REIT Unsecured Debt Issuance – Advantage Public REITs

There has been a flurry of Unsecured Bond issuance by the Publicly Traded REITs YTD. This has strengthened corporate balance sheets and provides the REITs with a competitive advantage at a time when other CRE borrowers are struggling to access new/refinance existing debt.

The collective public REIT balance sheet is in excellent shape with record low levels of leverage and ample reserves of unused credit. This puts the REITs in a very good position to capitalize on stress in the private commercial real estate markets.

Access to capital is one of the principal reasons to operate as a public company. Presently, many traditional lenders are wary of making new CRE loans and wish to reduce their exposure. **Public REITs with access to debt and/or equity at present have a Cost of Capital advantage versus most other market participants with regard to deploying capital related to acquisitions, releasing costs, refinancing debt and committing to new developments**. Currently there are signs of distress in parts of CRE, particularly regarding CBD offices. We believe there will be attractive opportunities for those parties with access to capital to make promising investments over the next few years.

Stress in CRE lending – The failure last year of Silicon Valley Bank and Signature Bank (Mar 2023) and most recently, New York Community Bank, Japan's Aozora Bank and Deutsche Bank (the latter two specifically citing US office issues), have highlighted CRE loan related stress. These problems have been driven by the rapid increase in US interest rates and the decline in property income which have impacted Loan-To-Value and Debt-Service-Coverage considerations. It is estimated that CRE loans amount to $2.7tr of which 80% is held by US Regional Banks. There is $1.5tr of CRE loans due to mature over the next 3yrs, much of which will be faced with the prospect of resetting at interest rates that may be double the rate on the expiring debt. Over recent times, we have seen big owners including Blackstone, Brookfield and RXR, 'hand back the keys' to the banks. In other circumstances, BXP and SL Green have negotiated favorable revised debt terms with their lenders. Either way, CRE debt stress appears likely to be an issue that will not be resolved quickly.

US10Y Yields are Up but Off the Highs and are Now Around 4.3% - The yield of the UST 10Y note is central to the valuation of financial assets and is of particular importance in CRE finance given the preponderance of long-term debt financing. The yield on the US10Y is generally influenced by the Fed Funds Rate (FFR). The Fed started increasing the FFR Mar 2022 from effectively zero to 5.25-5.50% July 2023 – unchanged subsequently - with the US10Y yield moving higher over this 2yr period (See Figure 1a below). More recently, the US10Y yield having touched 5.0% in late Oct 2023 had moved down to the high 3%'s in expectation of the Fed cutting rates over 2024. Since the beginning of the year, markets have cooled their expectations as to the timing/pace of rate cuts with the US10Y yield moving back above 4.0% (See Figure 1b below). Assuming a 'spread' (premium reflecting risk) of 125-150bps over the

US10Y, Investment Grade (IG) REITs appear to be able to target 10Y unsecured bond issuance with a yield in the mid-5%-6%.

Figure 1: UST10Y Yields.

1a. 2/20/2022 to Present.

Source: StockCharts.com

1(b). Last 6mths

Source: StockCharts.com

REIT Cost of Capital – REIT dividend distribution rules means that they are largely dependent on raising incremental capital to fund growth from acquisitions, developments, etc. The incremental Cost of Capital is calculated by adding the cost of raising debt and equity proportionately. In simple terms, the debt cost is self-explanatory and for equity, we invert the REIT's forward multiple using the Y24 FFO/sh

estimate/express as a yield and we use a 40% debt-equity/leverage ratio. (Note, some REITs also access Joint Venture, Preferred Equity which we exclude for simplicity). Assuming 5.5% debt costs, 7.1% equity costs based on 14x Forward FFO/sh and 40% leverage, we estimate a 6.5% Cost of Capital. It follows that if a REIT deploys capital to generate returns in excess of 6.5%, it will produce a positive return to shareholders. REITs with access to lower debt rates/having a higher equity multiple will have a lower Cost of Capital and have a greater competitive advantage, conversely those with higher debt costs/having a lower equity rating will have a higher Cost of Capital and be relatively disadvantaged. We note that today, for some REITs/sub-sectors that trade at higher valuations (for example, many Industrial/Warehouse companies), implied incremental equity costs may be less expensive than debt.

Figure 2: Selection of Recent Unsecured Bond Issuance by Investment Grade Public REITs, YTD 2024

		Property	Debt Details			
Company	Ticker	Type	Term	Size	**Rate**	Notes
Brixmor	BRX	Shopping Centers	10Y	$400m	**5.5%**	
Camden Property	CPT	Apartments	10Y	300	**4.9**	
ExtraSpace	EXR	Self Storage	7Y	600	**5.9**	
Realty Income	O	Triple Net	5 & 10Y	1,250	**4.75 & 5.125**	Blended 8.3Y, 4.99%
Kite Realty	KRG	Shopping Centers	10Y	350	**5.5**	
American Homes 4 Rent	AMH	Single Family Rental	10Y	600	**5.5**	Green Bonds
Alexandria Realty	ARE	Lifescience	12 & 30Y	1,000	**5.25 & 5.625**	Blended 19.2Y, 5.4%

Source: Company Disclosures (10Q)

Conclusion: Given a significantly lower cost of capital than their private market counterparts, public REITs are in a strong position to capitalize on the unfolding distress in parts of the private CRE sector. We expect public REITs relative to private market CRE will continue to exhibit strong operating performance and make meaningful acquisitions that will support accelerated earnings growth.

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David Harris
Richard Imperiale

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The 10-Year Treasury Rate is the yield received for investing in a US government issued treasury security that has a maturity of 10 year. The 10-year treasury yield is included on the longer end of the yield curve.

All investments carry a certain degree of risk, including possible loss of principal. REITs are subject to illiquidity, credit and interest rate risks, as well as risks associated with small and mid-cap investments. It is important to review your investment objectives, risk tolerance and liquidity needs before choosing an investment style. Value style investing presents the risk that the holdings or securities may never reach their full market value because the market fails to recognize what the portfolio management team considers the true business value or because the portfolio management team has misjudged those values. In addition, value style investing may fall out of favor and underperform growth or other style investing during given periods.

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