Green Street Advisors

HEARD ON THE BEACH:

THE SUM OF ALL FEARS

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The Sum of All Fears

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Green Street Advisors

Executive Summary

The COVID-19 recession has had an incredibly short incubation period. Fears about the virus' direct impact on health started to impact share prices less than five weeks ago. Those were soon compounded once the enormous costs of mitigation started to come into view. Now, policy makers are frantically fixing leaks as they appear in the plumbing of the global financial system. Each of these variables is impacting the valuation of REITs and real estate.

The fallout from what promises to be a record-breaking plunge in GDP should have somewhat predictable impacts across property sectors. The outlook is complicated, however, by outsized effects on properties that serve as gathering spots and/or cater either to tourists or an older crowd. The market has had time to pass a preliminary judgment on how these risks add up.

Less clear is whether the market has discounted the impact that cash flow disruptions/excessive leverage might have on REITs with less-than-pristine balance sheets. And there are plenty of them: 25% of US REITs now have leverage ratios (debt/enterprise value) in excess of 60%. Balance sheets have been easy to ignore in recent years, but they will serve as sizable return differentiators going forward.

To help clients better track fast-changing valuations, while also keeping an eye on balance sheet strength, we're simultaneously unveiling a new publication, *REITs Amid a Pandemic*.

RMZ: **790** | DJIA: **19,173** | 10-Year T-Note: **0.84%** | Baa Yield: **5.13%**

Heard on the Beach
March 22, 2020

The Sum of All Fears: As recently as five weeks ago, investors were paying little heed to news about the COVID-19 threat beyond the disruption it was causing to supply-chains for goods sourced in China. It has now become the only thing they care about.

As those weeks have unfolded, fears that were once focused primarily on the direct impact of the disease itself, transitioned to the enormous economic costs involved in containing it, and more recently to concerns about the ability of the global financial system to withstand the many stresses that are starting to mount. The sum of these fears has had a dramatic impact on the price of every asset, the most startling of which is the 32% decline in the value of the US equity market.

The first two fears were discussed three weeks ago, in *A Most Unwelcome Visitor*. The extent to which COVID-19 will directly impact a given property type is a function of several factors, including the extent to which: 1) it serves as a place for communal interaction; 2) its fortunes are tied to travel; and 3) it caters to an older crowd. Sectors where an outsized impact will occur include hotels, net-lease casinos, skilled nursing facilities, senior housing, non-grocery retail, and student housing. These impacts have generally been elaborated on in follow-up reports by our respective sector teams. In most other property sectors, the disease itself is unlikely to create a demand shock beyond what might occur in a sharp economic downturn.

The impact of an economic downturn on any given property sector is also a function of three variables: 1) the extent to which demand for space is affected by economic vigor; 2) operating profit margins; and 3) the protection afforded by long-term leases. Hotels are in a class of their own when it comes to economic risk, followed by retail, office, and industrial. Sectors that have historically held up well during downturns include health care, net lease, self-storage, and manufactured housing.

At the time *A Most Unwelcome Visitor* (3/4/20) was published, the idea that REIT balance sheets might be tested seemed a bit far-fetched. To be sure, there have long been a couple of handfuls of US REITs that warrant modest pricing discounts due to excessive leverage, but, as evidenced by the industry's average leverage ratio of 35% (liabilities/private-market asset value) as of the start of this year, most REITs had been doing a reasonable job of minimizing balance sheet risk. That piece was, however, written 8000 points ago in the ongoing plunge of the DJIA.

Now, news stories are starting to pop up that seem uncomfortably familiar to anyone who lived through the Global Financial Crisis. The Fed is buying MBS and flooding repo markets with liquidity; it is backstopping money market funds and, perhaps soon, business loans; and Congress is rushing to throw at least a trillion dollars at citizens/businesses. This may be well and good, but medicine this strong is normally reserved for only the most desperate situations.

There are, to be sure, large differences between then and now. Today's banks are far better capitalized, which alleviates fears of a true credit crunch, and the "whatever it takes" mentality is so pervasive in the minds of policy makers that responses will be swift and aggressive. A financial crisis loosely akin to the GFC is more plausible than it seemed a few weeks back, but it is still unlikely.

The experiences from that era are nevertheless illustrative. Whereas COVID is the "only thing that matters" today, balance sheets held that title during '08/'09. As equity values plunged and balance sheet metrics worsened, half of all US equity REITs felt compelled to issue equity at distressed share prices. The infamously dilutive impact this had on long-term total returns serves as the sector's biggest black eye over the past four decades. REITs that avoided balance sheet stress dramatically outperformed those that didn't. Even if the coming recession only remotely resembles the last downturn, REIT balance sheets will be a large differentiator of returns.

And there is reason to think that is in the cards. The collapse in REIT share prices has been akin to an ebb tide that has exposed plenty of naked swimmers: 10 REITs in our US coverage universe now have Debt/Enterprise Value ratios north of 70% and another 13 are above 60%. Put differently, more than a quarter of our coverage universe has leverage that is excessive by any normal standard. The north-of-70% group is comprised exclusively of REITs in risky sectors, such as hotels, retail, and office. Even if cash flow disruptions are not in the cards – and they are – REITs with such high leverage are clearly operating with sub-optimal capital structures. Equity raises, painful as they may be, will be a necessary dose of medicine for companies striving to maximize shareholder wealth.

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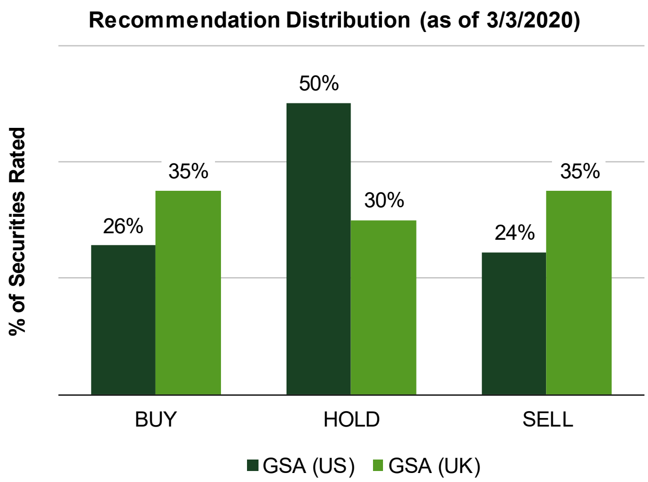

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Total Return of Green Street's Recommendations[1,2]

Year[3]	Buy	Hold	Sell	Universe
2020 YTD	-7.0%	-9.5%	-12.4%	-9.5%
2019	31.6%	22.4%	17.8%	24.0%
2018	-5.1%	-6.6%	-9.2%	-7.0%
2017	6.4%	0.2%	2.1%	2.6%
2016	14.9%	14.7%	13.1%	14.4%
2015	8.3%	0.9%	-1.7%	2.4%
2014	41.6%	31.5%	27.3%	33.3%
2013	4.1%	0.6%	1.7%	2.2%
2012	24.5%	24.7%	18.9%	23.0%
2011	18.9%	7.6%	-4.7%	7.6%
2010	43.3%	32.8%	26.6%	33.8%
2009	59.0%	47.7%	6.0%	37.9%
2008	-28.1%	-30.9%	-52.6%	-37.3%
2007	-6.9%	-22.4%	-27.8%	-19.7%
2006	45.8%	29.6%	19.5%	31.6%
2005	26.3%	18.5%	-1.8%	15.9%
2004	42.8%	28.7%	16.4%	29.4%
2003	43.3%	37.4%	21.8%	34.8%
2002	17.3%	2.8%	2.6%	5.4%
2001	34.9%	19.1%	13.0%	21.1%
2000	53.4%	28.9%	5.9%	29.6%
1999	12.3%	-9.0%	-20.5%	-6.9%
1998	-1.6%	-15.1%	-15.5%	-12.1%
1997	36.7%	14.8%	7.2%	18.3%
1996	47.6%	30.7%	18.9%	32.1%
1995	22.9%	13.9%	0.5%	13.5%
1994	20.8%	-0.8%	-8.7%	3.1%
1993	27.3%	4.7%	8.1%	12.1%
Cumulative Total Return	**21133.4%**	**1353.7%**	**42.0%**	**1617.6%**
Annualized	**21.9%**	**10.4%**	**1.3%**	**11.1%**

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(3) From 1993 until July 3, 2017, the returns for each year cover the period following the first RESM issued in the respective year through the first RESM issued in the following year and are not based on a calendar year. Subsequent to July 5, 2017, returns are based on calendar months.

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