

Special Report

Moody's Commercial Real Estate Finance

October 2009

Moody's Views on the Deleveraging of US REITs and REOCs

Overview

US REITs and other property firms face a particular need to delever their balance sheets given the acute challenges facing commercial real estate – deteriorating fundamentals, an uncertain profit outlook, falling property values, and a significantly tighter lending environment. This need has become even more pronounced with the sharp decline in REIT stock prices, which despite stronger recent performance, are still down 20% since 2008¹. This report reviews the progress REITs have made in this deleveraging process and the various methods by which they have undertaken to delever, and also comments on the possible lures that may ultimately pull the REITs from their current defensive postures.

In order to strengthen their balance sheets, many US REITs have issued common equity, embarked on asset sale programs, and adjusted their dividend policies. Common equity issuances have become almost commonplace, with 66% of Moody's rated universe² having issued stock in 2009. However, asset sales have proven more difficult to execute given the uncertainty over cap rates and a still tight financing environment for would-be buyers. Sales are getting done slowly, however, with the REITs generally seeing more success in executing smaller-scale transactions of less than \$50 million.

Table of Contents:

Overview	1
Ratings Impact	2
Leverage Trends: 2000-2Q09	2
Delevering via Common Equity and Asset Sales	5
Revised Dividend Policies – Another Helpful Tool	5
Secured Debt as a Key Source of Financing	6
Unsecured Credit Lines Remain a Critical Source of Liquidity	7
How Long Will REITs Stay on the Defensive?	7
Moody's Related Research	8

Analyst Contacts:

New York 1.212.553.1653

Lori Marks

Assistant Vice President -Analyst

Alice Chung

Associate Analyst

Philip Kibel

Senior Vice President

Nicholas Levidy

Managing Director

¹ Equity REITs within the FTSE NAREIT US Real Estate Index experienced a 41% stock price decline in 2008, partially offset by a 21% stock price increase January-September 2009.

² For this special comment, Moody's rated universe *excludes* the following rated US REITs and property-related firms unless otherwise noted: private corrections firms, timber REITs, property service firms, mortgage finance companies, as well as Prime Property Fund, Forest City Enterprises, Interstate Hotels & Resorts, Spirit Finance, Reckson OP, and Centro NP.



Moody's Views on the Deleveraging of US REITs and REOCs

Measured on a book value basis, Moody's rated US REITs' overall leverage is down 260 basis points from where it stood in 2000. However, leverage is up significantly as it relates to cash flows and property valuations, which Moody's believes are the more meaningful metrics in today's difficult environment. Net Debt/EBITDA stood at 6.4x as of 2Q09, up from 4.7x in 2000. Despite the progress in lowering book leverage to date, Moody's expects US REITs will need to delever further in order to align their balance sheets with reduced property values and expected declines in cash flows.

Complicating REITs' efforts to delever is the need to maintain liquidity in what remains a very constrained capital environment. Until recently, the unsecured debt markets had been largely shut for all but the largest, most creditworthy REITs. Even as this market has improved of late, mortgage financing is still one of the most cost effective and readily available sources of capital and many REITs are increasing secured debt levels accordingly. Increased secured debt does not necessarily result in negative ratings actions – particularly if a REIT entered this downturn with a large, high-quality, unencumbered asset pool. However, flexibility is more limited for those REITs that entered the downturn with high secured debt levels, particularly when covenants come under pressure. Negative ratings actions have resulted in some cases and more could follow as the cycle grinds on.

Most REITs are still in defense mode, focused on enhancing their capital structures and preserving liquidity. Once immediate liquidity needs are met (as measured by the ability to fund debt maturities, development, and capital expenditures, generally over the next two years), the longer term question remains as to how deleveraging will ultimately affect growth and business strategies. Many REITs are accumulating capital so that they may take advantage of distressed investing opportunities that will inevitably materialize. Moody's will closely monitor the extent to which leverage increases once REITs resume growth via development, acquisitions, or both.

Ratings Impact

It is important to note that a significant number of rated REITs have retained their ratings so far in the downturn. Since the beginning of 2009, only 18 issuers out of the 71 Moody's rated REITs and REOCs have been downgraded.³ Of these downgrades, 13 involved speculative grade companies. However, Moody's believes that REITs' current credit profiles could face further pressure given the headwinds that continue to confront the sector. The ability to make meaningful progress in deleveraging is essential to providing cushion against declining cash flows. The reduction of debt, along with moderate use of secured capital and adequate debt service coverage, are necessary for REITs to maintain existing credit ratings.

Leverage Trends: 2000-2Q09

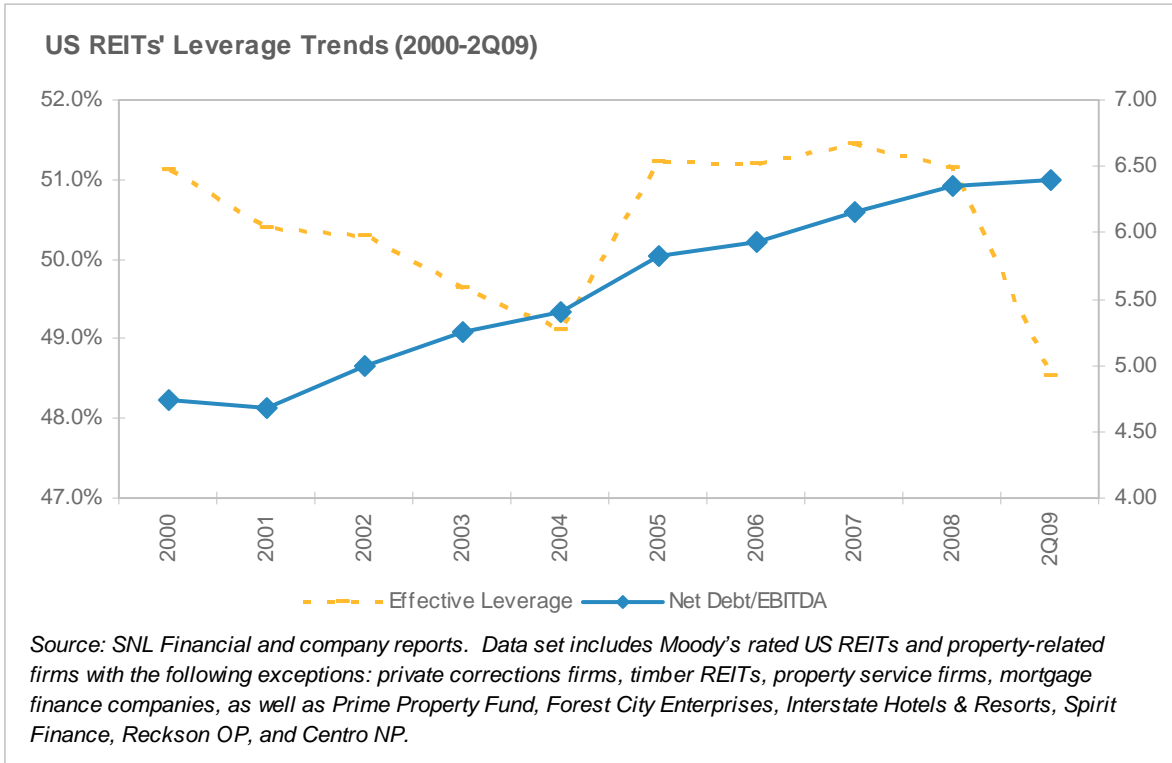
Moody's considers three metrics in assessing a given REIT's overall leverage. These metrics use a book value based approach, a cash flow based approach, and a market value based approach. During a period of rising property valuations, book value leverage (debt + preferred stock as a % of gross assets) is a conservative means of assessing leverage levels. However, in environments such as the one that exists today where prices are falling, book value might understate leverage. The extent of any such understatement depends on when (i.e., at what point in the real estate cycle) the properties in the portfolio of a given REIT were added to its balance sheet, as these assets are recorded on the balance sheet at cost.

As such, Moody's analysis also considers how a REIT's debt levels compare to its current and expected cash flows (Net Debt/EBITDA) as well as to its current and expected property valuations (debt + preferred stock as a % of estimated portfolio market value, with value assessed using a range of cap rates and stressed NOI amounts⁴). Moody's believes that together these metrics provide a more complete analysis of leverage and better comparison amongst companies. When assessing a particular REIT's capital structure, these leverage metrics are considered in conjunction with other key factors such as fixed charge coverage, earnings volatility, debt maturity laddering, and the size and quality of its unencumbered assets pool.

³ Includes all US REITs & REOCs rated by Moody's as of 9/30/09

⁴ "US REITs: Moody's Market Value Leverage Analysis," August 2009.

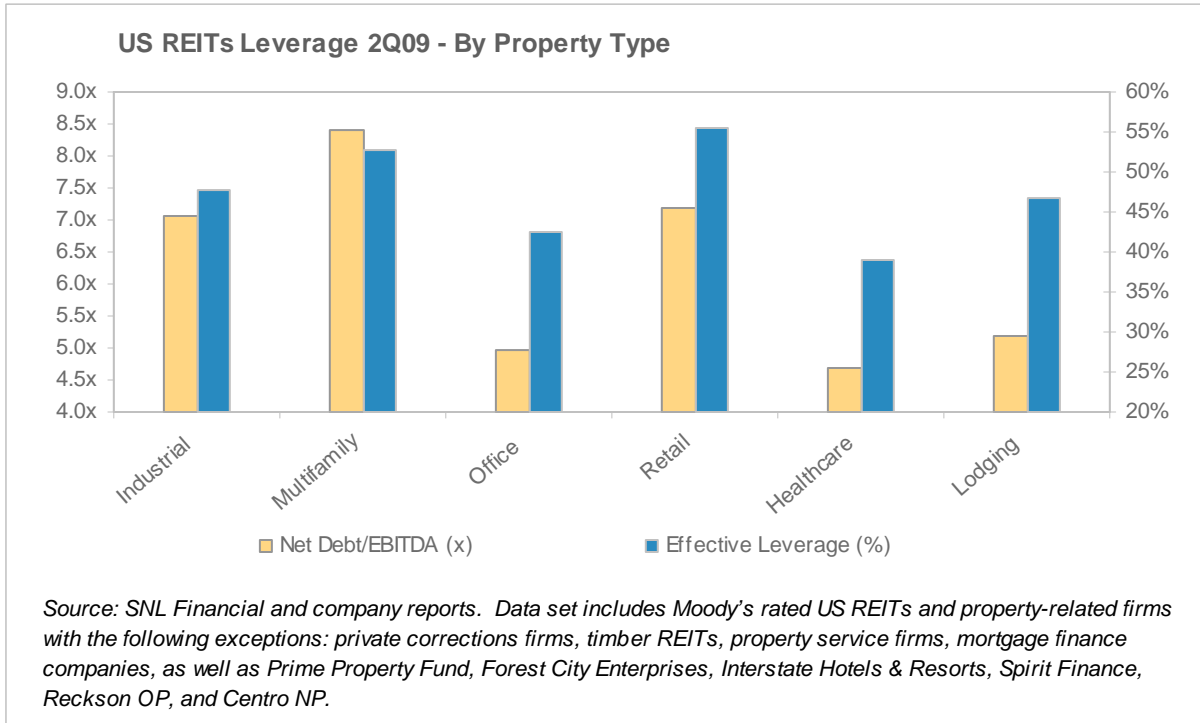
Moody's Views on the Deleveraging of US REITs and REOCs



Book Leverage vs. Current MVLA							
Sector	Book Leverage 6/30/09	MVLA Leverage @ 9% Cap Rate			MVLA vs Book		
		-2.5% NOI	-5.0% NOI	-7.5% NOI	-2.5% NOI	-5.0% NOI	-7.5% NOI
Industrial	47.4%	60.6%	61.8%	63.0%	13.2%	14.4%	15.6%
Multifamily	52.8%	70.0%	71.6%	73.3%	17.1%	18.7%	20.4%
Office	42.2%	46.5%	47.6%	48.7%	4.3%	5.4%	6.5%
Retail	55.4%	60.6%	62.0%	63.4%	5.2%	6.5%	8.0%
Average:	49.5%	59.4%	60.7%	62.1%	10.0%	11.3%	12.6%

Measured on a book value basis, Moody's rated US REITs' overall leverage is down 260 basis points since 2000. However, leverage is up significantly on a market value basis derived by analyzing projected cash flows and property valuations, which are the more meaningful metrics in today's environment of pressured earnings and rising cap rates. Moody's MVLA indicates that average book leverage would be understated by 10 to 13 percentage points, depending on the decline in NOI (assuming a 9% cap rate). Net Debt/EBITDA stood at 6.4x as of 2Q09, up from 4.7x in 2000. Despite the progress in lowering book leverage to date, Moody's expects US REITs will delever further in order to align their balance sheets with lower property valuations and expected declines in cash flows.

Moody's Views on the Deleveraging of US REITs and REOCs



Within Moody's rated REIT universe, leverage varies greatly by company and property type. On a book leverage basis, retail REITs have the highest debt levels on average, followed by multifamily, industrial, lodging, office, and healthcare REITs. Retail REITs, particularly the regional mall REITs, historically have carried relatively higher leverage (over 60%) due to the steadier nature of the cash flows generated by long-term leases and large properties.

As measured on a Net Debt/EBITDA basis, multifamily REITs are among the most highly leveraged REITs. Retail REITs have longer lease terms (typically 10+ years with renewal options versus one-year leases for multifamily), so the negative impact from occupancy pressures and tenant bankruptcies has been somewhat offset for the retail sector by positive re-leasing spreads. The multifamily REITs' historically higher leverage is partly owing to their access to financing through the GSEs – a particularly cost efficient means of accessing capital in today's market. Many companies have increasingly taken advantage of this form of financing over the past year as a means of enhancing liquidity. Moody's notes that even as higher Net Debt/EBITDA ratios are key credit challenges for many multifamily REITs, the companies' access to GSE financing somewhat mitigates these risks by enhancing the sector's direct access to liquidity and by making the sale of assets easier in today's market due to a potential buyer's access to this financing.

Healthcare REITs have the lowest leverage as measured on both a book and cash flow basis. Despite the longer-term nature of the leases, healthcare REITs are exposed to a high amount of potential earnings volatility due to changes in government reimbursement programs, which have had a pervasive negative impact on the sector in the past. They are also exposed to high tenant and property sub-type concentrations, and often weak tenant credit profiles. Therefore, Moody's expects healthcare REITs to maintain relatively more conservative credit metrics. We note that many healthcare REITs' book leverage is substantially below historical levels (effective leverage at 39% as of 2Q09 versus 50% in 2000), although Net Debt/EBITDA is up modestly (4.7x for 2Q09 versus 3.9x in 2000). This is partially due to the large volume of lower-yielding investments executed over recent years – a cyclical peak in real estate valuations. Positively, we note that much of this activity has enhanced diversification, with many healthcare REITs investing more capital in lower cap rate property sub-types (such as medical office buildings) and reducing exposure to higher cap rate, higher risk businesses (such as skilled nursing facilities.)

Moody's Views on the Deleveraging of US REITs and REOCs

Delevering via Common Equity and Asset Sales

In response to the financial crisis, many US REITs have issued common equity as a means of strengthening their balance sheets. Despite sagging stock prices, a handful of REITs tested the equity markets in early 2009 and experienced surprisingly strong investor demand and subsequent share price outperformance. As the REIT equity markets have rebounded in 2009, an increasing number of REITs have been encouraged to tap common equity as an available form of capital, although one still expensive by some measures. Through September 2009, 66 real estate companies have issued \$22 billion of common equity⁵.

The first use of this capital has been to ensure sufficient liquidity to meet short- and intermediate-term funding needs, including debt maturities, capital expenditures, and development in progress. Once the ability to meet these needs has been satisfied, many REITs are using the incremental equity to reduce debt via tender offers, open market repurchases and paying down credit lines. Looking within Moody's rated universe, 31 REITs have issued equity year-to-date through September 2009. Among these REITs, effective leverage has declined 367 basis points as of 2Q09 while Net Debt/EBITDA has increased 1 basis point (note that 3Q09 issuances won't be reflected until 3Q09 financials are reported.)

While REIT stock prices may remain relatively volatile over the next year as a result of declining fundamentals, constrained capital markets and negative sentiment towards commercial real estate, we note that stock price does not necessarily reflect an individual REIT's credit worthiness, though relative performance can provide valuable signaling information. However, if REIT stock prices were to resume significant declines without recovery, it could make it increasingly difficult for the firms to access this important source of capital and accomplish their delevering goals.

Many REITs have also embarked on asset sale programs as a means of enhancing liquidity and delevering. However, asset sales have proven more difficult to execute given the uncertainty over cap rates and a still tight financing environment for would-be buyers. Sales are getting done slowly with the REITs generally seeing more success in executing smaller-scale transactions (less than \$50 million). Multifamily assets are particularly marketable investments in this environment given the availability of GSE financing. We note that sales executed in today's market would likely be dilutive to earnings. Given the challenges of sourcing capital at this time, however, the effect on a given REIT's credit profile would likely be neutral-to-positive, depending on the extent to which proceeds were used to reduce leverage.

Revised Dividend Policies – Another Helpful Tool

Several REITs have also adjusted their dividend policies via either an outright reduction in payment and/or partial distribution in the form of stock. The movement to a stock dividend takes advantage of a December 2008 IRS ruling which gave US REITs the green light to pay out up to 90% of their common dividends in stock. So far, only nine REITs have elected to pay a portion of 2009 dividends in shares while 57 REITs have cut or suspended their overall payments⁶. The highest proportion of dividend cuts was among the office and retail companies.

Moody's views the stock dividend as a short-term net credit positive to rated REITs and the sector as a whole, as it provides an additional channel by which firms may shore up liquidity.⁷ However, the use of stock dividends over a sustained period does raise questions as to whether a given REIT is using this as a lever of last resort to mask the existence of deeper liquidity challenges. As it stands now, the IRS ruling remains in effect only through the 2009 tax year so it might be of limited use to REITs going forward. However, to the extent a REIT is paying out amounts in excess of its taxable income, a dividend cut would remain a viable option.

⁵ SNL Financial. This data set includes all North American real estate companies tracked by SNL.

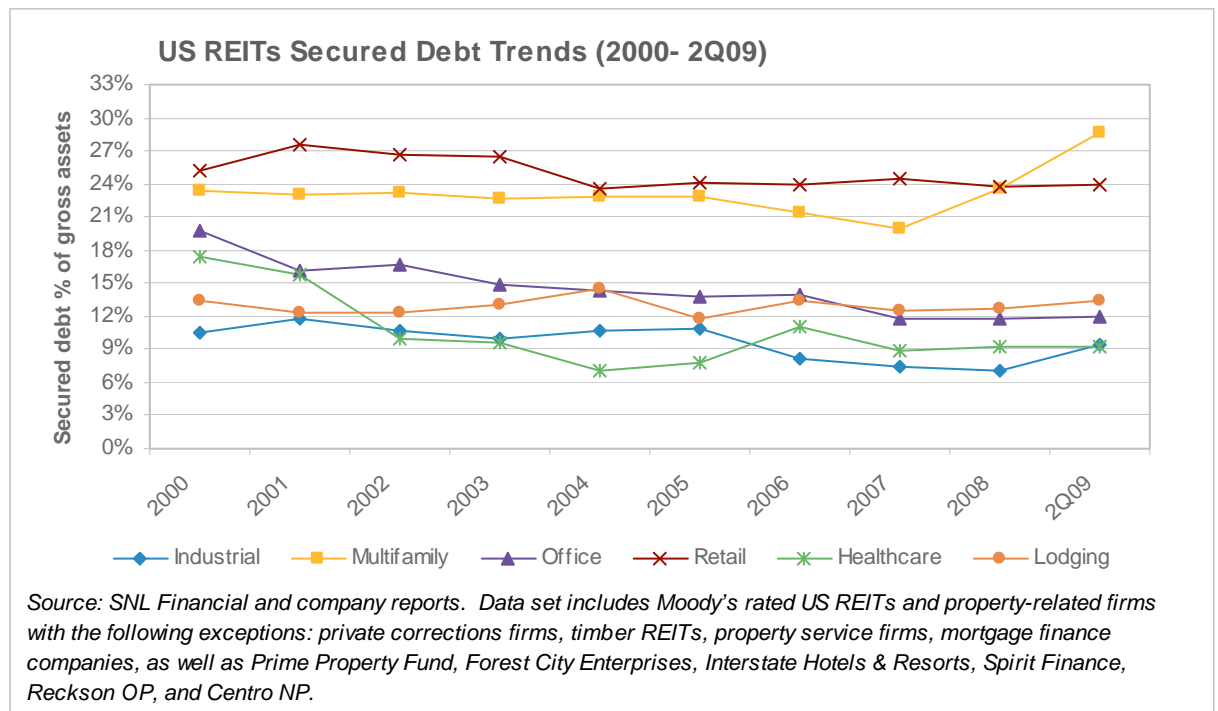
⁶ SNL Financial. This data set includes all US real estate companies tracked by SNL.

⁷ "US REITs: Utilization of Taxable Stock Dividends – Today, Net Credit Positive," January 2009

Moody's Views on the Deleveraging of US REITs and REOCs

Secured Debt as a Key Source of Financing

Although access to the unsecured debt markets has improved somewhat for the sector of late (particularly for the most creditworthy REITs), this market was largely closed for the last 18 months. As a result, REITs have been forced to pursue other types of external capital, mainly secured financing. With the CMBS market in a state of flux, most of the secured borrowing activity has been in the form of traditional mortgages on individual assets. A handful of REITs, however, are working to structure CMBS deals that would allow them to borrow through the Federal Reserve's Term Asset-Backed Securities Loan Facility (TALF) program. Whether it be through TALF or traditional mortgage financing, investment grade REITs generally have better access to secured capital versus other real estate companies due to their overall lower leverage levels, higher quality assets and sizable unencumbered asset pools. As a result, many REITs have been taking advantage of this capital source, using proceeds to refinance maturing debt and pay down lines of credit balances. Some REITs have also been able to buy back or tender for their debt at a discount, minimizing future refinancing risk. Not surprisingly, the challenging capital environment has caused REIT secured debt levels to rise modestly. Among REITs rated Baa by Moody's, the average level of secured debt was 13.7% of gross assets at 2Q09, up from 10.9% at YE07.



The GSEs continue to be the silver lining supporting liquidity in the multifamily space. The average secured debt level for Moody's rated multifamily REITs has steadily increased to 28.6% at 2Q09, up from 20% at YE07. Conversely, effective leverage for the space has remained relatively flat at 52.9% at 2Q09 versus 53.1% at YE07. Relative to other forms of debt available, agency capital has been a cheaper alternative with loan terms that are generally longer, making this a favorable financing tool. This probably explains why we have not witnessed as many multifamily REITs participating in the recent waves of equity issuance across the sector. We expect the multifamily REITs to continue leaning on Fannie Mae and Freddie Mac for capital, so long as the GSEs' appetite for this product type remains strong and pricing stays competitive.

Moody's notes that while the use of secured financing has strengthened some REITs' liquidity positions, it does also result in weakened unencumbered asset profiles. Securing assets causes incremental subordination for unsecured creditors and limits operating flexibility as it can be difficult to sell the collateralized assets at a later date. Furthermore, most REITs' unsecured bonds have secured debt and unencumbered assets covenants (typically requiring a secured debt to total assets ratio of less than 40% and an unencumbered assets to unsecured debt ratio of greater than 150%) - two covenants that would be put to

Moody's Views on the Deleveraging of US REITs and REOCs

the test if the use of secured debt were to become excessive. We do note that the GSE financings typically feature asset substitution rights, which afford the multifamily companies greater operational flexibility versus traditional secured debt.

Moody's anticipates that rated REITs will seek to reduce the amount of secured debt in their capital structures as the credit markets recover. That being said, until the markets show further improvement, we expect secured financing will remain an important source of liquidity for REITs.

Unsecured Credit Lines Remain a Critical Source of Liquidity

Moody's believes that retaining unrestricted access to a committed unsecured line of credit is critical in the current credit environment. As such, Moody's closely monitors a REIT's ability to maintain adequate cushion under all covenant tests. Moody's considers a committed unsecured line of credit as reliable as cash as long as there is adequate covenant cushion, the line is funded by a diverse group of well-capitalized banks, and there are at least two years remaining until maturity (including extensions at the issuer's option). Equally important is the size of the credit facility versus the REITs' capital needs coupled with sufficient line availability (at least 50%).

As 2009 began, Moody's was concerned that the REIT sector would be unable to renew credit lines sufficiently large to deal with upcoming funding needs. Thus far, strong bank relationships have generally helped REITs renew their credit lines on reasonable terms, albeit at higher interest rates. Even as capacity on the new lines has declined for some companies, REITs generally seem to be obtaining facilities adequate in size to address their capital needs.

How Long Will REITs Stay on the Defensive?

What happens after REITs satisfy their deleveraging goals? Undoubtedly, some companies will be better positioned than others to take advantage of the profitable investment and development opportunities that will arise. Moody's views the current deleveraging within the space as necessary and positive, but it remains to be seen whether REITs will remain committed to lower leverage levels over the longer term – particularly once capital markets have stabilized. This unique economic environment could create several opportunities for the sector:

- **Acquiring quality assets at bargain prices.** REITs with fortified balance sheets are well prepared to acquire distressed assets down the road. Although the transaction market remains strained⁸, we expect to see some stressed, over-leveraged operators offload their properties in the coming months, creating buying opportunities for well-capitalized REITs with modest leverage.
- **A return to development when market fundamentals improve.** For many REITs, development is a core business and part of their overall growth strategy. But since the credit crisis began, REITs which were large developers have had to scale back development projects as a means to preserving liquidity. Moody's will be closely monitoring development activity as we expect that REITs will slowly ramp up their construction programs once development economics improve.
- **A competitive advantage over debt-burdened players in the private space.** Those investors who employed excessive leverage during the real estate boom will continue to face challenges as they try to refinance their debt and meet other funding needs. However, these situations could present a distinct window of opportunity for those better capitalized REITs. Moody's expects that we could see an increase in M&A activity as stronger companies acquire weakly-capitalized companies or portfolios.

⁸ "Moody's/REAL Commercial Property Price Indices," October 2009

Moody's Views on the Deleveraging of US REITs and REOCs

Moody's Related Research:

- Moody's/REAL Commercial Property Price Indices, October 2009 (SF182118)
- US REITs: Moody's Value Leverage Analysis, August 2009 (119418)
- US CMBS: Rise in Delinquency Rates Prompts a Review of CMBS Hotel Exposure to the Top 25 MSAs and Non-US Markets, August 2009 (SF176504)
- REITs & REOCs Statistical Supplement: Canada, Latin America, the Caribbean, and the United States, July 2009 (117970)
- US REIT and REOC Industry Study, June 2009 (117614)
- Multifamily REITs – Fundamentals Continue to Weaken, April 2009 (115407)
- US OFFICE REITs: 4th Quarter 2008 Earnings Commentary and Outlook, March 2009 (115230)
- US REITs: Utilization of Taxable Stock Dividends – Today, Net Credit Positive, January 2009 (114377)

To access this report, click on the entry above. Note that this reference is current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Moody's Views on the Deleveraging of US REITs and REOCs

Report Number: 120779

Author(s)

Lori Marks
Alice Chung

Production Specialist

Cassina Brooks

CREDIT RATINGS ARE MOODY'S INVESTORS SERVICE, INC.'S (MIS) CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES. MIS DEFINES CREDIT RISK AS THE RISK THAT AN ENTITY MAY NOT MEET ITS CONTRACTUAL, FINANCIAL OBLIGATIONS AS THEY COME DUE AND ANY ESTIMATED FINANCIAL LOSS IN THE EVENT OF DEFAULT. CREDIT RATINGS DO NOT ADDRESS ANY OTHER RISK, INCLUDING BUT NOT LIMITED TO: LIQUIDITY RISK, MARKET VALUE RISK, OR PRICE VOLATILITY. CREDIT RATINGS ARE NOT STATEMENTS OF CURRENT OR HISTORICAL FACT. CREDIT RATINGS DO NOT CONSTITUTE INVESTMENT OR FINANCIAL ADVICE, AND CREDIT RATINGS ARE NOT RECOMMENDATIONS TO PURCHASE, SELL, OR HOLD PARTICULAR SECURITIES. CREDIT RATINGS DO NOT COMMENT ON THE SUITABILITY OF AN INVESTMENT FOR ANY PARTICULAR INVESTOR. MIS ISSUES ITS CREDIT RATINGS WITH THE EXPECTATION AND UNDERSTANDING THAT EACH INVESTOR WILL MAKE ITS OWN STUDY AND EVALUATION OF EACH SECURITY THAT IS UNDER CONSIDERATION FOR PURCHASE, HOLDING, OR SALE.

© Copyright 2009, Moody's Investors Service, Inc., and/or its licensors and affiliates (together, "MOODY'S"). All rights reserved. **ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY COPYRIGHT LAW AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT MOODY'S PRIOR WRITTEN CONSENT.** All information contained herein is obtained by MOODY'S from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, such information is provided "as is" without warranty of any kind and MOODY'S, in particular, makes no representation or warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability or fitness for any particular purpose of any such information. Under no circumstances shall MOODY'S have any liability to any person or entity for (a) any loss or damage in whole or in part caused by, resulting from, or relating to, any error (negligent or otherwise) or other circumstance or contingency within or outside the control of MOODY'S or any of its directors, officers, employees or agents in connection with the procurement, collection, compilation, analysis, interpretation, communication, publication or delivery of any such information, or (b) any direct, indirect, special, consequential, compensatory or incidental damages whatsoever (including without limitation, lost profits), even if MOODY'S is advised in advance of the possibility of such damages, resulting from the use of or inability to use, any such information. The credit ratings and financial reporting analysis observations, if any, constituting part of the information contained herein are, and must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell or hold any securities. **NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY MOODY'S IN ANY FORM OR MANNER WHATSOEVER.** Each rating or other opinion must be weighed solely as one factor in any investment decision made by or on behalf of any user of the information contained herein, and each such user must accordingly make its own study and evaluation of each security and of each issuer and guarantor of, and each provider of credit support for, each security that it may consider purchasing, holding or selling. MOODY'S hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by MOODY'S have, prior to assignment of any rating, agreed to pay to MOODY'S for appraisal and rating services rendered by it fees ranging from \$1,500 to approximately \$2,400,000. Moody's Corporation (MCO) and its wholly-owned credit rating agency subsidiary, Moody's Investors Service (MIS), also maintain policies and procedures to address the independence of MIS's ratings and rating processes. Information regarding certain affiliations that may exist between directors of MCO and rated entities, and between entities who hold ratings from MIS and have also publicly reported to the SEC an ownership interest in MCO of more than 5%, is posted annually on Moody's website at www.moody's.com under the heading "Shareholder Relations — Corporate Governance — Director and Shareholder Affiliation Policy."



Moody's Investors Service