interest rates and staggering investor demand, retail REITs, like all commercial real estate, seem poised for a fall. But until a viable alternative investment emerges, the smart money is staying right where it is.

By any metric, REIT shares are overvalued. This has led several influential analysts, including Citigroup Smith Barney's Jonathan Litt and Morgan Stanley's Greg Whyte to downgrade the sector in recent months. The Fed's decision to raise rates also caused tremors, briefly sending some investors fleeing from REITs.

“The group is now overvalued and is due for a pause in total returns as earnings catch up with extended valuations,” Litt wrote. He predicted that REIT stocks will forfeit gains over the next year, with share values dropping 5 percent.

Almost all retail REITs have reported steady upward movement in per share returns on FFO (funds from operations). Developers Diversified Realty Trust, for example, posted a 31.3 percent increase in stock price between the second quarters of 2003 and 2004, leading shopping center REITs, according to a report from Prudential Equity Group LLC. Federal Realty Trust's stock increased 28.1 percent during the same period and Kimco Realty Corp. was up more than 20 percent.

The failure of alternative investments to rebound in 2004 has enabled all REITs to continue their surge. Overall, REITs are up 15 percent year-to-date, and continue to outperform other equity market stocks, according to a Citigroup Smith Barney report.

Many analysts argue that the current rate of growth in the retail REIT sector is not sustainable. Litt points out that this is particularly true of the regional mall business, which has limited capacity. “Occupancies are nearing peak levels and releasing spreads will be facing tougher comps,” he says. Similarly, Prudential has maintained a neutral rating on the retail REIT sector, despite its strong performance over the past year. Prudential analysts based the rating on the sector's performance historically, as well as a predicted slowing in growth of profits for the REIT industry overall.

While agreeing that REIT stock is overvalued, other analysts contend that a strong economy will benefit REITs as much as other sectors. Morningstar senior analyst Dan McNeela notes that REITs are dependent on job growth to stimulate better earnings, which will help fill apartments, offices and other commercial space.

Retail REITs are at the center of real estate's continued strength with the sector's fundamentals far surpassing other categories of commercial real estate. Until those areas — namely office, multifamily and industrial — show occupancy and income growth, retail will remain the investment of choice.

“Right now we remain overweight in retail REITs,” says Nancy Holland, head of American property for ABN-AMRO Asset Management LLC, which manages a real estate fund. “We are looking for sector rotation. It's just that the economy is not growing as robustly as everybody had envisioned.” Holland, however, does agree with some that retail as a sector may be overvalued. The strong run by retail in comparison with other classes means that it has less upside going forward. The sector will continue to make money. It may just be outpaced.

Gwen MacKenzie, vice president of Sperry Van Ness believes people will continue to favor retail REITs even if the stock market stabilizes and T-bond yields rise. “REITs have good corporate governance and strong fundamentals,” she says.

“These are well-run companies,” adds Steve Algermissen, senior director of Cushman & Wakefield's Financial Services Group in Los Angeles. “Their operations are more efficiently run than in the past, and I expect them to grow from both development and

acquisitions."

REIT Execs Strike Back

At the heart of retail's robust record has been the sector's ability to raise rents. That's something that hasn't happened in other commercial real estate arenas. Even with a lot of new retail product coming online, retailers are still vying for the limited space in the best properties and strongest markets.

Both David Jacobstein, president and COO of Ohio-based Developers Diversified Realty Corp., and Steve Sterrett, chief financial officer for Indiana-based Simon Property Group, say rent increases on lease rollovers are significant sources of higher profits.

Developers Diversified rent increases average 22 percent for new leases and 8 percent for renewals, because occupancy is up to 97 percent from last year's high of 94.4 percent.

"We roll over 15 percent of our portfolio each year, so that's a big growth factor," Jacobstein says.

Similarly, Sterrett reports that his firm's rents are up 20 percent to 25 percent for all new and renewed leases.

"We like the long-term growth potential of the regional mall companies," Holland adds. "We like the rental improvements they are going to have as leases continue to roll over. … There are very strong fundamentals."

Also, though low interest rates have been a boon to real estate, enabling REITs to refinance their debt and helping to drive investor demand for property. Retail REIT executives say they are not concerned about rates reversing course either. They note higher interest rates signal a strong economy, which is good for business. Additionally, as a group, the retail REITs are not heavily leveraged and have locked in low fixed rates on much of their debt.

Strong balance sheets have helped retail REITs fund new development and acquisitions. Developers Diversified funded about 12 percent of its ground-up development from its own profit. The company has also been able to parlay its strong track record into accessing new sources of capital. It has formed a joint venture with Macquarie Bank of Australia and expanded its relationship with Coventry Real Estate Advisors to fund 80 percent of its value-added opportunities.

Aside from development, retail REITs have continued to consolidate through one-off and portfolio acquisitions and mergers with other firms. This year witnessed several high-profile mergers. General Growth Properties Inc. closed the biggest REIT merger ever with its $12.6 billion acquisition of the Rouse Co. Developers Diversified purchased Benderson Development Co. and gained a portfolio of 110 centers, with a total of 18.8 million square feet, for $2.3 billion. Simon bought Chelsea Property Group Inc. for $3.5 billion and gained a portfolio of 60 outlet centers, with 16.1 million square feet. This trend is likely to continue.

"Ours is a mature industry, and mature industries tend to consolidate," Sterrett says.

Bank of America Securities analyst Ross Nussbaum recently drafted a list of 10 more REIT merger targets. In the retail sector he identified Macerich Co., Pan Pacific Retail and Taubman Centers as potential prey.

But with so many of the largest players in the process of digesting new assets, are there other REITs in a position to make big deals? Holland points to shopping center giant Kimco Realty Corp. as a potential buyer along with CBL & Associates, Mills Corp., Regency Centers and Pan Pacific.

"There are other companies that can buy," Holland says. "Will they do that? It's probably unlikely given the rich valuations we're seeing for properties today. It just really doesn't add a lot to the bottom line to do these big deals."

Instead, REITs with the strongest numbers are continuing to build new centers while expanding into new retail categories or across borders. Algermissen notes that active retail REITs are developing new projects, while renovating and re-tenanting existing properties.

For example, California-based Pan Pacific is focusing its growth on its core asset type: drug- and grocery-anchored neighborhood centers.

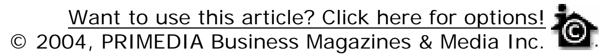
"We believe smart management teams stick to core assets," says Stuart Tanz, Pan Pacific president/CEO. "Pricing is at historic levels in terms of cap rates. From our standpoint, it's better to grow earnings in this environment by buying and selling assets — what we call 'churning' our capital, getting rid of non-core assets and re-deploying capital in assets with more growth potential."

He adds: "That's what is different about us. We will continue to focus on growing centers that provide everyday essentials."

Additionally, retail REITs are going overseas, "trying to make their expertise work in other countries," says Algermissen.

Simon has interests in Puerto Rico, Poland, France and Italy. The company acquired four assets in Japan, when it picked up Chelsea's portfolio. General Growth has formed joint ventures with Latin American firms, investing in two regional malls and a property management firm in Brazil, and is building a 500,000-square-foot regional mall in Costa Rica.

This is another trend that's likely to continue, MacKenzie says. "Most areas are built out for malls, it's hard to get entitlements, so mall REITs will have to cross borders to grow." Jacobstein admits that his firm is looking at opportunities in other countries along with everyone else. But he says, "We're inclined to stay in North America, rather than going to Europe, Asia or Latin America."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