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RETAIL REITS

Federal Realty Investment Trust, the second largest shopping center real estate investment trust in the United States, thrived through most of the real estate downturn. And now, with a $4.4 billion market cap and a relatively light debt load, it is well positioned, and tuned up, for future growth. BNA's Richard Cowden spoke recently with Donald Wood, Federal's president and chief executive officer, about the retail REIT sector and its prospects as the nation's economy begins to recover. Wood offered insights into Federal's clearly successful business strategy, which includes plans to upgrade its existing properties and to expand its portfolio.

Federal Realty Firing on All Cylinders During Tricky Times in Retail Property Sector

DONALD WOOD

BNA: Federal Realty is known for developing high-quality retail and mixed-use properties. What factors separate high-quality properties from lesser-quality properties?

Wood: Location. Location. Location. We as a company are in key markets between Boston and Washington, D.C., on the East Coast; San Francisco, Silicon Valley, and Los Angeles on the West Coast; and, by the way, we do have some stuff in Chicago, too, but it's not a large market for us. For the most part, the rest of the market in the country we leave alone, and it's not because there is not good real estate in those markets at all. It's simply because our whole [modus operandi] is to look at the long term, in terms of how you would own and operate and hold real estate. Those markets on the coasts, with the greatest preponderance of population, income, and—frankly, most importantly—barriers to entry, coupled with the education base and the jobs base, are the markets that serve us best over the long term.

When you really think about it, the only leverage that there is in owning real estate is just good old-fashioned supply and demand. [That means] limits on that supply in the form of barriers to entry—so that you just can't build a new shopping center every two miles.

BNA: Concentrating on higher-quality real estate has become a trend in the industry itself in recent months. Does that mean that competition for those higher-quality assets is driving up their price even higher that you would expect them to be?

Wood: Yes, I think that's fair. One of the interesting things about the great commercial real estate years and the residential real estate years of 2005, 2006, 2007, and 2008 is that there was very little differentiation in cap rates between close-in properties in A locations and those properties in secondary markets or tertiary mar-

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kets. And the reason for that is a rising tide lifts all boats.

So, as long as everybody was doing well, people would price shopping centers and other commercial assets in tertiary markets very close to those that were in the inner suburbs in most major metropolitan areas. It's really true. But you forget what's true when times are good for everybody. And so, as times get tougher and tenants start leaving—when there is no backfill because you're in that location where demand is simply not as strong—then what do you do?

And as a result of that, which really has happened over the last couple of years, everybody says, ''Oh, my gosh, I've got to own quality real estate.'' So, certainly, it is pushing up the values on high quality.

The Pursuit of Quality. What's interesting is that everybody has a little different definition of what high quality is. I always find that really interesting because what high quality is to Federal is a steady stream of increasing cash flows. So, whether that's Target or whether that's a great local restaurant or whether that's Gucci, all of those things could be high-quality income. It's not necessarily tied to—in my view at least—the use. It's tied to the ability of a tenant to provide a product that is in such need over a long period of time that their sales continue to rise and therefore we can put rent pressure on them over time. That really is the key.

I think more than most of our competitors, we spend more time on what we call the merchandising of a shopping center. By that I mean in all the different categories of real estate, retail is the only one where it matters who your neighbor is—who is next door in the shopping center with you? Think about the office building that you're in. It really doesn't matter who is upstairs or who is downstairs from you. It's all about whether they will pay the rent. If you think about a rental apartment building, it doesn't really matter who the neighbor is if you're the landlord. It's a matter of whether they pay the rent or not. But in retail, it's critical to put the right string of tenants together to create the right kind of environment that is conducive to higher sales.

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We call it merchandising. We spend more time on that merchandising than I think many of our competitors do, which is why if you came to where I am right now, our headquarters are in the back of a shopping center called Congressional Plaza here in Rockville, (Md.). If you walked upstairs, you would be astounded by the number of moms pushing baby strollers through the shopping center. The reason for that is we have merchandised it very carefully for that particular section of the populace.

So there is a Bye-Bye Baby, which by the way was the first Bye-Bye Baby outside of New York. There is a great Whole Foods. There are terrific little shops that are meant specifically for moms with children. There are special parking places for moms with infants.

It's covered from the elements. It's not enclosed but it's got a nice walkway that's covered from the elements. There is music. It feels very safe. All of those things put together create a better environment for that particular constituency and it's one of the most productive shopping centers in our portfolio.

So there are nuances in retail that make it a little bit more challenging than some of the other components of commercial real estate.

America 'Over-Retailed.' BNA: So what happens to properties that are of lesser value in a market like this?

Wood: Look, it depends. I very much believe that the United States of America is over-retailed. That is, there is too much retail square footage for the amount of demand. And I don't necessarily think that's a temporary thing. I think that's more of a permanent thing as the Internet gains more traction, as the big boxes have created a lot of capacity in the market . . . There is just generally too much retail space.

So, if you think about that—all retail space is not created equal—but those properties that are out in secondary and tertiary locations are having more of a challenge with respect to how to get replacement tenants as people leave. And if there is not very much demand, then there is only one way to compete, and that's on price, so you reduce your rent, you reduce your rent, you reduce your rent. And in most places they will be able to keep them filled, but at far, far lower rents. In some places they won't be able to compete. They will build and they will just have to be torn down. So that's just what I see over the next five years.

BNA: Strip malls appear to be falling out of favor. Do you expect to see more of them developed after the market rebounds or have preferences moved on to newer retail models?

Wood: Oh, gosh, it's very interesting to me because in our business everybody wants to categorize types of products. When you say strip mall, for example, something comes to mind; you know exactly what you're thinking. I can tell you you're thinking probably about a 40,000 square foot grocery and maybe a 15,000 square foot drug store, a pizza place and a nails salon, etc., in the shape of an L.

BNA: That's pretty much it.

Wood: And when you look at the strip center segment, certainly among the public companies, what's really interesting is that I don't think we own any of those things. Maybe a couple. Your average strip center in the country is about 120,000 square feet, which is what I just described to you. Federal's average property is 230,000 square feet, nearly double. So it's a different breed, a different animal.

The Next New Thing. It's also retail that's downtown and in some mixed-use communities and lifestyle centers. Every few years, somebody comes out and says this new thing is the next new thing. Everything else is going to go away. And then within a few years, the new thing is no longer the new thing.

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I'll give you my favorite example. Every community in this country wanted a town center for the last six or seven years, and what they envisioned was a little center of town with apartments on top of retail space and a main street filled with retail, a couple of office buildings with retail underneath them, maybe a hotel, some parking that probably is underground because of the higher density there. And this is a town center.

The problem is the construction—which is higher-cost, more complicated—the enclosed parking, which is very expensive, and other complexities of putting uses together. It makes that kind of product really only work in a few locations. What I just described only works in very high-density areas—lots of people with a lot of money—because the rents are going to have to be higher to justify the cost of a product like that. The joke we had around here for a while was there were two town centers in every town.

The reality is that many of them didn't make it; a few of them are amazing and incredibly productive. That same thing applies with strips; the same thing applies with outlet centers. It really does depend on the specific location and the dynamics of what the community around it needs.

So, am I bearish on strips going forward? I'm certainly bearish on small, unanchored strip centers in tertiary markets, but . . . I'm down on that all the time. I'm very bullish on necessity-anchored strips of a couple of hundred thousand square feet or so that are in the first-ring suburbs of major metropolitan urban areas. I don't mean to say all the time that it depends, but, it depends primarily on the location and on what the community needs.

Out of the Woods? **BNA:** Do you think commercial real estate in general is, pardon the pun, out of the woods for this cycle, or is it still in danger of more downward pressure in the coming year?

Wood: It is in my view in danger of downward pressure for a number of reasons. Commercial real estate overall has been highly levered. Commercial real estate is primarily held in private people's hands. Private investors quickly levered their properties up more than the public companies did. So a reduction in value will make much of that debt very difficult to refinance. That's still to come. That has not in my view [worked] its way through the system.

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The public companies, for a lot of reasons—not the least of which is the discipline that's required to be a publicly owned enterprise—normally carry lower debt levels. I can tell you Federal today has debt that is about 30 percent of our market value. Which means that if debt is 30 percent, then equity is 70 [percent]. Federal is certainly not going to have any issue with refinancing itself over the next five to seven years. But that's not the case with everybody.

It is generally the case that the better quality real estate is owned by the public companies because of the discipline that's necessary there. So those companies will suffer far less than others. But when you ask is commercial real estate as a whole out of the woods, I'd say no, it's not. And I think it will give some opportunities for some of the better capitalized, strong companies to take advantage.

BNA: REITs come back faster after an economic downturn than the rest of the CRE sector anyway, but it seems that they're coming back especially fast this time around. Are you surprised how quickly the REITs are rebounding?

Wood: I was extremely surprised at how quickly the REITs went down and to the extent that they went down with complete panic. REITs, like all components of commercial real estate, were not going to be able to refinance their debt coming due. So the equity markets, in my view, overreacted and drove down prices severely. So much of the coming back is from a very low base. So it's like, ''Oh, my God, the company's up 100 percent.'' Well, yeah, but it shouldn't have been down whatever it was down in the first place.

Market Anticipating Recovery. It's critical to be balanced in terms of how much debt you take, how much growth you chase, how aggressive you are in acquisitions. We try to be very balanced on that. The market is anticipating a continued recovery from an overall economic position. We have not seen that yet in jobs; we've seen it modestly in consumer spending, but, again, these are really easy comps over the last year, which was really the bottom. So those comps will get tougher as the year goes out, period over period.

I'm certainly not doom and gloom. I certainly see a continued recovery of consumer sales. I hope we start seeing it in the jobs numbers, but I haven't seen signs of that yet. So it's going to be a slow recovery from there. I think the equity markets got us all there all at once and we'll see where that settles out. I can never tell. As I say, I think it went down too far and came back very fast, too.

Overall, the fundamental business is solid vis a vis where it was. Retailers are doing deals. Consumers are spending, but not to the level that they were.

BNA: Federal Realty has raised both debt and equity capital in the last year. Do you expect to continue raising capital in the near future?

Wood: As I say, our balance sheet is really pristine. It's in great shape today. However, to the extent we find opportunities to expand our portfolio, whether that be with acquisitions or redeveloping our existing properties, we very much intend to and as always we will be in the capital markets, both debt and equity.

In the Market for Acquisitions. **BNA:** Are you in the market to acquire more properties right now?

Wood: We are. We're looking hard.

BNA: What types of assets are you looking at?

Wood: High-quality retail, and I don't particularly care what package that's in. It could be in a grocery-anchored strip. It could be wrapped in a street retail project. It could be wrapped into a mixed-use community. The only thing we really don't do here at Federal is malls. So it's high-quality, excluding malls.

If I can give you one silly analogy to make this point, I'm kind of a car nut. And I think about a company like Honda and I know that Honda makes a particular V6 engine and they wrap this V6 engine into an Odyssey Minivan for families or a Prelude sports car for anybody who buys sports cars. Or an Accord for business people and families. They wrap the same product, which is that motor in whatever wrapper for the particular constituency they are going after. It's no different with us.

We are happy to buy or build a grocery anchored strip if that's what the community needs, a street retail project if that's what the community needs, a mixed-use community in certain cases if that's what the community needs. But the product is the high-quality retail underlying it.

You know, it's so funny that the only people who really don't care are customers and tenants. Tenants just want to know: ''Can I sell enough stuff here so I can make some money?'' And customers just want a clean, feel-good environment, which can apply to all of them.

Recovery of Capital Markets. **BNA:** Let's shift here over to financing. Do you think the securitization market is going to return to something approximating its former level?

Wood: I don't know about approximating its former level but I do expect to see [commercial mortgage-backed securities] come back. We are starting to see signs of that today. It's interesting that on the public side, the unsecured debt markets are wide open today. The secured debt markets, you know, putting a mortgage on a good property, are open today. The equity markets are open today. Bank lending is open for the right real estate today. So, most major markets are open.

I think even through the absolute worst time—during 2009 or early 2009—Federal did about $800 million of financing. Eight hundred million dollars to pay off $400 million that was coming due and to give us some money to make sure that we could go out and buy. We did that $800 million in the four major food groups: We did a bank loan. We did secured financing. We did common equity—we issued stock. And we did unsecured bonds. All four were open. They still are today and frankly I think they will be.

There is still a need for collateralized mortgage-backed securities—CMBS—not necessarily for us; we won't do it. But will financial institutions recreate that market? Yeah, I think so and we're starting to see it today. Will it reach the level that it did? I would doubt it.

BNA: Do you think there is still a crisis in refinancing a lot of CRE debt that's still out there?

Wood: Yeah, I think in poor-quality locations out in the hinterlands, if you will, there is still a shoe to drop. In the better-quality stuff, I don't. One reason has to do with the question you asked about a flight to quality. Oh, yeah, there is a flight to quality and that drives up values. When you drive up values, that sure helps your financing issues.

But again, this has been a very healthy process. There were loans made at asset values that never made any sense—leverage never made any sense—based on feel-good economics for a number of years in a row. That stuff has to work its way through the system. It will not be debilitating to our industry or the well-capitalized companies out there.

BNA: I understand you are a certified public accountant by training. How does that affect your approach to running a company?

Business by the Numbers. **Wood:** You know, it's funny you ask that because I have a 17-year-old who is graduating high school this year and he's going to Penn State in the fall and we were just talking about this . . . I'm 49 years old. When I look back and ask what was important, one of the critical things—one of the best things I could have done—was to get an accounting degree. And the reasons for that is that, first of all, money is the common language of all capitalism. So it allows you, first of all, to understand that language and translate it to a lot of different industries.

So, starting as an accountant out of Arthur Andersen and a 23, 24-year-old guy, I was with chief financial officers of lots of different companies in lots of different industries. It gives you a very balanced, broad perspective. So I'm a huge believer in that. When I got to Federal Realty, which was 20 years later basically, the culmination of all of that experience allowed me to look at the real estate industry from a financial point of view and have that base of information.

Now, especially a retail company, if you run it totally by the numbers, without an understanding of some of the merchandising things, or without good, plain business judgment that can't be quantified, then I think you fail. But if you can balance it right, having that accounting foundation is one of the most valuable tools you can start with.

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