

## The Great REIT Bubble - "All bubbles must one day burst"

"The REIT's are horrible buys at this time even after falling more than 70-90% from their peak."

This is the story of the Great REIT Price Bubble of 2000-2008. Their prices got way ahead of themselves. REIT's in the last decade created a bubble that is now deflating. After many years of falling cap rates, low interest rates, accommodating credit markets and a massive expansion in the securitization of real estate, the tide has turned. Retail REIT's are still heading into their worse crisis ever, driven by new vacancies, many of which are yet to come from a contraction in the big box tenants during 2009.

Structurally REIT's are not entrepreneurial enough to fight back, nor do they have enough talent in the field to lease fast enough to maintain their NOI. They face a very difficult few years as they try to operate in a completely hostile environment for which they are structurally unprepared.

REIT's are cash machines, but they now face conditions where they will starve for cash. First, the capital they need to re-lease their newly vacant spaces is a staggering percentage of their current after debt cash flow. In addition, their lenders are forcing them to reduce their debt as their NAV's plummet. Given their requirement to distribute most of their cash flow, they simply do not have enough reserves



to deal with these two issues simultaneously. Thus, REIT's will be forced to slash their dividends by 70-90% in 2009. Their stock prices have already dropped as the value of their assets was reassessed at 8+% cap rates. Yet, their stock prices will fall even further as they reduce their dividends which were billed as safe, secure and "always growing".

Watch what a rapidly falling economy does to "Example REIT":

### Before the Crash "Example REIT":

1. Total Assets: \$4.0B (NAV based on 6.0% cap rate)
2. Size: 25 MSF
3. Debt \$2.0B (50% of NAV with \$120M in debt service at 6%)
4. NOI: \$240M
5. Shareholder Equity: \$2.0B (with 4-5% dividend, \$80-100M per year).
6. Average Vacancy: 5%

In late 2007 and building throughout 2008, vacancy and retailer weakness creep in, lowering rents and forcing turnover. Beginning in late 2008 and accelerating in 2009 more shops will close, many of which are boxes which are hard for REIT's to re-lease. Right now 2/3rds of all vacant space in Florida are un-leased boxes - these are very hard to fill right now. For most of the next 3 years, 8-10% of the space in a typical REIT will turnover annually. This massive

turnover will cost a fortune in construction, tenant improvements and leasing commissions to re-lease - all told it will consume about 30-50% of REIT's cash flow after debt service.

The REIT's will try to re-fill the new vacancies at lower rents, but they can't do it fast enough because tenant demand for boxes and small space are so weak. Also, they don't have enough leasing agents. Finally, their portfolios are diversified over too wide of geographies and the management is too thin to cover so much territory. They must literally run everywhere to fill space – this is truly the case of a chicken with its head cut off.

To make matters worse because the markets have crashed, REIT's can't issue new debt or equity. Their banks will force them to reduce their debt. Thus, the only way REIT's can raise cash over the next few years is by selling properties. But, others are being forced by their banks to sell too. As a result, the market will become flooded with "forced sales". With too few buyers, cap rates jump to 8+%, a spread of 500+bps over treasuries, the same spread rate as in 2003 during the last market bottom.

The prior bottom in real estate prices occurred simultaneously with the stock market bottoming after the internet bubble burst. This time it will be the same, but the bubble bursting that causes the stock market to fall will be the deflating of the real estate bubble.

#### **After the Crash "Example REIT":**

1. Annual tenant turnover: 10% - 2.5 MSF (hard to fill with weak box demand and too few leasing agents)
2. Cost to re-lease per year: \$70M (over \$28/SF, this cash drain lasts for 2009-2011)
3. NOI drops 12% in 2009 on increase vacancies: \$210M (down from \$240M)
4. Debt Service rises: \$130M (lenders want pay downs to lower LTV's and higher rates)
5. Dividends are slashed or eliminated to conserve cash for TI/LC's and loan pay downs:

## **About Woolbright Development**

*Woolbright Development is one of Florida's largest private owner/developers of retail shopping centers based in Boca Raton, Florida. Further information on the firm along with a complete listing of our portfolio can be found on our website [www.woolbright.net](http://www.woolbright.net). For more information about Woolbright's research please email to [lhoyer@woolbright.net](mailto:lhoyer@woolbright.net) or call Liz Hoyer, Research Director 561-989-2247.*

\$10M (from \$80-100M)

6. NAV drops as the NOI falls and assets are valued at 8+% cap rates: \$2.6B (with \$2.0B in Debt)

7. Share Prices plummet: 10X dividend is \$100M, NAV is \$600M (down from \$2.0B, shares prices down 70-90% from their peak).

What is the answer to the REIT dilemma and how will the industry behave after this crash?

I don't know. Somehow REIT's will limp through 2009, 2010 and 2011 and eventually re-fill their vacant space and deleverage. By 2012, their NOI should stabilize at 90-95% of the current levels. Over the next few years, REIT's will begin to deleverage from the 75% LTV peak they will hit in 2009 as a result of falling property values. The deleveraging process will keep them out of new investments and developments for at least three years. Finally, the only way for REIT's to deleverage is to merge or to raise new equity because selling alone will take too long. Eventually, Wall Street will come to the rescue of the real estate market once again –

I am just not sure yet what the new structures will look like.

By 2012, Cap Rates will stabilize near 7.5%, which is the average of the last decade, as the forced selling and panic subsides. By 2012, this "Example REIT" will have assets worth \$3B and equity of \$1.0B and pay an 8% dividend. Today, REIT's stocks trade at 30% of their peak values. Their stocks will fall even more before they climb back to 40-50% of their peak value in 2012. Buying now does not seem to offer a big enough reward for so much risk when the future is still so uncertain. This begins the end to the great REIT bubble story.

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