REITs: A Port in the Capital Market Storm

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The rapid rise in interest rates since the beginning of 2022 has exposed fault lines in banking, private equity, and commercial real estate business models that were predicated on low debt rates. For many real estate investors, the days of low-cost, readily available property financing are gone. Today, borrowers face significantly higher interest rates, stricter underwriting standards, and potential debt availability issues. The public-private market divergence in real estate valuations has further complicated the mortgage underwriting process, as private property valuations have been slow to adjust to market realities. As a result, many private market real estate investors seeking to refinance their properties find themselves in a pickle. Some face the prospects of negative leverage; others find their current loans cannot be refinanced at par.

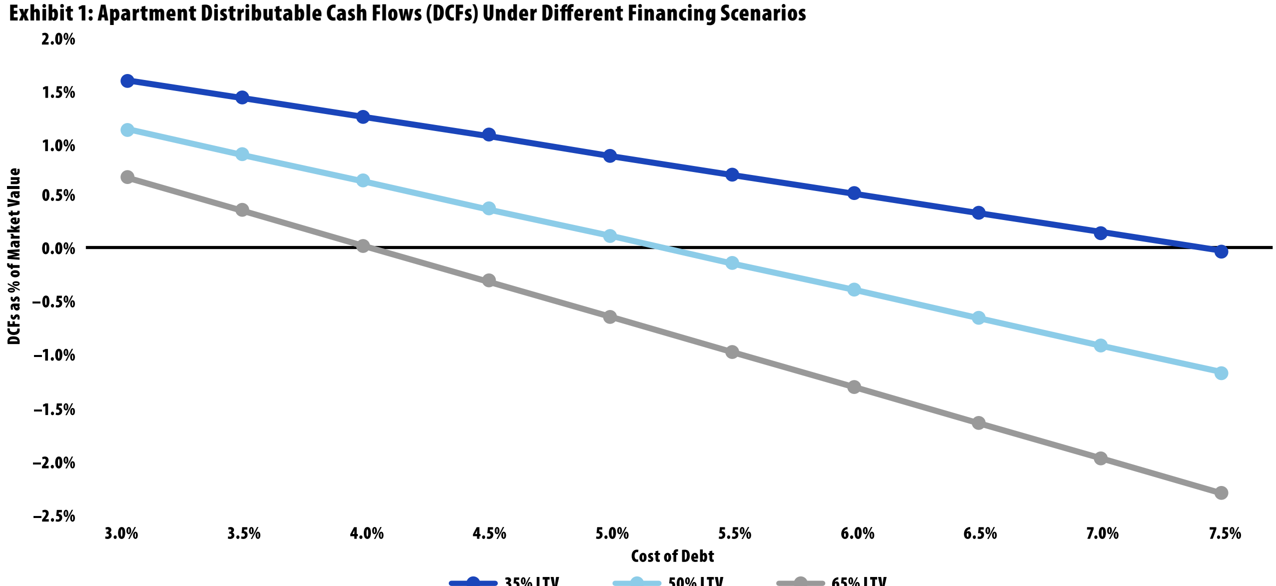
Although US public equity REITs have not been immune from the current mortgage market turmoil, they have limited their exposure to these challenges by maintaining leverage ratios consistent with core investment strategies and focusing on unsecured, fixed rate, and longer-term debt. Access to the unsecured debt market has provided REITs with a competitive financing advantage over many of their private real estate market counterparts. Amid this period of capital market uncertainty, investors may find REITs to be a welcome port in the storm.

Cash Flow Sensitivities to Rising Debt Costs

The potential refinancing challenges real estate investors face can be illustrated with a simple analysis that examines a property's distributable cash flow under different financing scenarios. For this exercise, let's focus on an existing apartment investment managed by an institutional real estate private equity manager with the following characteristics:

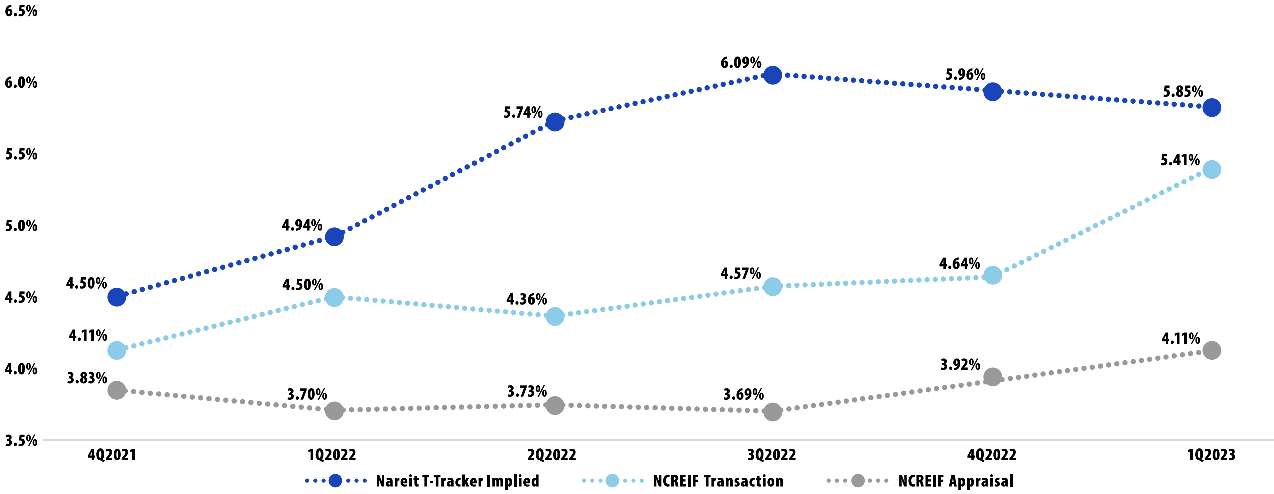
- *Market value is $100 million.*
- *Cap rate is 4%.*
- *Net operating income (NOI) is $4 million.*
- *Capital expenditures are 25% of NOI.*
- *Investment management fees are 10% of NOI.*
- *Debt service is calculated on an interest-only basis.*

Exhibit 1: Apartment Distributable Cash Flows (DCFs) Under Different Financing Scenarios



Sources: NCREIF; Nareit analysis

Exhibit 2: Public and Private Real Estate Cap Rates



Sources: Nareit, NCREIF

These assumptions are intended to reflect a typical apartment investment. The cap rate and capital expenditure measures are gleaned from NCREIF apartment data. For simplicity, investment management fees, which are asset management fees private equity real estate fund managers charge, are calculated as a percentage of NOI. Distributable cash flow is calculated as NOI less capital expenditures, less investment management fees, less debt service.

Exhibit 1 displays the hypothetical apartment investment's distributable cash flows as percentages of market value under three financing scenarios with loan-to-value (LTV) ratios of 35%, 50%, and 65%. For each scenario, the cost of debt increases by increments of 0.5% and ranges from 3.0% to 7.5%. Positive percentages indicate cash flow levels available for potential distribution to investors. Negative values indicate deficits—i.e., the apartment fails to generate sufficient funds to fulfill its capital expenditure, management fee, and debt service obligations.

It may come as no surprise that distributable cash flow percentages declined with increasing LTVs, and the same relationship held with increasing costs of debt. Some investors, however, may be astonished at how quickly the distributable cash flow percentages descended toward zero and turned negative, with increasing LTVs and/or debt costs. This was particularly true for the higher-leverage strategies. Under the 50% LTV scenario, the distributable cash flow percentage turned negative at a debt cost of 5.5%. At 65% LTV, the threshold was 4.5%. Given these results, this apartment project would likely be unable to refinance its current loan at par under the higher leverage ratios in today's rate environment.

Divergence Complicates Refinancings

The public-private market divergence in property valuations has further complicated the refinancing process. With public real estate cap rates continuing to be higher than private real estate cap rates, further material write-downs are likely on the horizon for the private real estate market.

Exhibit 2 shows public (REIT-implied) and private (transaction and appraisal) real estate cap rates from the fourth quarter of 2021 to the first quarter of 2023 using data from the Nareit Total REIT Industry Tracker Series (T-Tracker) and NCREIF. All the cap rate calculations utilized historical, or backward-looking, NOIs.

The relationship between REIT-implied and transaction cap rates shows that the real estate valuation adjustment process has been working. As expected, the difference between REIT-implied and transaction cap rates has been narrowing, with changes in both REIT and private market valuations. The gap reached

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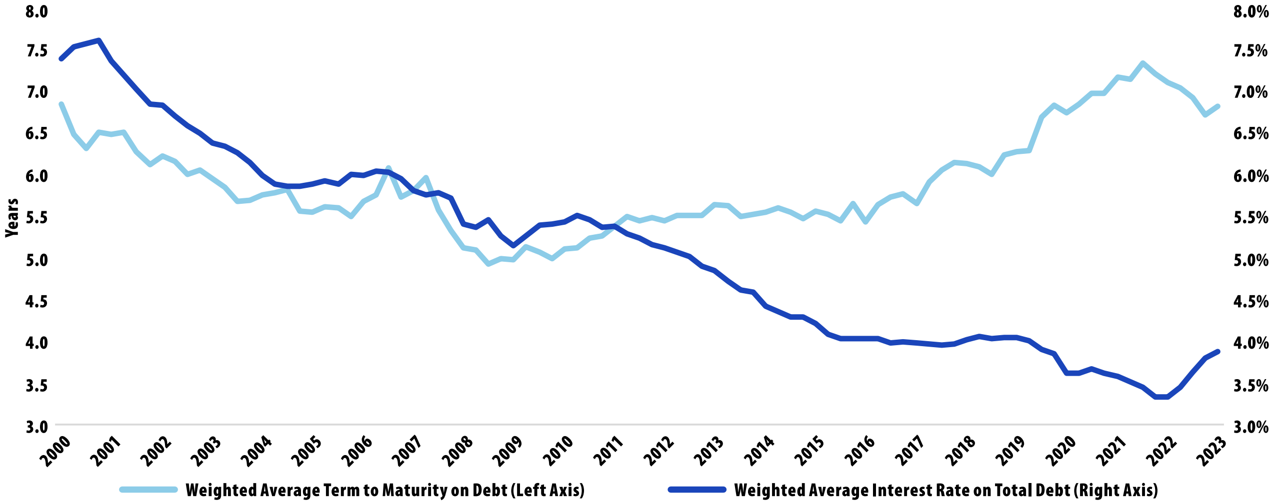
Exhibit 3: REIT Debt—Costs and Terms to Maturity



Source: Nareit T-Tracker

a maximum of 152 basis points (bps) in the third quarter of 2022; two quarters later it stood at 44 bps. Yet the difference between REIT-implied and appraisal cap rates has remained wide; it was 174 bps in the first quarter of 2023.

Although the price discovery process has been making progress, this improvement has been reflected in only a sliver of NCREIF valuations. In the first quarter of 2023, the transaction cap rate represented a market value of slightly more than $3 billion; the appraisal cap rate accounted for nearly $850 billion. With transaction activity throttled and many private real estate investment managers reluctant to accept brokers' opinions of value that are significantly below current carry values, the slowly turning wheels of progress are unlikely to accelerate anytime soon.

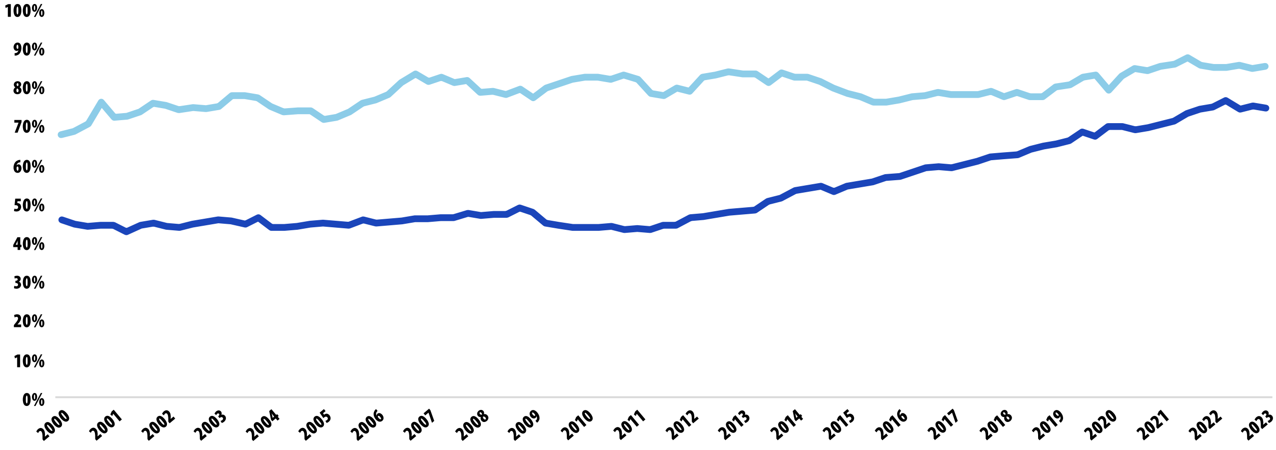
Insulated from Mortgage Turmoil

US public equity REITs have not been immune from the current mortgage market turmoil, but they have been reasonably well insulated from it. With more-limited exposure to mortgage, or secured, debt than their private real estate counterparts and a weighted average term to maturity on debt of nearly seven years, REITs have had less need to refinance and, therefore, their distributable cash flows have been under less stress from higher interest rates. Data from Nareit's T-Tracker for the first quarter of 2023 shows that, on average, equity REITs maintained long-term, well-structured balance sheets with low leverage ratios, predominantly utilizing unsecured debt and fixed interest rates. Capital markets have also been open for REITs, and they have been successfully issuing unsecured debt and equities. REIT valuations have already adjusted as well.

REITs learned lessons from the great financial crisis, with many lowering their leverage ratios and locking in debt at low, fixed rates. As of the first quarter of 2023, the REIT debt-to-market assets ratio was 33.9%. This leverage ratio has generally remained below 35% since 2013; a threshold that is consistent with core investment strategies private real estate funds follow.

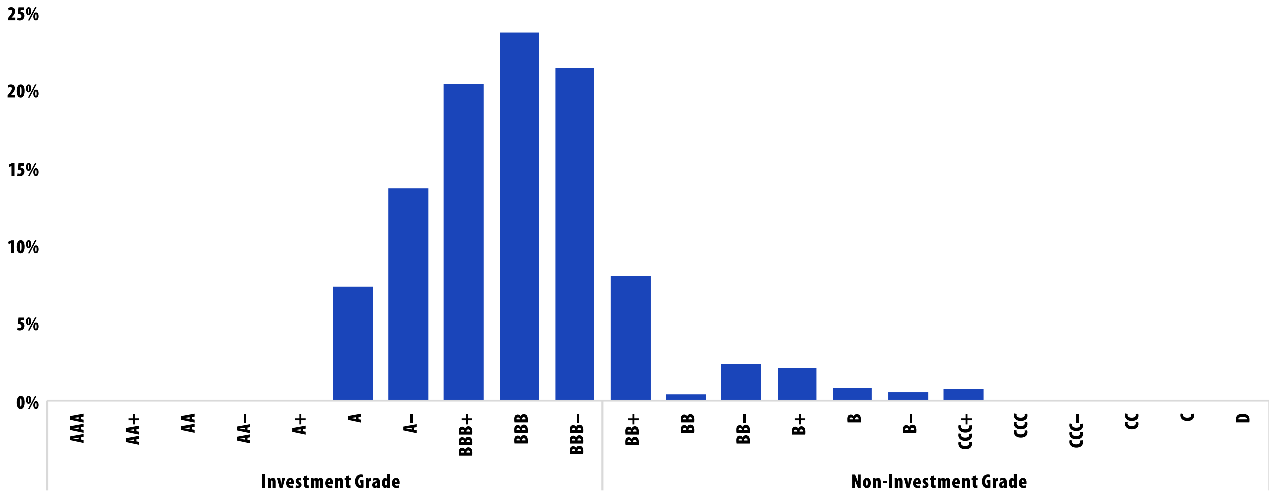
Exhibit 3 presents weighted average terms to maturity and weighted average interest rates on total debt for US public equity REITs from the first quarter of 2000 to the first quarter of 2023. The chart shows that the equity REIT weighted average term to maturity has followed an upward trend since the great financial crisis, increasing from approximately five to nearly seven years. Compared to the surge in the ten-year Treasury yield, REIT debt costs have increased only marginally. From the fourth quarter of 2021 to the first quarter of 2023, the US ten-year Treasury yield increased by 212 bps to 3.7%. Over the same time frame, the public equity REIT weighted average interest rate on total debt rose by 55

Exhibit 4: REIT Unsecured and Fixed Rate Debt as Percentages of Total Debt



Source: Nareit T-Tracker

Exhibit 5: Shares of REIT Unsecured Debt by Credit Ratings



Source: Capital IQ Pro; as of March 31, 2023

bps to 3.9%. Although the average in-place REIT debt cost has steadily increased over the past year, it is now just slightly higher than the ten-year US Treasury yield.

Exhibit 4 displays unsecured and fixed rate debt as percentages of total debt for US public equity REITs from the first quarter of 2000 to the first quarter of 2023. REIT unsecured debt utilization has grown consistently since 2013, reaching 76.0% of total debt in the most recent quarter. REITs have also favored using fixed rate debt; it composed 87.0% of total debt in the first quarter of 2023. By focusing on unsecured, fixed rate, and longer-term debt, public equity REITs have limited their exposure to the challenges of the current mortgage market.

Unsecured Debt as a Competitive Advantage

Access to the unsecured debt market has provided REITs with a competitive advantage over many of their private real estate market counterparts. Exhibit 5 highlights the percentages of US public equity REIT unsecured debt by credit ratings from S&P Global Ratings. Investment-grade ratings include all those that are BBB– or better.

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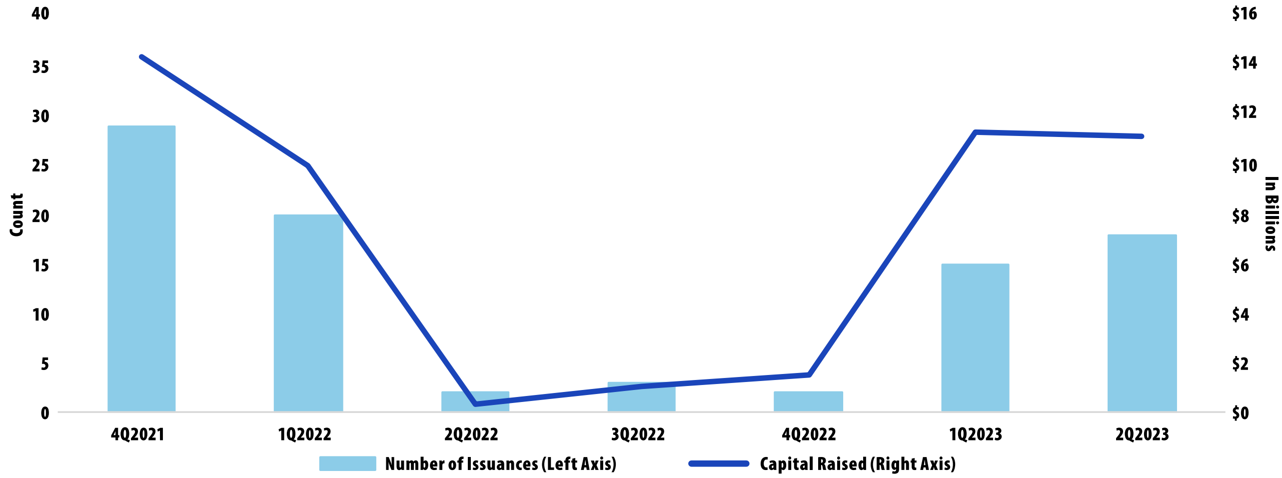
Exhibit 6: US Public Equity REIT Unsecured Debt Issuances



Sources: Nareit, S&P Global Market Intelligence

Today, more than 85% of public equity REITs have an investment-grade bond rating. These REITs accounted for $1.4 trillion in capital as of the first quarter of 2023. Although the majority of that capital was sourced from common equity, nearly one-fourth was in unsecured debt; approximately 5% was in the form of secured debt–like mortgages.

The unsecured debt market has remained open and available to REITs during this period of mortgage market tumult. Exhibit 6 presents unsecured debt issuance by US public equity REITs from the fourth quarter of 2021 through the second quarter of 2023, highlighting both the number of issuances and the total capital raised.

With the rise in interest rates and debt costs in 2022, REITs acted rationally; their unsecured debt issuance fell off precipitously. In the first half of 2023, there was a material uptick in unsecured debt issuance. Thirty-three senior debt deals with an aggregate value of $22.6 billion were closed during that time. The gross amounts offered, including over-allotment and yield-to-maturity median values, for these issuances were $650 million and 5.1%, respectively. The unsecured debt market provides REITs access to significant capital at attractive interest rates.

A Welcome Port in the Storm

With higher interest rates, stricter underwriting standards, and changing property valuations, many private real estate investors are ill-equipped to face the current financing environment. This has fueled concerns about real estate debt holdings and the potential for escalating property defaults. It has also increased the perceived risk of the overall industry. Although US public equity REITs have not been immune from the challenging capital market conditions, they have been well insulated from them. On average, they have maintained balance sheets with low leverage that focus on unsecured, fixed rate, and longer-term debt. Access to the unsecured debt market has provided REITs with a competitive financing advantage. With sound balance sheets and solid operational performance, REITs are well prepared for a period of economic and capital market uncertainty. In a tumultuous time, REITs are a welcome port in the storm. ■

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