

# Why Investors Are Still Betting on REITs

WITH OTHER ASSET CLASSES FALTERING, REITS REMAIN HOT. BUT ARE VALUATIONS OVER-INFLATED?

By Nicholas Yulico Illustration by Todd Umbarger

**B**y all accounts, real estate investment trusts find themselves in the proverbial sweet spot. The moderate, albeit choppy, economic recovery has helped boost real estate fundamentals while simultaneously capping any rally for the broader equities market.

In fact, the REIT market has outperformed every broad market index since 2000. The only exception was 2003, when the Nasdaq Composite Index shifted into recovery mode, beating REITs, according to research firm SNL Financial. In 2003, the Nasdaq finished up over 50% on a price basis only. The total return for the Morgan Stanley REIT Index was nearly 27%.

So far this year, REITs remain hot. As of mid-October, the Morgan Stanley REIT Index had posted a total return of 17.8% year-to-date, while the S&P 500, Nasdaq Composite Index and Dow Jones Industrial Average were all in the red (*see chart, p. 22*).

So, it's little wonder that both institutional and individual investors continue to place their bets on REITs. With returns on other asset classes falling, investors have been pouring money into REITs and

driving up prices.

Last year, a record \$4.75 billion flowed into real estate mutual funds, according to AMG Data Services. Through September of this year, investors have plowed nearly \$4 billion into real estate mutual funds. Real estate funds posted an average 12-month total return of 25% at the end of September and were ranked the fourth-best performing mutual fund category in *The Wall Street Journal's* third-quarter mutual fund report, based on trailing 12-month performance. Only Latin America funds, gold-oriented funds and natural-resources funds performed better.

## Caution Ahead

But over the past several years, REITs have become much more expensive on a price-to-earnings basis. In 2001, REITs generally traded at a price-to-FFO (funds from operations) multiple of 10. Today, based on a broad index of REITs, the average stock is at a 13 multiple, SNL research shows. The question now is whether inflated share prices will hold or bust. "If REITs have historically traded at 8- to 10-times multiples, then share prices might have to come back down,"



"Part of the reason REITs look expensive on an NAV estimate is that analysts' estimates of NAV are very conservative in relation to where transactions are happening on the private market," says Pauley of LaSalle Investment Management Securities.

### Rating the Property Types

Litt isn't the only Wall Street analyst to express concerns about REIT valuations. Every fund manager interviewed by *NREI* for this story agreed that REITs are getting expensive. But they also expressed their devotion to the sector, mostly because of REIT stocks' ability to post solid, long-term historical returns.

And, notes Pire of Heitman, one-half to two-thirds of REITs' total returns come from the "income return" of dividends — or that portion of the total return of a REIT that goes back to the investor as income — which are generally stable.

Performance, of course, varies by property type. So, which sectors are the best performing? Retail gets the nod from many managers. "It's been the one place where one can invest with confidence in recent years, and it continues to exhibit strong fundamentals," says Rush of PRRAX. Retail REITs are up 20% year-to-date as of Sept. 30 (see chart, p. 22).

"Retail continues to be the solid part of the foundation of a portfolio today," says Michael Torres, CEO of Berkeley, Calif.-based Adelante Capital Management LLC, formerly Lend Lease Rosen Real Estate Securities LLC. Adelante Capital invests in REITs on behalf of institutions and pension funds. Although Torres admits mall stocks are getting pricey, he is high on the sector because he believes that development of new malls will be constrained, and existing owners will benefit.

However, the retail sector does pose some risks next year, especially if there is a dramatic pullback in consumer spending. That would be precipitated by a stronger-than-forecasted rise in interest rates, which would hurt mortgage refinancings, the method by which many consumers are getting their excess cash, says Hans Nordby, a research strategist with Property & Portfolio Research.

"If retail sales get hurt by the end of

**"Even with the high share prices, [REITs] have been paying out healthy dividends."**

— Keven Lindemann, SNL Financial



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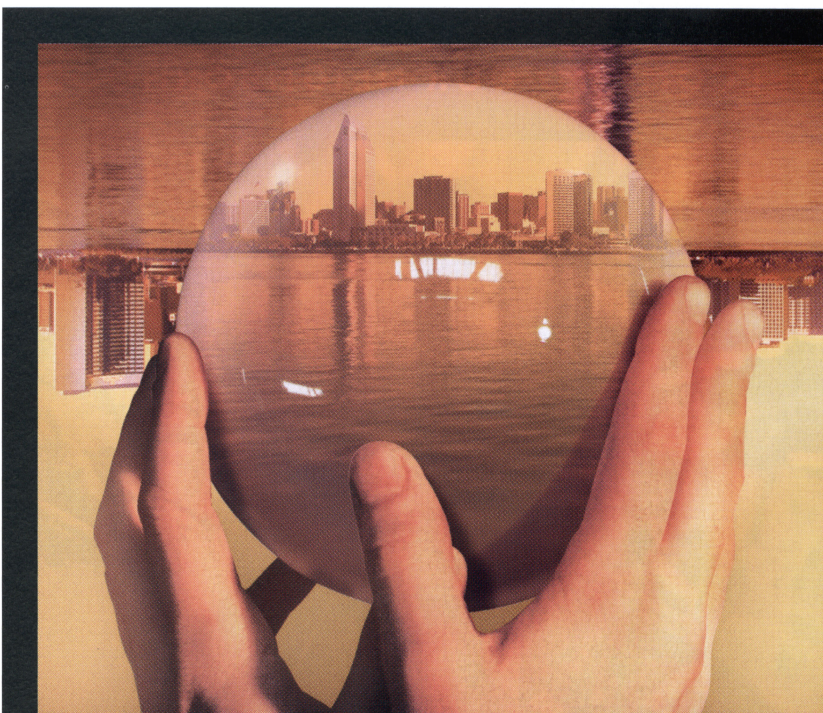
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# 7-Eleven's Fresh Approach

With a fresh approach to its food business — and to its real estate strategy — the convenience store chain is launching a large expansion.

Randall Shearin

7-Eleven, Inc. is a retailer that likes big numbers: the economies of scale created by 6 million people a day shopping at one of the retailers' stores in the U.S. and Canada is unfathomable to most retailers. As the world's largest convenience store chain, the company did more than \$10.8 billion in sales in 2003. And it wants to see its numbers grow in terms of revenue and in the number of stores it opens around the world. With a real estate strategy that calls for more corporate locations, and a merchandising philosophy that quickly responds to consumers' changing habits, 7-Eleven is focused on the future.

*Shopping Center Business* recently met with executives from 7-Eleven's real estate team at the company's headquarters in Dallas. SCB met with David Littwitz, director of real estate, Ed Carnevale, director of construction, and Steve Hall, vice president of store development.

## CREATOR OF CONVENIENCE

Because it is a convenience store, 7-Eleven must constantly strive to improve its product offerings. In 1968, 7-Eleven was the first convenience store to offer coffee in to-go cups. Today, coffee still tops the best-seller list at the company — customers can purchase coffees 1,300 different ways, according to the company. When the retailer saw that consumers wanted low-



Many 7-Eleven stores in suburban locations now offer gasoline (top), but the Number 1 seller at the company's stores remains coffee (right), which can be prepared more than 1,300 ways at 7-Eleven.



hot dogs are monitored for how long they are on the grill. Coffee is brewed at regular intervals to ensure freshness.

## A FRESH APPROACH

Just as it has done with its products, 7-Eleven has freshened its stores over the last few years. With 60 percent of its stores franchised, the company introduced a new franchise agreement in 2002 and has converted 90 percent of its franchisees to the new agreement. The company also spent a lot of time and capital on a new information technology system that further enables the company to understand who its customers are, what they are buying and when they are buying it. This helps replace inventory quicker and understand the type of product that 7-Eleven has to carry in its stores.

## FRESH REAL ESTATE

The company has also changed its real estate strategy. It has vigorously attacked urban markets,

entering cities such as Boston, New York and Chicago, and worked hard to secure high-traffic suburban locations. The company also introduced a new proprietary software for development called Site Development Management System, which allows it to track construction from site prospect to store opening.

carbohydrate items, 7-Eleven had to respond to keep sales; when consumers wanted healthier food, 7-Eleven began offering items like single-serve vegetables, low-carb energy bars, candies and other healthy snacks. The company has mandated that everything in its stores be fresh — all perishable baked goods are date stamped and even items like grilled