This is the first issue of **REIT Insight**, a market commentary newsletter by RRE’s Real Estate Securities Global Portfolio Manager, Scott Crowe. **REIT Insight** is designed to offer unique perspectives on publicly traded and non-traded REITs, from an experienced, investment practitioner. Each month, Scott analyzes the REIT and real estate securities markets’ activity to provide relevant information for your business and clients.

**In this month’s REIT Insight:**

**NON-TRADED REITs**

The continued “connectivity” between publicly traded and non-traded REIT markets, including the listing of Cole and the acquisition of ARC IV by ARCP

**INTEREST RATES**

The impact of interest rates on the real estate and real estate securities markets (both traded and non-traded REITs)
American Realty Capital Trust IV Acquired by American Realty Capital Properties

An important trend is the increasing connectivity between the publicly traded and non-traded REIT markets, most recently with the proposed acquisition of the non-traded REIT American Realty Capital Trust IV (“ARCT IV”) by the publicly traded American Realty Capital Properties (“ARCP”). This represents a record speed liquidation, given that ARCT IV closed in April. However, it is worth noting that about half of ARCT IV’s portfolio came in the form of a $1.5B bulk acquisition of fast food-tenanted properties (Burger King, KFC and Taco Bell) on a 6.8% yield with a 7-year lease term. Our belief is that, while this is a win/win for all parties, the velocity of the “raise it, invest it and list it” approach is probably unsustainable, and there could be some deterioration in quality in order to achieve the outcome. For instance only 33% of the tenants in ARCT IV are investment-grade1, versus more than 70% of tenants in ARCP’s earlier non-traded REITs.

ARCP benefits primarily by becoming the second-largest net lease REIT. While ARCP will enjoy some AFFO accretion from this deal, the bulk of its recent increase in earnings guidance actually reflected the acquisition of Caplease2. The lack of cash flow accretion reflects a relatively full price, in our view3. The transaction does have other benefits for ARCP, including the reduction of its dividend payout ratio and increasing the duration of its debt. ARCP is pushing for a credit rating and indicated that they would be internalizing the management of the REIT. ARCP is setting up to garner attention from the big institutions.

While we do not own ARCP in our allocation of publicly traded Net Lease REITs, we are investors in select ARCT Non-Traded REITs.

Listing of Cole Real Estate Investments

Cole Real Estate Investments’ (“COLE”) recent listing, with a market cap over $5B, represented the addition of yet another institution that now straddles both the world of non-traded and publicly traded REITs4 and continues the “merging of worlds” between the two markets. Unfortunately for COLE, the listing was in the jaws of the downturn in the REIT market, and their debut was less than stellar, listing at $11.50 – at one point trading below $10. We view COLE as a high quality portfolio with an attractive yield and an asset management business that is not understood or valued correctly by traditional investors.

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1 American Realty Capital analyst presentation.
2 In May ARCP announced the acquisition of another publicly traded REIT, CapLease (LSE), a net lease REIT-mostly focused on suburban office (52%) & warehouse (21%).
3 We estimate ARCT IV acquisition was at a 5.9% implied cap rate versus ARCP’s Adjusted FFO yield of 5.7% at the time.
4 In addition to American Realty Capital Properties (ARCP), WP Carey (WPC), NorthStar Realty Finance (NRF) and Resource America (REXI).
publicly traded REIT investors. Our response was to acquire positions over the first few
days of its listing, and we still hold them. Remember that this was a portfolio that ARCP
was willing to pay $13.59 for in script\(^5\) during its recent acquisition proposal for COLE.

A broader consequence of COLE’s listing is perhaps the impact on investor psychology
and the dramatic decline in the share prices of Triple Net REITs is the possibility of
dampened investor expectations of the ability for Net Lease REITs to easily exit above
10 into the REIT market.

**Trends in the Secondary Market for Non-Traded REITs**

Part of our strategy is to invest by making markets in non-traded REITs in the secondary
market. We believe that in the longer term there is a huge benefit for the development
of an active secondary market in non-traded REITs, since they provide liquidity for
existing investors, price discovery (with smaller NAV discounts) and transparency for the
industry. This should help new capital raisings if investors have a viable exit option\(^6\).

We constantly monitor trends in these markets and provide valuable feedback. During
recent months we noticed a material tightening in discounts in the secondary market
(from -17% to -12% from Q4-12 to Q1-13). Our expectation is that, with the selloff in
the publicly traded REIT market, combined with the lackluster listing of COLE and
tempered expectations regarding the profitability of “liquidating into the REIT market,”
we should see some widening in secondary market spreads and some more volume of
non-traded REITs to emerge in the secondary market.

\(^5\) Or $12.50 in cash.

\(^6\) RRE Property Securities may be able to provide liquidity for your positions in non-traded REITs. Please ask your RRE Representative to find out more.
Markets have been dominated by a shift in views on interest rates, with the 10YR yield increasing from a low of 1.7% at the start of the year to 2.5% today. We believe market consensus was for the Federal Reserve to continue Quantitative Easing7 (QE) into next year. However, with signs of economic recovery and better job numbers, the Federal Reserve has now stated that they may begin to end QE this year8.

While we have recently seen a number of forecasters increase their 10YR forecast to 3.5% to 4.0% for next year, our view is that 2.5% to 3.0% is where interest rates will probably range for the balance of this year. We believe that there is a limit to how far and how fast interest rates can increase without derailing the recovery (at which point they would recede again). For instance, we are seeing definite signs that the housing market will lose a bit of momentum (mortgage rates are back up to 4.5%, reflecting interest rate increases).

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7 Quantitative easing (QE) is an unconventional monetary policy used by central banks to stimulate the national economy when standard monetary policy has become ineffective. A central bank implements quantitative easing by buying financial assets from commercial banks and other private institutions, thus increasing the monetary base. This is distinguished from the more usual policy of buying or selling government bonds in order to keep market interest rates at a specified target value.

8 While short term interest rates are not expected to increase until 2015 due to an increase in conventional monetary policy, QE has had the effect of reducing long term rates and giving all borrowers an interest rate subsidy. The Fed had put this in place as a way to stimulate the economy with rates already at zero. It seems that perhaps now this may not be needed for as long as had been anticipated.
Private Market Values Likely to Continue Appreciating

We have seen a few forecasters predict that the increase in interest rates will lead to higher yields (and a fall in values) for real estate in private markets. We disagree. We believe that, at worst, real estate yields will remain roughly constant and that cash flow growth (in line with an improving economy and low real estate supply) should translate to continued appreciation of real estate values.

The bull-case scenario would be for values to increase in excess of organic cash flow growth as better economic prospects and higher investor confidence push yields down even further (and prices up), given the still relatively high spread between property yields and debt costs.

We acknowledge, however, that we have probably reached the lows for interest rates, and that growth prospects are on a much firmer footing than at any point in the recovery. One impact that we expect from this is a slowdown in the rate of yield compression and value appreciation from more “bond like” types of real estate, including Net Lease Retail, which has seen some of the strongest returns in both the publicly traded and non-traded REIT sectors.

The table represents a sensitivity matrix by UBS showing equity value changes given various cap rate and same-store NOI growth (property cash flow growth) scenarios. The top horizontal axis shows potential increases in cap rates by the end of the third year (i.e. 0.25% = a 25bps increase by the end of year 3). The left vertical axis shows average annual increases in same-store NOI growth (i.e. 3% = 3% average growth over 3 years, or 9.3% total compounded growth).

% Change in Equity Values over a 3 Year Period

Source: UBS

Note: Assumes a three year time frame, 35% leverage and a starting cap rate of 5.5

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We also believe that we are at the beginning of the second stage of the commercial real estate market recovery – the first stage was driven primarily by low interest rates and stabilizing fundamentals (rents and occupancy); the second stage will be characterized by above average rental growth, given the historically low supply of commercial real estate. We believe that investors are underestimating the rental growth potential due to extremely low supply and a lack of capital willing to take the development risk, combined with the long lead times for real estate construction and a continuing improvement in tenant demand.

Publicly Traded REITs: Selloff Was Overdone

The impact of the recent increase in interest rates has been dramatic, with REITs rapidly correcting 20% -- in our experience it is one of the most dramatic corrections since the Great Recession. The hardest hit sectors included Healthcare and Triple Net9. The market has somewhat recovered; however, it is trading back toward NAV.
We believe that nothing demonstrates our view of the market better than a description of our actions. Beginning about one month ago, we began rotating money into the publicly traded REIT sectors. Our view was that even factoring higher interest rates into our valuations, it would only account for a -10% correction -- the remainder of the dip reflected some panic selling as well as an opportunity. We have also been investing in some of the hardest hit sectors, such as Triple Net REITs, which we believe will still be secular winners this cycle. The change in interest rates is not nearly enough to drastically affect the value of the franchises.

However, with the 9% recovery in REIT prices from their low, we are out of the market. In fact, given our recent investments, we currently overweight publicly traded real estate in our asset mix, and may look to reduce this on further strength10.

Taking a longer term view, we believe that higher rates may be accompanied by lower yields and increasing values. This would be consistent with the experience of last cycle, where rates increased as the economy strengthened and real estate prices continued to be bid up (see “Property Yields and 10YR Gov Yields” chart above). In fact, the current spread between government bond rates and property yields is very wide and is likely to compress, both because of an increase in interest rates and gradually increasing yields. Similarly, looking at the “REIT Equity Prices and 10YR Gov Yields” chart, REIT prices also appreciated in tandem with increasing bond yields during the last cycle. It is true that since the Great Recession REIT prices have been buoyed by extraordinarily low interest rates, and it is not surprising that the market would go through an adjustment phase as the outlook for interest rates adjusts.

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1 Single tenant net lease such as National Retail Properties (NNN), American Realty Capital Properties (ARCP), WP Carey (WPC).

10 RRE Diversified Income Fund neutral allocation represents a 35% publicly traded REIT Equity; 35% publicly traded REIT Preferred, 30% non-traded REIT.