RE STRATEGIC SOLUTIONS, LLC

Deriving Valuation Metrics From the REIT Market

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What if there are no sales!

- ***Good news: CRE transactions have doubled in the last year or so***
- ***Bad news: CRE transactions have declined 80% from the peak volume in mid 2000's***

NO SALES – NO PROBLEM

- Cap Rate
- Price/SF or Price/Unit
- Effective Gross Income Multiplier

Can be derived from REIT stock prices

Traditional Ro

- Comparable Sales
- Band of investment
- $R_o = Y_o - \Delta a$
- Surveys
- $R_o = DCR \times M \times R_m$

But, all these rely on transactions or mortgage info

Premise of REIT Model

- Institutional investors indifferent to buying private or public real estate, i.e. their current actions in either market should reflect fair value
- Real estate fundamentals (rent, rent growth, vacancy, expenses etc.) affect public and private real estate similarly
- Public real estate pricing moves in same direction as (although often leads) private real estate pricing

Ro = Io / Vo

- Io (net operating income) can be measured from info in a REIT's quarterly SEC filings and website reports
- Io can be annualized going forward based on appraiser's, wall street analyst's and company's guidance of Io growth over N4Qs

Vo = Vm + Ve

- Vm = mortgage loans and non-convertible preferred stock on balance sheet
- Ve = stock market price X number of shares outstanding

Therefore, in formula

Ro = Io / (Vm + Ve)

Only variable is stock price!

Skills an appraiser needs to have

- Analyze an income statement
  - GAAP net income vs. real estate NOI
  - Straight lining of rent
- Analyze a balance sheet
  - Non-convertible subordinated debentures???

Limitations of the model

- REITs more liquid/volatile than private real estate

  Yes, but

  - REIT investors accept more liquidity in exchange for more volatility
  - Private investors accept less liquidity in exchange for less volatility.
  - Volatility differences can be mitigated by using ave. stock price L30D

Limitations of the model

- REIT assets may not mirror subject property

Yes, but choose “comp” REITs with

  - similar geographic “tilt”
  - similar physical and economic characteristics, as reflected by ave. rent per unit or per SF

CA “tilted” REITs (by reported % of NOI or base rent)

- Office
  - – Douglas Emmett (95%)
  - – Kilroy Realty Corp (97%)

- Industrial
  - – Mission West Properties (100%)
- Retail
  - – Regency Centers (30%)
- Apartments
  - – BRE Properties (80%)
  - – Essex Property Trust (80%)
  - – Equity Residential Trust (30%)

Need for Add’t Research

- **Back-testing data to determine the historical correlation between Ro in the private market versus Ro extracted from the public market.**

Conclusion

- Evidence of current market activity, as demonstrated daily in the public markets, can represent alternative market information for appraisers
- See *Appraisal Journal,* Fall 2009, “Deriving Capitalization Rates and other Valuation Metrics from the REIT Market”