

# cash is king

Dried-up capital markets  
have forced commercial real estate  
companies to conserve

By Allen Kenney

SINCE THE BIRTH of the environmental movement, conservationists have promoted a number of easy, everyday ways to minimize consumption of natural resources.

Turn the water off while you're brushing your teeth. Walk or ride a bike in lieu of driving. Recycle your bottles and cans.

These days, the commercial real estate industry finds itself in the midst of its own conservation push involving one of its most precious resources: capital.

"Capital is the mother's milk of commercial real estate," says David Fick, managing director with Stifel Nicolaus. "In good times, you need that capital as your growth engine, and in bad times, you need that capital just to survive. Without it, there's no ability to weather the kind of economic storm we're going through today."

82 in 2007. Debt offerings fell from 43 for \$18.2 billion in 2007 to 11 for \$5.2 billion through the end of 2008.

The commercial mortgage-backed securities (CMBS) market is a non-starter. Since the middle of 2008, CMBS issuance has ground to a complete halt. Whereas 2007 saw \$230 billion in CMBS issuance, just \$12 billion of securities were issued in 2008, all of which occurred during the year's first half.

Likewise, commercial real estate companies that approach banks for new borrowing are either turned away or offered ruinous lending terms. Banks have ratcheted up credit standards significantly, with nearly 90 percent reporting tighter requirements in the fourth quarter of 2008 compared with three months earlier, according to Federal Reserve Board data. As a result, new bank lending has been reduced and has become increasingly expensive.

## Capital Roads Closed

In their never-ending search for new capital, commercial real estate companies appear to be finding more closed doors than open ones. Data compiled by NAREIT and SNL Financial Inc. show that initial public offerings of REITs have steadily declined since 2004, with just two companies going on the market in 2008 as of Dec. 31. REITs made 69 secondary equity offerings in 2008, compared with

## Liquid Courage

All of this comes at a tough time for the industry. Federal Reserve data show that outstanding commercial real estate debt currently totals approximately \$3.4 trillion, the vast majority of which has been provided by banks and CMBS. In the next three years, some estimate that more than \$1.2 trillion of that debt will mature, including \$400 billion in 2009.

In the past, commercial real estate companies relied on the credit markets to refinance their debt when it came due. If the credit markets aren't functioning, however, it puts the companies in a position where their short-term goal of thriving is replaced by simply surviving.

Consequently, the dearth of affordable capital available through the debt and equity markets is forcing companies to do some creative belt-tightening in the name of conservation.

"Capital preservation has become an imperative because the global credit crisis has greatly diminished the availability—and increased the cost—of capital available to real estate companies to fund their businesses, including acquisition and development activities and long-term



ownership of property,” says Paul Adornato, a senior analyst with **BMO Capital Markets** who covers the REIT industry.

Brad Case, NAREIT’s vice president of research and industry information, notes that the inability to acquire fresh capital is affecting all industries, not just commercial real estate. With banks concerned about their own liquidity, businesses of all stripes are finding few borrowing opportunities.

“Even companies with conservative capital structures are trying to conserve cash so that they don’t get into liquidity trouble,” Case says. “Some other industries are facing a worse situation than REITs.”

## Dividends Down

Just as recycling became one of the first eco-friendly practices to generate momentum among consumers, reducing development and cutting dividends appear to be the two capital conservation strategies gaining the most traction in commercial real estate. While the benefits of slowing down the development pipeline seem clear, decreasing dividends can be somewhat more perilous.

Investors generally view dividend cuts as a sign that a company or industry is in significant distress. However, analysts contend that REITs are a special exception to that rule.

“The leakiest part of the REIT structure is the dividend payout,” Fick says in reference to the capital outflows created by the payments.

By law, REITs are required to pay out 90 percent of their taxable income to shareholders annually in the form of a dividend. The majority distribute an even greater percentage of their taxable income, though. In 2007, for instance, more than half of all publicly traded REITs distributed dividends in excess of 100 percent of their taxable income. REITs paid out nearly \$20 billion in dividends for the year.

In 2008, at least 38 equity REITs opted to pull back some of their dividends.

"The REITs that have cut their dividends are saving, on average, tens of millions of dollars compared to their pre-cut payouts," Adornato says. "The retained capital is mostly being used to strengthen the balance sheet. That is, it's being used to repay debt."

A new ruling by the Internal Revenue Service also has created some additional flexibility for REIT dividends. NAREIT requested the ruling, which allows all REITs at their election to utilize a 10 percent minimum cash floor with the balance paid with REIT stocks for dividends declared with respect to taxable years ending on or before Dec. 31, 2009. Since the ruling was handed down, a number of REITs, including **Vornado Realty Trust** (NYSE: VNO), **Simon Property Group** (NYSE: SPG) and **Sunstone Hotel Investors Inc.** (NYSE: SHO), have announced their intentions to pay dividends in a combination of cash and stock.

## Dear Prudence

Although investors tend to punish companies that reduce their dividends, Case says investors likely have rewarded REITs for their prudence, given the circumstances in the capital markets. "Investors really want to see that companies are taking steps to improve the company in the long term," he says. "It's more a sign that the industry wants to stay out of distress, rather than a sign that it actually is in distress."

Adornato agrees that the move to cut dividends signifies a solid operating strategy for a capital-starved REIT.

"We feel that in the current capital market environment, shareholders are likely better served by management strengthening the balance sheet of the REIT, rather than by making a payout to investors that could weaken the financial position of the company and hurt its ability to compete going forward. Rather than the sign of an industry in distress, we view the REIT dividend cuts as one response of a dynamic industry to address a once-in-a-generation financial crisis," he says. "With a few notable exceptions, we expect the vast majority of public REITs to survive the crisis and emerge as viable, competitive entities. The same cannot be said of the private

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real estate universe, where corporate and property-level failures have been, and will continue to be, more rampant."

Having already met its distribution requirement for the year, industrial REIT **AMB Property Corporation** (NYSE: AMB) suspended its dividend in the fourth quarter of 2008. The move enabled the company to retain \$53 million in the quarter. AMB also announced plans to cut its 2009 dividend, saving an estimated \$98 million for the year.

That additional cash flow could come in handy when facing debt maturities of approximately \$340 million, as is the case for AMB in 2009.

"To be prudent you've got to look at ways to preserve liquidity any way you can," says Tom Olinger, AMB's chief financial officer. "We were paying a dividend well in excess of our requirement for REIT status."

## Open the Books

In many cases when times have been tight in the past, commercial real estate companies have sold off assets to accrue cash. Companies seeking capital can't go that route, according to Fick, for the same reason they need capital in the first place: "We don't think a lot will happen in terms of asset sales, because you need to have a buyer who has capital."

Data from **Real Capital Analytics** (RCA) appear to confirm Fick's suspicion. In January 2009, RCA reported that

worldwide commercial property sales volume fell approximately 60 percent from 2007 to 2008. Total commercial property investment declined from \$1.2 trillion in 2007 to \$495.9 billion last year.

Both Daly and Fick also predict executive pay will attract some scrutiny in the hunt for cash. "We're expecting executive compensation to take a big hit," Fick says.

Olinger notes that the credit crunch has spurred AMB to take other measures besides just lowering dividends. In November 2008, AMB announced that it would be curtailing its development pipeline. Then, in the fourth quarter of 2008, AMB instituted its first-ever workforce reduction. Olinger says the decision was "very tough," but that it was also part of a rigorous effort to survey its internal costs and identify efficiencies.

Olinger stresses the importance of communicating with the investment community when such capital-saving measures are put in place. In discussions with analysts, ratings agencies and institutional investors, Olinger says AMB has received a "favorable" response to its strategies for saving capital. By thoroughly explaining themselves, companies can assuage the fears of investors and analysts who suspect the worst, he says.

"Put the information out there and be transparent," Olinger advises. "You have to trust the market."

Olinger also notes that there's another advantage to saving capital in a tight credit environment. Because REITs have used moderate levels of leverage compared to private real estate firms, they should be in a better position to capitalize on distressed fire sales, according to Olinger. All the more reason to save cash now, Olinger says.

"The REIT industry really should be one of the big winners through this entire process, as they will be in a position to be really opportunistic. Those public market disciplines will position REITs to manage this downturn and take advantage on the upswing," he says. "When we get out of this, my hope is that markets will see REITs are one of the preferred ways to invest in real estate and offer opportunity in tough times." ♦