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State of the Public and Private Net Lease Marketplace

Recent market volatility has led to a changing landscape for publicly traded net lease REITs. The REITs that are performing well in the equity markets are primarily focused on acquiring retail properties and are better positioned to achieve acquisition goals by utilizing a lower cost of capital. The REITs that are underperforming, which primarily acquire office and industrial properties, are less likely to achieve their acquisition targets based on their inability to acquire properties at accretive cap rates given their higher costs of capital. Underperforming REITs may be forced to consider alternative strategies, such as increasing leverage in order to reduce their cost of capital so that they can achieve their acquisition goals. However, these REITs must successfully execute their alternative strategies to increase FFO or they will be subject to long-term financial risks associated with higher leverage. Uncertainty in the public markets will result in more opportunities for private real estate investors who have benefitted from increased allocations in a yield starved global market.

Some net lease REITs have benefited from increased investor demand while others have not been able to consistently produce long-term stock gains. A key indicator of market perception is a REIT's FFO multiple, which is defined as Price per Share / FFO per Share. All else being equal, a REIT trading at a higher FFO multiple is more likely to have to have a lower cost of capital than a REIT trading at a lower FFO multiple. Based on a comparison of net lease REIT FFO multiples, there is a clear divide between REITs that can acquire properties at accretive cap rates and those that cannot. Those REITs that are able to acquire properties at accretive cap rates will be better positioned to execute their acquisition targets in 2016 while those who cannot may be forced to lower their 2016 expected acquisition pace.

In order to make any conclusions, it is important to note the property type that each of these REITs target. According to 2015 Annual Reports, a majority of the net lease REITs with an estimated lower cost of capital target retail properties and are seeking to invest approximately $5 billion to $6 billion in net lease assets throughout 2016. With retail cap rates near all-time lows, it is unlikely that this sector would experience increased cap rate compression. However, given these REITs' ability to acquire properties at accretive cap rates and their 2016 acquisitions target, it is probable that low cap rates will persist throughout the sector in 2016.

Conversely, those REITs with estimated higher costs of capital primarily target office and industrial assets. However, rather than forego potential acquisition opportunities, these REITs may be able to reduce their cost of capital by recapitalizing their balance sheets. This becomes particularly compelling if a REIT has access to traditional bank financing, which is currently cheaper than CMBS financing. Should a REIT consider such a recapitalization, it must assess the risks of doing so. Typically, REITs prefer to maintain a conservative balance sheet and therefore target leverage ratios between 20% and 40%. While increasing this ratio to 50% - 60% may result in a lower cost of capital in the near-term, it does pose some long-term risk. If a REIT were to take on more leverage, it must deploy those proceeds in a way that allows it to increase FFO, which in turn could be utilized in the future to pay down the debt it initially took on and maximize shareholder value.

State of the Public and Private Net Lease Marketplace (continued)

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However, if a REIT is unable to execute that strategy, it is likely to experience negative pressures in both the equity and debt markets. First, if a REIT remained highly levered relative to its peers over the long-term, then cost to raise additional proceeds through the debt markets would increase as those lenders would seek higher compensation given the increased business risk. Consequently, debt financing, which was once deemed an attractive option to reduce the cost of capital, would become less feasible with the higher cost. Secondly, investors in the equity markets would likely sell the shares of a highly levered REIT and redeploy those proceeds into REITs with a more conservative capital structure. This would result in downward pressure on the REIT's share price and FFO multiple, which would further inhibit its ability to raise equity proceeds at accretive levels. Therefore, the REIT's only option would be to sell properties to raise additional proceeds. While this may be an attractive alternative at the peak of a real estate cycle, it would certainly lower returns if a REIT were forced to sell properties in a down market. So what does it all mean?

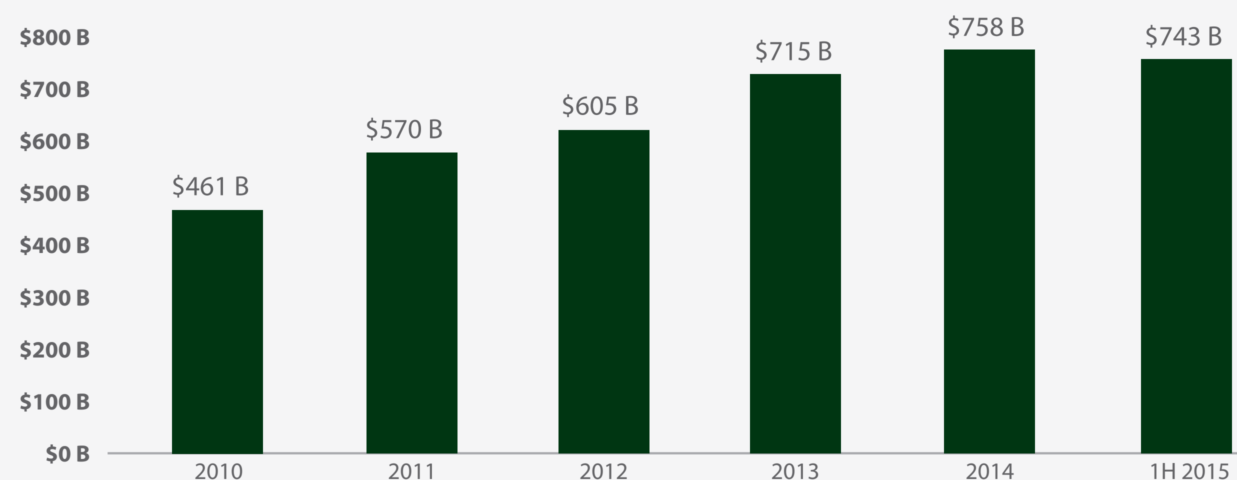
With public net lease REITs that focus on acquiring retail properties trading near all-time highs, it is unlikely that the retail sector will experience a pullback in the near term and it can be assumed that cap rates will remain low and property valuations high. The fate of the office and industrial property sectors is less certain. If public net lease REITs that target office and industrial properties continue to experience weakness in the equity markets and are unable to reduce their costs of capital, then there will be reduced demand for those property sectors. This would lead to cap rate expansion that would give rise to attractive opportunities for private investors.

With the equity markets signaling a divide between the "have" and "have-not" net lease REITs in the public sector, the question becomes whether the private market can compete with the "winners" while simultaneously filling the potential void left by the "losers". With significant capital to invest, the answer is dependent on private real estate fund managers' ability to meet or exceed investors' return hurdles amid the general expectation that the real estate market may experience a slowdown over the medium-turn. The Fed's decision to keep interest rates near 0% for nearly a decade has reduced return expectations for many alternative asset classes, and real estate, which is often viewed as a fixed income substitute, has benefited from the current investment landscape. According to Preqin, a leading source of data and intelligence for the alternative assets industry, real estate allocations have risen approximately 61% over the past five years.

Over that same period of time, many of these closed-end funds have produced strong returns due to capital appreciation of the underlying assets. However, investors are now beginning to question the sustainability of such returns as it seems the real estate is close to its peak. It has become difficult for investors to determine if the success of fund managers has been the result of a disciplined and prudent investment strategy able to produce strong risk-adjusted returns or simply the result of participation in a strong market cycle. While these concerns are justified, it is unlikely that there will be a significant decline in allocations in a yield starved environment without the occurrence of a major market event.

With ample capital to deploy, private equity real estate funds are well positioned to continue to acquire net leased assets. However, with the real estate cycle nearing its peak, the success of managers will be predicated on execution. With a potential slowdown in the market, it is not enough to simply arbitrage cost of capital to trade existing cash flows. Rather, private equity funds must focus on utilizing a differentiated investment strategy that incorporates prudent risk management to manufacture cash flows that are the basis for superior risk-adjusted returns.

Since the financial crisis, the real estate market has experienced a strong recovery and rising property valuations, which has benefited public and private property investors alike. However, the upswing in the real estate market has made it more difficult to distinguish between those investors who have a differentiated and unique investment strategy and those whose success is a function of timing. The investors, both private and public, who adhere to a prudent risk management strategy and a differentiated investment strategy that is predicated on maximizing value through disciplined underwriting rather than the assumption of capital appreciation, will be well positioned to meet their acquisition targets in both the near and long-term.



Weakening in the CMBS Market: Story written by Serena Ng and published in the Wall Street Journal on February 16, 2016

The financial engine of the market for office buildings, hotels and malls is showing signs of strain, raising questions about the resilience of the commercial real-estate boom. Bonds backed by commercial-real-estate loans have weakened significantly since the start of the year amid concerns of an economic slowdown.

Risk premiums on some slices of commercial-mortgage-backed securities have jumped 2.75 percentage points since Jan. 1, a move that translates into a roughly 18% drop in prices for triple-B-rated bonds, according to data from Deutsche Bank AG.

Investors in some cases are demanding to be paid as much to take on CMBS risk as they are to take on corporate junk bonds. Property owners and developers now are facing the prospect of higher rates on loans, tougher refinancings and diminished property values as debt issuance slows and financing becomes more expensive. CMBS with triple-B-minus credit ratings now yield close to eight percentage points above benchmark rates—a four-year high and a similar risk premium to corporate junk bonds, according to Morgan Stanley.

Traders said a key reason risk premiums on CMBS have taken off is Wall Street banks' reluctance to hold securities on their books.

Banks have to hold more capital against assets on their balance sheets, making them less willing to hold securities they can't quickly sell. There also are fewer banks that now trade CMBS because some firms have exited the market.

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Some $3.3 billion of CMBS were issued in January, the lowest monthly total since August 2012, according to Commercial Mortgage Alert.

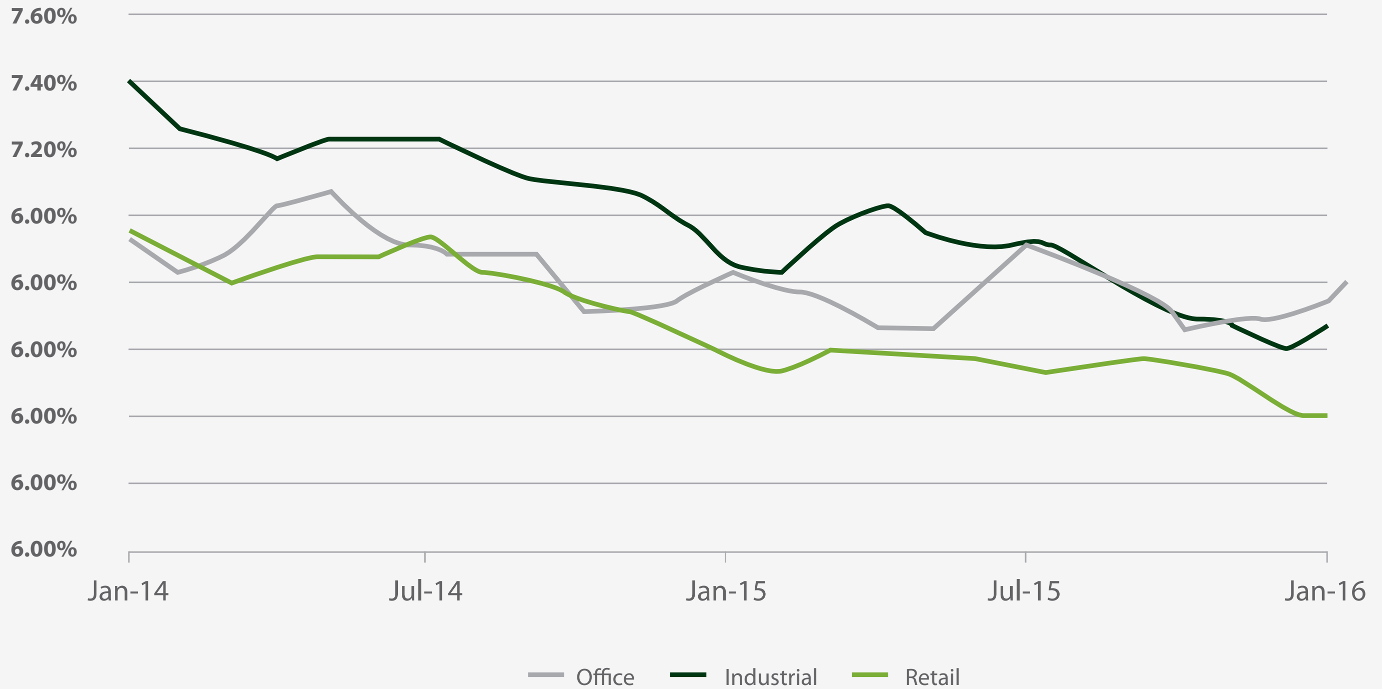
Management's Take on Weakening in the CMBS Market

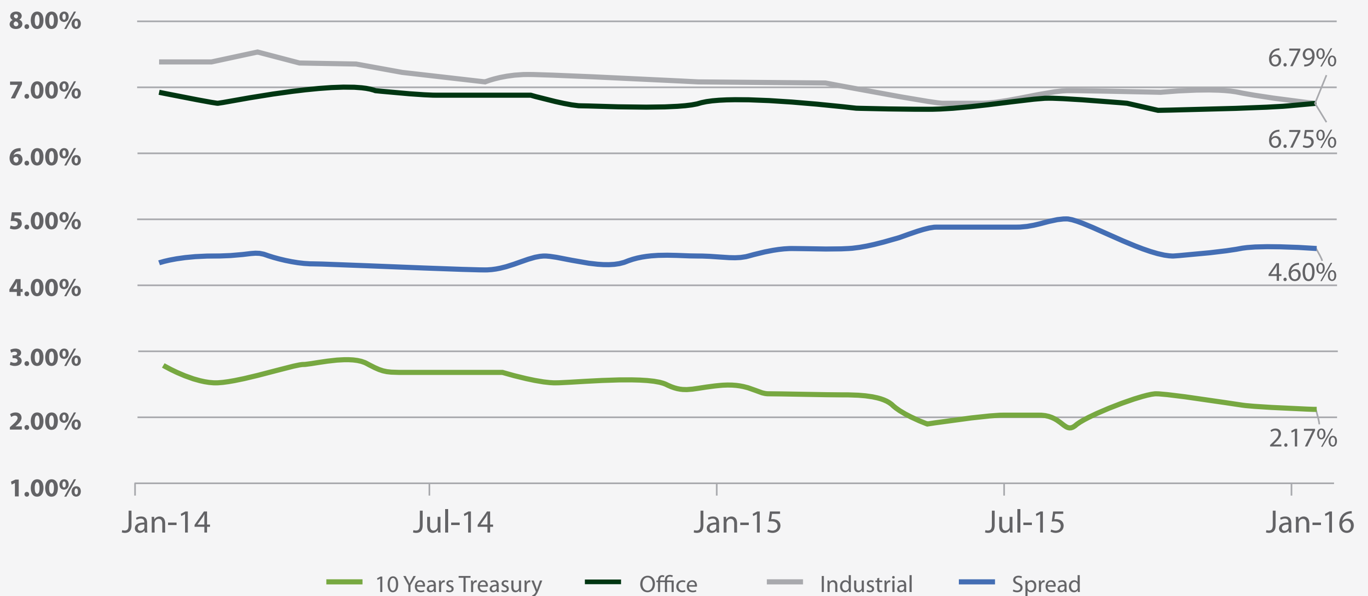
Management's opinion is provided below.

In a market driven by cheap equity and low leverage, volatility in the CMBS market today no longer has the same impact as it did in 2007 and 2008. Roughly $228 billion in CMBS securitizations fueled the real estate capital markets in 2007. In 2015, there was only $101 billion of issuances; and in 2016 CMBS volume will probably drop to $70 billion. While the broader institutional market no longer relies on the CMBS market for liquidity, investors still look at CMBS spreads as a proxy to pricing opportunities. Wider spreads have created a yield floor in secondary markets where deals seem to price at a +7 cap rate so bid/ask spreads have widened, resulting in lower transaction volume in the 1st quarter 2016. With that said, core assets in primary markets or deals that have stabilized cash flows and credit continue to push new heights as investors seek high quality and defensible yield in preparation for a potential cycle in the following 24 months.

The jury is still out. With interest rates remaining low in the foreseeable future coupled with the influx of foreign capital that can't find yield at home, it's difficult for Management to envision an external shock that would create a fundamental problem in the real estate market. There will still be noise over the next 12-18 months that will create volatility in the public REIT arena, where some REITs will be sidelined while others will benefit from the flight to quality. But the overall momentum in foreign capital, a market that has not been overbuilt, and the healthy spreads over treasuries that can be generated in real estate will continue to make it an attractive asset class over the next 36 months.

Net Lease Market Update





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