REIT Office Sector

As of 9/5/2023

L D R CAPITAL MANAGEMENT

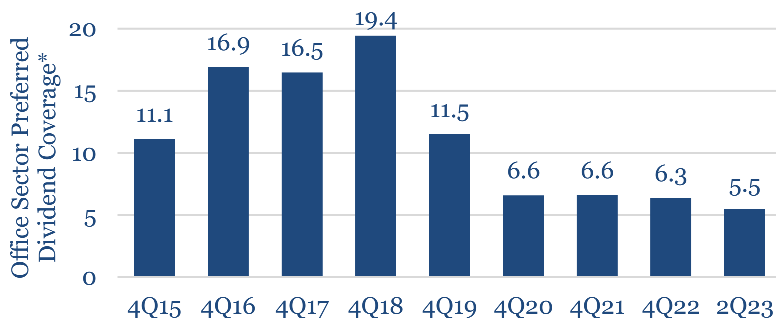
Office REITs and Their Preferred Stocks

The psychology surrounding commercial office real estate could not get much worse. A pronounced shift toward higher interest rates and work-from-home trends have put into question the operating results and asset values within the property sector. Consequently, valuations of office-based REIT equities – and even preferred stocks – have been negatively impacted. Specific to the office REIT preferred shares, we calculate the group is now priced with an average yield of 9.2% and an average discount to par of a whopping 60%.

That said, we find the actual financial standing of the public office REITs (that have preferred shares outstanding) to stand different than the underlying psychology. As you'll see below, office REIT preferred dividend coverage ratios, while recently trending lower, still appear solid. All companies carry financial ratios in excess of debt covenants while at the same time holding liquidity and unencumbered assets at reasonably high levels.

Of note, the office sector represents **only 3% of the REIT equity universe** and **7% of the REIT preferred universe** compared to the private real estate market where office is 22%.

- **Valuation:** We calculate that office-based REIT preferreds trade at an average 9.4% strip yield and average $17.98 price based on $25 par
  - We haven't seen sector yields this high and prices this low since the Great Financial Crisis
- **Preferred Dividend Coverages:** Q2.2023 Preferred dividend coverages are trending lower but still stand at solid levels
  - Q2.2023 free cash flow coverage on preferred dividends stood at an average 5.5x after deducting for senior debt service, maintenance capital expenditures and tenant concessions



  - Preferred coverage in this sector has certainly been trending down, and something to keep an eye on.
  - We calculate that EBITDA would need to decline by an average -26% from current levels before preferred dividend coverage falls to 1x.
- **Average Occupancy Levels:** As of Q2.2023, we calculate that average occupancy rates for office REITs (with preferreds outstanding) to be 87.6%. Lower occupancy rates are most definitely putting pressure on office REITs, hence the decline in preferred dividend coverage levels.
  - Q2.2023 – average occupancy levels were 87.6%
  - Q2.2022 – average occupancy levels were 89.3%
  - Q2.2021 – average occupancy levels were 89.5%
  - Q2.2020 – average occupancy levels were 93.0%

**Weighted average preferred dividend coverage after capital expenditures for office REITs. (4Q22 includes CIO, EQC, HPP, OPI, SLG, and VNO; 4Q15 includes ARE, BXP, BDN, EQC, OFC, KRC, SLG, VNO. In between, various issuers came and went as preferreds were issued or called.)*

*** Office REITs that issue preferred include City Office REIT, Equity Commonwealth, Hudson Pacific Properties, Office Properties Income Trust, SL Green, and Vornado. Preferred coverage averages are weighted based on the issuer's preferred outstanding. Certain debt metrics exclude Equity Commonwealth since the company carries no debt.*

Source: LDR Capital Management Proprietary Database

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- **Lease Expirations Schedules:** As of Q2.2023, we calculate that office REITs (with preferreds outstanding) will see an average 10.6% of base rents expiring in each of the next three years. We estimate weighted average lease terms to be ~7 years, which provides some cushion during a difficult operating environment.
  - 2023 – expirations average 6.7% of average base rent
  - 2024 – expirations average 12.8% of average base rent
  - 2025 – expirations average 12.3% of average base rent
- **Liquidity:** As of Q2.2023, we calculate that office REITs (with preferreds outstanding) contained liquidity* of as much as 15% of total enterprise value.
  - Liquidity defined as free cash on hand plus available capacity on credit lines
  - This liquidity metrics does not account for a considerable number of unencumbered assets that leveraged for capital
- **Unsecured Debt Levels:** Represents 52% of total debt outstanding for office REITs with preferred shares outstanding
  - High levels of unsecured debt creates pools of unencumbered properties that provide liquidity during times of distress
- **Compliance with Debt Covenants:** As of Q2.2023, we calculate that office REITs (with preferreds outstanding) were well in excess of requirements under debt covenants. These rigorous covenants provide a shock absorber to REIT balance sheets and restrict leverage levels well below private market levels.
  - Total outstanding debt/total assets
    - Required to be less than 60%
    - Q2.2023 average stood at 42%
  - Secured debt/total assets
    - Required to be less than 40%
    - Q2.2023 average stood at 19%
  - Interest coverage ratio
    - Required to be greater than 1.5x
    - Q2.2023 average stood at 2.5x
  - Unencumbered assets/unsecured debt
    - Required to be greater than 150%
    - Q2.2023 average stood at 250%
- **Average Debt/EBITDA Levels:** As of Q2.2023, we calculate that net debt for office REITs (with preferreds outstanding) to be 8.2x of annualized EBITDA. This debt level stands on the high side of REIT universe averages.
  - Most (if not all) companies are seeking to reduce leverage through asset sales, reduced capital expenditures, and even common stock dividend cuts
- **Total Debt Maturities:** As of Q2.2023, we calculate that near term debt maturities over the next three years within the office REITs (with preferred shares outstanding) to be ~40% of their total debt, with the bulk occurring in the year 2025. Debt maturing in the next two years is on the lower side of former averages and look to be manageable given liquidity levels stated above.
  - 2023 – 3% of total debt maturing
  - 2024 – 14% of total debt maturing
  - 2025 – 23% of total debt maturing
- **Unsecured Debt Maturities:** As of Q2.2023, we calculate that near term unsecured debt maturities over the next three years within the office REITs (with preferred shares outstanding) represent just 19% of their total unsecured debt maturing.
  - 2023 – 0% of unsecured debt maturing
  - 2024 – 5% of unsecured debt maturing
  - 2025 – 14% of unsecured debt maturing

**Liquidity is a combination of available credit and cash.*
Source: LDR Capital Management Proprietary Database

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There are several risks associated with investing in real estate of which investors must be aware, which may include, but are not limited to, fluctuations in the value of underlying properties, defaults by borrowers or tenants, market saturation, changes in general and local operating expenses, and other economic, political or regulatory occurrences affecting companies in the real estate industry. In addition to those in general, investing in REITs involves certain other risks related to their structure and focus, which can include, but are not limited to, dependency upon management skills, limited diversification, the risks of locating and managing financing for projects, heavy cash flow dependency, possible default by borrowers, the costs and potential losses of self-liquidation of one or more holdings, the risk of a possible lack of mortgage funds and associated interest rate risks, overbuilding, property vacancies, increases in property taxes and operating expenses, changes in zoning laws, losses due to environmental damages, changes in neighborhood values and appeal to purchasers, the possibility of failing to maintain exemptions from registration under the Investment Company Act of 1940 and, in many cases, relatively small market capitalization, which may result in less market liquidity and greater price volatility. REITs are also subject to the risk that the real estate market may experience an economic downturn generally, which may have a material effect on the real estate in which the REITs invest and their underlying portfolio securities. Investors should carefully consult all offering and legal documents to ensure suitability before investing.

LDR Database Definitions
LDR's calculations regarding REIT preferreds described herein are derived from its proprietary database, which strives to track the performance and valuation metrics for all currently outstanding publicly-traded REIT preferreds issued in North America (excluding $1000-par preferreds, as they are not exchange-listed). LDR's proprietary database does not include historical data, so references to historical yields and returns prior to 9/30/22 are based on relevant indices, as noted. Overall issuance data, where indicated, includes U.S. and Canada-issued fixed-rate and convertible REIT preferreds. Yield data consists only of U.S.-issued fixed-rate preferreds. All pricing and trading data for the database are derived from Bloomberg.

Use of Indices
The market index information shown herein is for illustrative purposes only and is included to show relative market performance and other metrics for the indicated periods. The indices presented do not represent any LDR account; no such account will seek to replicate an index. Market participants cannot invest directly in an index; indexes are not actively managed, subject to management fees, broker commissions or other expenses, and investors should not rely on them as accurate means of comparison.

Indices
REIT Preferreds is based on the LDR Capital Management proprietary database. Overall Preferreds are represented by the ICE BofA Core Plus Fixed Rate Preferred Securities Index, which tracks the performance of fixed U.S. dollar-denominated preferred securities issued in the U.S. domestic market. Municipal Bonds use the Bloomberg Municipal Bond Total Return Index, which covers the USD-denominated long-term tax-exempt bond market. High Yield Bonds are represented by the ICE BofA BB US High Yield Index which tracks the performance of the U.S. dollar-denominated below investment grade corporate debt rate BB1 through BB3 publicly issued in the U.S. domestic market. Investment Grade Bonds use the ICE BofA BBB US Corporate Index which tracks the performance of U.S. dollar-denominated investment grade corporate debt rates BBB1 through BBB3 publicly issued in the U.S. domestic market. The TNX Index represents the U.S. 10-Year Treasury. Qualified Dividend Income ("QDI") are ordinary dividends that meet specific criteria to be taxed at the lower long-term capital gains tax rate of 20% rather than at the higher tax rate for an individual's ordinary income.