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Asset Class Update: Real Estate Investment Trust (REIT) Stocks

Signs of Stabilization in the Commercial Property Market

Relatively high dividend yields may offer a source of income

KEY TAKEAWAYS

- **Business conditions for real estate investment trusts (REITs) generally have stabilized in recent months due to greater access to cheaper capital (debt and equity), historically low levels of new supply, and an incremental recovery in funds from operations (i.e. profits).**
- **REIT stocks are trading at slightly expensive levels on a variety of measures relative to their historical averages.**
- **As a group, REITs may offer a higher source of income (dividend yield) than the 10-year U.S. Treasury bond and, as real assets, may provide some protection if inflation were to rise.**

So far in 2010, real estate investment trust (REIT) stocks rallied 22% through November.[i] The following article provides some insight on the current business fundamentals for commercial real estate and the valuations of REIT stocks.

Spotlight on Fundamentals

Improving credit conditions supportive of REITs

The improved credit market conditions seen since the peak of the 2008-09 financial crisis have been supportive of REITs, which primarily are corporate entities that purchase income-producing commercial real estate, such as office buildings, shopping malls and apartment complexes. In particular, lower borrowing costs for commercial property can allow more rental income to filter through to REIT profits (technically referred to as funds from operations, or FFO). Cheap financing also provides an incentive for REITs to acquire property in an attempt to increase profits. To raise capital and acquire property, REITs have the option of issuing common or preferred stock, or bonds. As an example of the lower cost of capital today, credit spreads on the investment-grade bonds issued by REITs—the risk premium demanded by investors over risk-free U.S. Treasury bonds—fell to around 150 basis points in October 2010, from 340 bps a year earlier and a near record high of more than 1200 bps in the fourth quarter of 2008. Spreads on high-yield REIT bonds and commercial mortgage-backed securities (CMBS) have seen similar tightening over the same periods.[ii]

Bank lending less restrictive

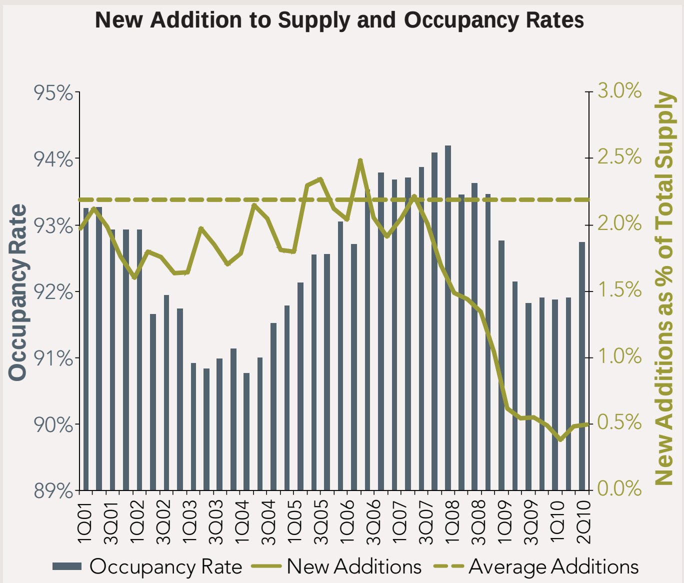
Generally speaking, less restrictive bank lending has provided a more favorable backdrop for commercial real estate markets in 2010. Unlike a year ago when most banks were still tightening their lending standards, today most banks have stopped tightening their standards and, for the first time since 2007, a small number of banks have eased their requirements. At the same time, a larger number of banks have reported stronger demand for commercial real estate loans than those seeing weaker demand—something not seen since 2006. Further, after hitting an all-time high of around 9% a year ago, the overall delinquency rate on commercial real estate loans has remained at that level for the past year.[iii] Investors should keep in mind that while these credit conditions indicate some stabilization, bank lending practices remain tight and delinquency rates remain high.

Demand stabilized amid low levels of new construction

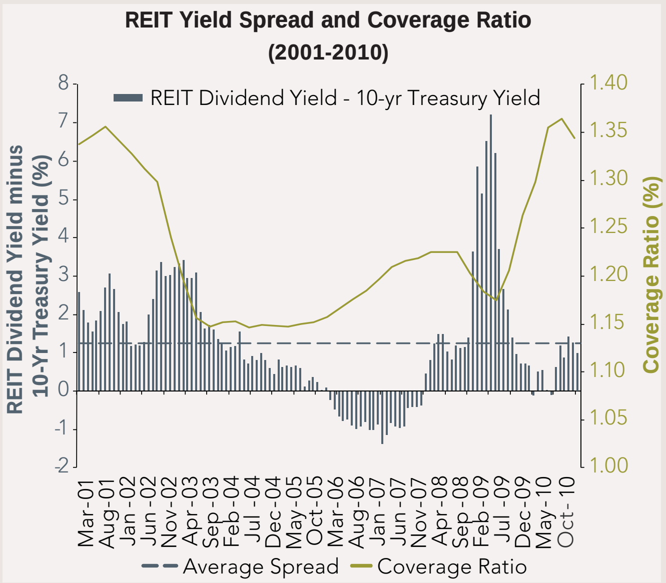
Although overall supply-and-demand conditions in the commercial real estate market remain challenging, there are some signs of improvement. On the demand side of the equation, historically elevated vacancy rates and low rents exist in the office, mall and industrial sectors—property types that typically require long-term leases. High unemployment and a tepid rebound in consumer spending has hindered the economic recovery and thus clouded the outlook for

EXHIBIT 1: New commercial real estate projects started by REITs are entering the market at an all-time low rate while occupancy levels have ticked up from prior lows (below left).

EXHIBIT 2: REIT dividend yield spreads vs. Treasuries are near historical average levels, and REIT coverage ratios remain at healthy levels (below right).



Occupancy and supply data above representative of the commercial real estate owned by publicly traded REITs. Source: Citi Investment Research and Analysis, FMRCo. (MARE) as of 6/30/10.



Source: NAREIT, Citi Investment Research and Analysis, FMRCo. (MARE) as of 10/31/10. The coverage ratio is calculated by dividing the adjusted funds from operations by the annual dividend. Coverage ratio data as of 9/30/10.

these particular sectors. However, increased corporate travel and a growing population of home renters has led to higher occupancy levels among property sectors with shorter-term lease structures—such as hotels and multi-family apartments—that adjust more quickly to shifting supply and demand conditions. Overall, occupancy rates rose during the second quarter of 2010 for the first time since prior to the start of the financial crisis in 2008, but remain below levels seen in 2006-07 (see Exhibit 1, above).

While the overall level of U.S. commercial property supply in the publicly traded REIT universe is at an all-time high, the outlook on the supply side remains supportive. The number of new commercial real estate projects initiated by REITs in the United States stood near an all-time low in the second quarter of 2010, and below levels seen during the previous commercial real estate downturn in 1990-91. New commercial real estate supply represented 0.5% of all outstanding commercial real estate space owned by publicly traded REITs—the lowest rate in a least 25 years. The moderately improving demand for commercial real estate and the low level of new supply coming online likely contributed to some stabilization in commercial property prices, and provided some optimism for forward-looking investors during the past year. As of October 2010, prices were up 30% from prior lows seen in May 2009, though they were still about 20% below the peak level seen prior to the 2008-09 financial crisis.[iv]

REIT earnings expected to improve in 2010

The profitability of REITs (i.e. FFO) hit a low in 2009, with a per share contraction of -13.4%. Wall Street analysts estimate a 5.9% average per share rate of growth for REITs in 2010, and 11.9% growth rate in 2011.[v] The current high coverage ratio of REITs—meaning their financial ability to pay dividends—is supportive of potentially higher REIT dividend payouts going forward (See Exhibit 2, above). Future profit growth projections are based on the low cost of capital and continued improvement in other fundamentals, such as supply and demand dynamics.

Technical factors often overwhelm fundamentals

REIT stock prices can be influenced by technical factors as well, such as swings in investor sentiment that affect capital flows to the asset class. For example, REITs were relatively unloved amid strong investor demand for tech stocks during the "dot-com" era, with REIT stock prices falling more than 17% in 1998—a year seen as one of the most fundamentally sound ever for commercial real estate.[vi] More recently, and perhaps due to changes in the investor base (e.g. increased hedge fund interest), the performance of REITs has become more volatile and more correlated with broader U.S. stock price movements. For example, since 2007, REITs have been much more volatile than the broader U.S. stock market, with a standard deviation (measure of volatility) of 40.3, compared to 24.5 for the broader market. From the start of the asset class in 1972 to 2006, the standard deviation for REITs and U.S. stocks was 12.9 and 13.8, respectively. From 1972 to 2006, REITs had a 0.5 correlation (modest) with the broader market; since then, REITs have had a high correlation (0.9) to other stocks.[vii] Whether the recent increases in the volatility and correlations of REITs/stocks continues is difficult to determine, but the long-term history of the asset class suggests otherwise.

Assessing Valuation & Outlook

REITs moderately expensive

Several valuation metrics suggest REIT stock prices were slightly expensive as of the end of October 2010. On a price/FFO basis, REITs traded at a multiple of 15.2, which was above the category's 11.8 historical average.[viii] Separately, REITs historically have traded at a slight premium to the net asset value (NAV) of the properties they own, but were about 16% above NAV as of the end of October.[ix] Another way to assess REIT stock valuations is to compare REIT dividend yields vs. 10-year Treasury bond yields. At the end of October, REIT dividend yields were about 100 basis points higher than the 10-year Treasury yield, which is slightly below the average spread of 122 bps—indicating a modestly elevated valuation for REITs.[x]

On an absolute basis, REITs provided a dividend yield of 3.6% at the end of October, which is attractive in a climate of historically low bond yields.[xi] Further, should inflation pick up and interest rates rise, bond prices would be expected to fall. Because REITs invest in a hard asset (i.e. property) that may be expected to adjust higher with the rate of inflation, REIT stocks and the dividend income they provide may provide some inflation protection. When inflation averaged more than 9% per year during the 1970s, REIT stocks delivered an average total return of 18% per year, with income representing 10.3% of that return. By comparison, investment-grade bonds advanced 5%, with price declines detracting from total returns.[xii]

Investment Implications

The fundamental improvements in the commercial real estate market provide some support for REIT profits and stock prices going forward, with elevated valuations signaling that some of that outlook may already be priced in. However, REITs provide a source of income, and as real assets may hold up better than bonds during an environment of rising inflation. Long-term investors may take comfort from the diversification benefits that REITs can provide to a portfolio, as they historically have been only moderately correlated with U.S. stocks, operate under a different corporate structure than most companies, and may provide an alternative source of income to the currently low yields offered by bonds.[vii,xi] ■

Know What You Own: REITs

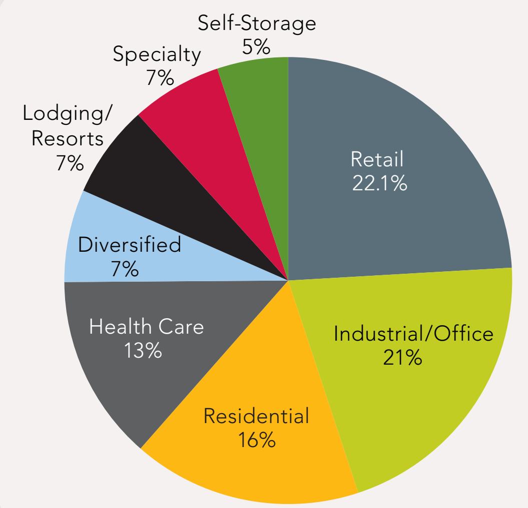
What is it?

A real estate investment trust or REIT is a corporate entity that invests in real estate property and is required to annually distribute 90% of its taxable income in the form of dividends to its shareholders. A REIT can be publicly or privately held.

Key facts

- Currently there are 112 publicly traded REIT stocks operating in the U.S. with a market value totaling more than $307 billion (as of November 2010).
- REITs own approximately 10% of all U.S. commercial real estate.
- REITs are not directly exposed to the U.S. single family, residential housing market.

EXHIBIT 2: REIT Sector Breakdown



Source: FactSet, FMRCo (MARE) as of 10/31/10.

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Past performance is no guarantee of future results.

Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk.
Neither diversification nor asset allocation ensures a profit or guarantees against loss.

Changes in real estate values or economic conditions can have a significant positive or negative effect on issuers in the real estate industry, which may affect your investment.

Stock values fluctuate in response to the activities of individual companies and general market and economic conditions.

In general the bond market is volatile, and fixed income securities carry interest rate risk. As interest rates rise, bond prices usually fall, and vice versa. This effect is usually more pronounced for longer-term securities. Fixed income securities also carry inflation risk and credit and default risks for both issuers and counterparties. Any fixed income security sold or redeemed prior to maturity may be subject to loss.

[i] All data and text references to the commercial real estate property market in this article reflect the publicly traded universe of real estate investment trusts (REITs). All references to REITs represented by the FTSE NAREIT U.S. Real Estate Equity Index, unless otherwise noted. REITs were up 22% from 12/31/09 to 11/30/10. Source: FactSet, FMRCo. (MARE) as of 11/30/10.
[ii] Investment-grade REIT bonds represented by the Barclays Capital (BC) Investment Grade REITs Index. The spread over 10-year Treasury bonds reached a peak of 1212 basis points (bps) in Nov 2008. The spread stood at 153 bps in Oct. 2010. Source: FactSet, FMRCo. (MARE) as of 10/31/10.
[iii] Source: Federal Reserve Board, Haver Analytics, FMRCo. (MARE) as of 11/19/10.
[iv] Source: Green Street Advisors, FMRCo. (MARE) as of 10/31/10.
[v] Source: Barclays Capital, Thomson Financial, FMRCo. (MARE) as of 11/05/10.
[vi] REITs fell 17.5% in 1998. Source: FactSet, FMRCo. (MARE) as of 11/30/10.
[vii] U.S. stocks represented by the S&P 500 Index. Source: Morningstar EnCorr, FMRCo. (MARE) as of 10/31/10.
[viii] Average for available data from Q1-1998 to Q2-2010. Source: Citi Investment Research and Analysis, FMRCo. (MARE) as of 10/27/10.
[ix] Source: Green Street Advisors, FMRCo. (MARE) as of 10/31/10.
[x] The average spread is from Jan. 2001 to Oct. 2010. Source: NAREIT, Federal Reserve Board, FMRCo. (MARE) as of 10/31/10.
[xi] The 10-year Treasury bond yield was 2.63% as of 10/31/10. Source: Federal Reserve Board, FMRCo. (MARE) as of 10/31/10.
[xii] From Jan. 1974 to Dec. 1980 inflation averaged 9.3% as measured by the Consumer Price Index. REITs and investment-grade bonds data from Jan. 1974 to Dec. 1980. Source: Morningstar EnCorr, FMRCo. (MARE) as of 10/31/10.

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The FTSE NAREIT U.S. Real Estate Equity Index is an index of 112 publicly traded U.S. real estate investment trusts.

The BC Investment-Grade REITs Index is an index of bonds issued by investment-grade real estate investment trusts.

Standard deviation shows how much variation there is from the "average" (mean, or expected value). A low standard deviation indicates that the data points tend to be very close to the mean, whereas high standard deviation indicates that the data is spread out over a large range of values.

All indices are unmanaged and performance of the indices include reinvestment of dividends and interest income, unless otherwise noted, are not illustrative of any particular investment and an investment cannot be made directly in any index.