

# LDR CAPITAL MANAGEMENT



## REIT Securities Primer

August 2018

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**LDR Capital Management, LLC**

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## I. WHAT ARE REITS?

### Overview of REITs

- Real estate investment trusts (REITs) were created in 1960 to enable individuals to invest in commercial real estate. REITs are considered pass-through entities whereby they do not pay corporate income tax, but must distribute 90% of their earnings to investors.
- To qualify as a REIT, a company must:
  - Distribute 90% of its taxable income to shareholders in the form of common or preferred dividends;
  - 75% of its assets must be considered real estate and they must derive 75% of their gross income from rents from real property or interest on mortgages financing real estate;
  - Have a minimum of 100 shareholders and have no more than 50% of its shares held by 5 or fewer individuals.
- In aggregate, U.S. REITs have a market capitalization of \$1.1 trillion, based on the FTSE NAREIT All REITs index. This universe is comprised of 221 companies.
  - The REIT structure has also been adopted in 35 other countries.
- REITs primarily invest in stabilized properties and seek to provide stable rental cash flow. REITs generally have long-term leases ranging from 1 year to more than 10 years. REITs also engage in property development, but that activity typically represents no more than 10% of assets, and more often less than 5% of assets.
- REITs own commercial assets, including apartments, office buildings, retail shopping centers / malls, hotels, industrial buildings, self-storage facilities, data storage centers, communication towers, among other asset classes.
- REITs typically have conservative debt levels – on average, the sector’s debt to capital is 43.5%\*.
- The average daily trading volume of all REITs is approximately around \$6.8 billion as of April 2018\*.

*\*Source: NAREIT. Data as of 04/30/2018*

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## II. WHAT ARE REIT PREFERRED SECURITIES?

### Basic Terms of REIT Preferreds

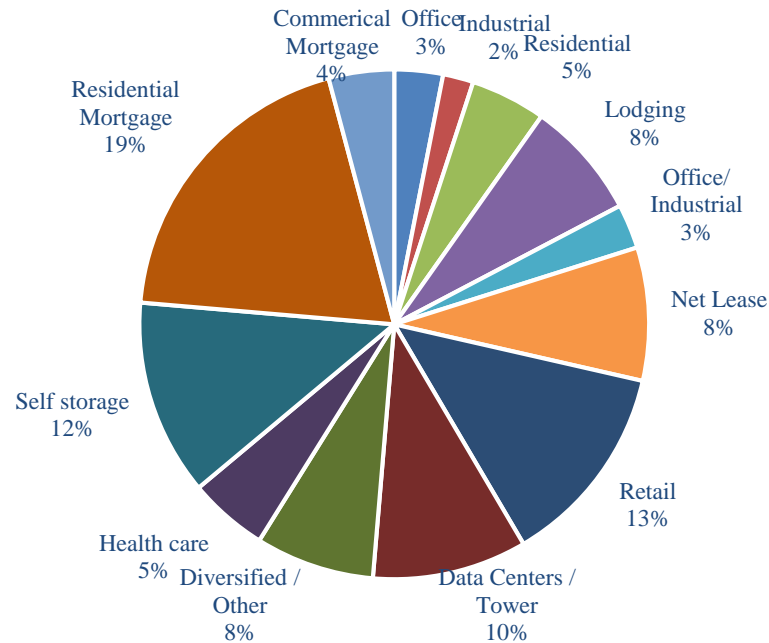
- \$25 par value **perpetual** fixed and floating rate security
- Dividends paid **in cash** on a **quarterly** basis
- New issues carry **5-year call protection**
- REIT preferred securities carry **cumulative** dividend covenants. A cumulative preferred stock requires that if a company fails to pay any dividend or any amount below the stated rate, it must make up for it at a later time
- Preferred dividends are paid **entirely before** paying any **common** dividends
- REIT preferred securities are normally a **non-voting** class of ownership
- Preferred shareholders have the right to elect 2 directors in the event that preferred dividends are deferred for 6 quarters
- **Priority over common stock** on the assets in the **event of liquidation**
- REIT preferred securities and their ratings are usually **junior to most forms of debt** since preferred dividends do not carry the same covenant protection as interest payments from bonds
- Most **new issues incorporate change of control provisions**

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## II. WHAT ARE REIT PREFERRED SECURITIES?

### REIT Preferreds Are Represented Among Substantially All Property Sectors



- North American market stands at approximately \$46 billion
- Approximately 270 securities issued by 111 real estate companies
- Industry has been growing organically and through REIT conversions, at approximately \$2 billion per annum

*Based on LDR Capital Management proprietary database of REIT preferreds, as of 7/31/18.*

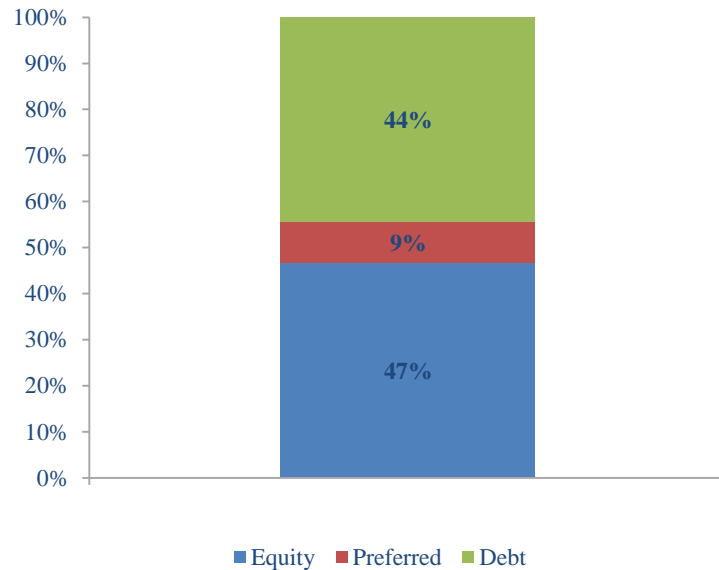
*Source: LDR Capital Management, Bloomberg. Based on U.S. listed REIT preferreds. Data as of 7/31/18*

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## II. WHAT ARE REIT PREFERRED SECURITIES?

### Preferred Stocks Represent 9% of U.S. Equity REIT\* Capitalization



*\*Data excludes mortgage REITs given different leverage profile of mortgage REITs. If mortgage REITs were included, equity, preferred and debt would represent 39%, 8%, and 53%, respectively, of the capital structure. Based on LDR Capital Management proprietary database of REIT preferreds. Data as of 1Q18.*

### Distribution of U.S. REIT Preferred Ratings

S&P Rating	% of REIT Universe
BBB+ to BBB-	32%
BB+ to BB-	18%
B+ to B-	1%
CCC+ or lower	1%
Unrated	48%

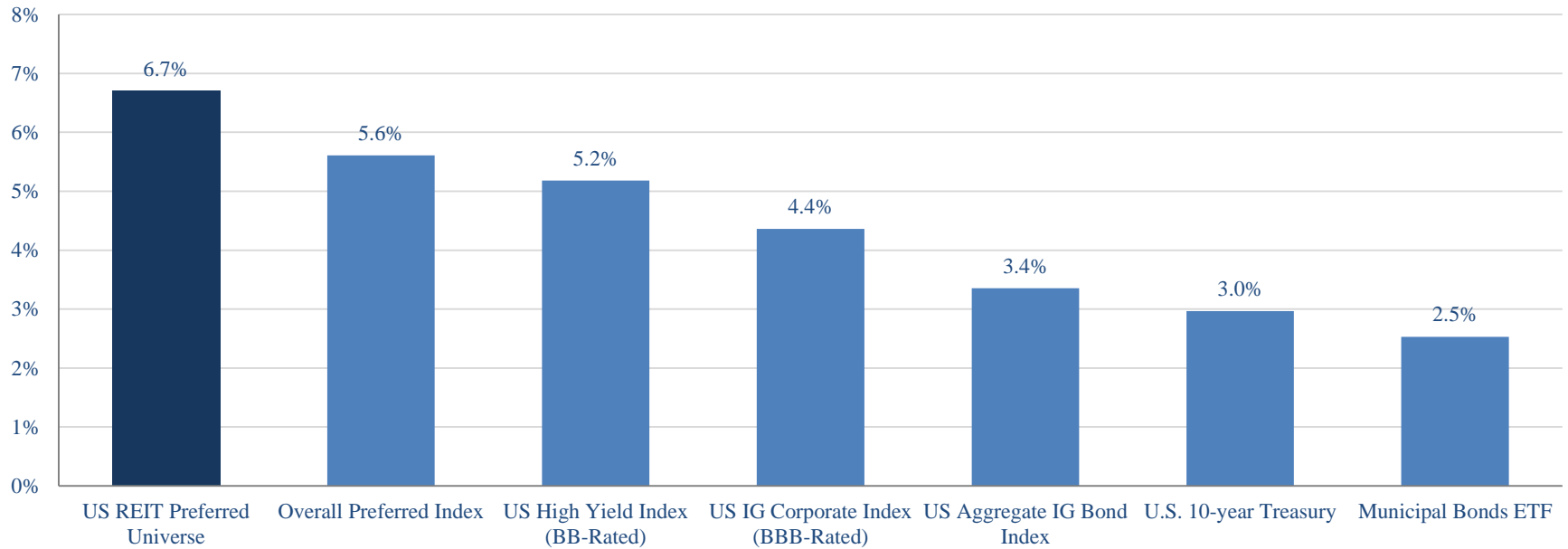
*Based on LDR Capital Management proprietary database of U.S. listed REIT preferreds. Source: LDR Capital Management, Bloomberg. As of 7/31/18.*

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## III. INVESTMENT CHARACTERISTICS OF REIT PREFERRED

### REIT Preferred Current Yields in Comparison to Other Fixed Income Alternatives



*REIT preferred universe based on LDR Capital Management proprietary database. Overall preferred index based on ICE BAML Fixed Rate Preferreds Securities Index. US high yield index based on ICE BAML BB US High Yield Index. US investment grade corporate index based on ICE BAML BBB US Corporate Index. US aggregate investment grade bond index based on Bloomberg Barclays US Aggregate Bond Index. Municipal bonds ETF based on iShares National Municipal Bond ETF.  
Source: LDR Capital Management, Bloomberg. As of 7/31/18.*

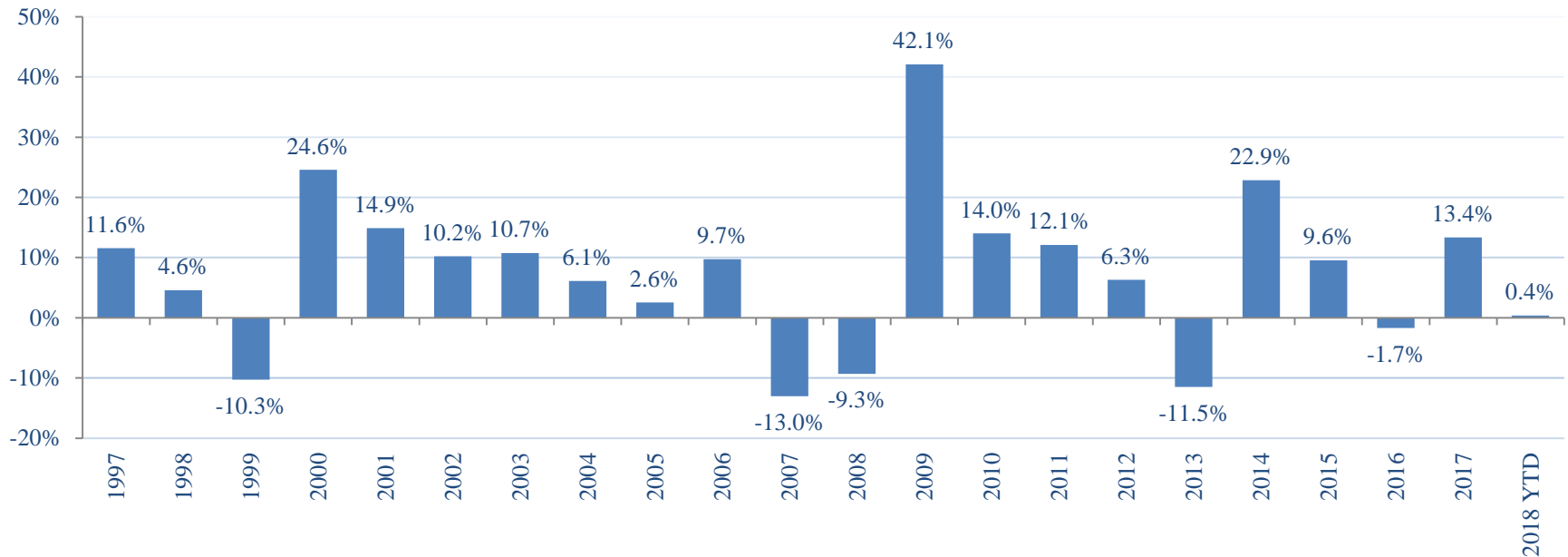
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## III. INVESTMENT CHARACTERISTICS OF REIT PREFERRED

### REIT Preferred Index Generated Positive Total Returns in 17 of Past 21½ Years

*Calendar year returns for ICE BAML REIT Preferred Securities Index 1997 to 2018 YTD*



*Data based on ICE BAML REIT Preferred Securities Index inception (January 1997) to 7/31/18. Source: Bloomberg.*

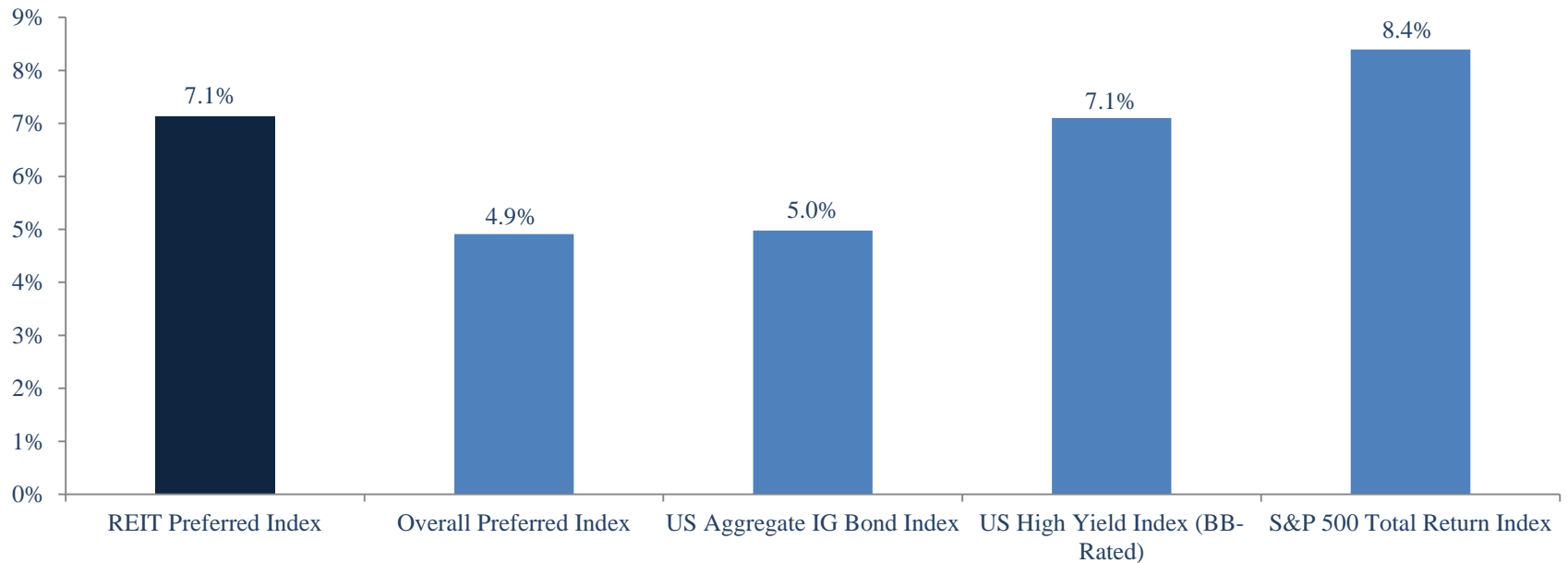
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## III. INVESTMENT CHARACTERISTICS OF REIT PREFERRED

### Comparative Returns of REIT Preferred Index Over Past 21½ Years

Compound annual returns from 1/1/1997 – 7/31/2018



REIT preferred index based on ICE BAML REIT Preferred Securities Index. Overall preferred index based on ICE BAML Fixed Rate Preferred Securities Index. US aggregate investment grade bond index based on Bloomberg Barclays US Aggregate Bond Index, US high yield index based on ICE BAML BB US High Yield Index. Source: Bloomberg.

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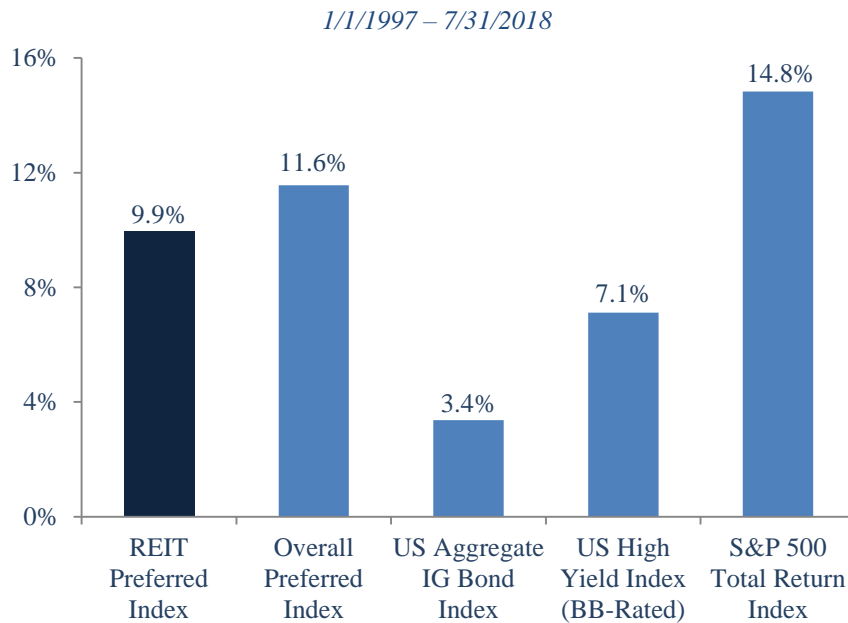
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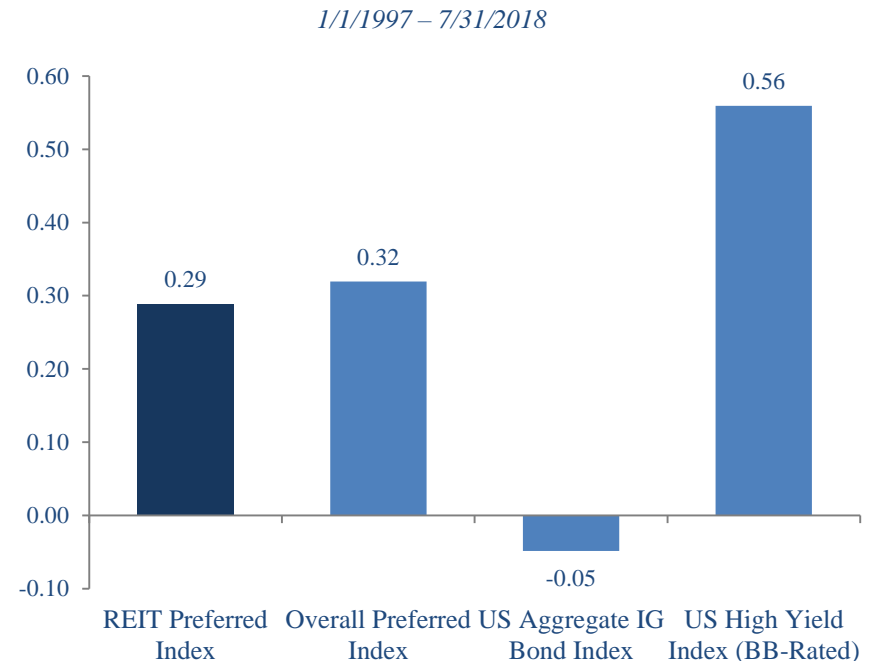
## III. INVESTMENT CHARACTERISTICS OF REIT PREFERRED

### REIT Preferreds Exhibit Relatively Low Volatility and Correlations

#### Comparative Annualized Standard Deviation



#### Comparative Correlation to S&P 500



REIT preferred index based on ICE BAML REIT Preferred Securities Index. Overall preferred index based on ICE BAML Fixed Rate Preferred Securities Index. US aggregate investment grade bond index based on Bloomberg Barclays US Aggregate Bond Index, US high yield index based on ICE BAML BB US High Yield Index. Source: Bloomberg,

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## IV. FREQUENTLY ASKED QUESTIONS

### 1. What happens to REIT preferreds when rates rise?

**During Short Bursts in Interest Rates, REIT Preferreds' Performance Has Historically Been Resilient – and in Each Case When Losses Have Occurred, the Asset Class has Recovered Within 6 Months**

#### Performance of REIT Preferreds During and After Short Bursts in Interest Rates

Period	# of months	10-year Treasury Rate			REIT Preferred	
		Start rate	End rate	Difference	During rising rates	6-month after
Nov 2001 - Mar 2002	5	4.2%	5.4%	1.2%	3%	7%
Jun 2003 - Jul 2003	2	3.1%	4.1%	0.9%	0%	7%
Apr 2004 - May 2004	2	3.7%	4.9%	1.2%	-7%	11%
Sept 2005 - June 2006	10	4.0%	5.1%	1.1%	2%	7%
Nov 2010 - Dec 2010	2	2.6%	3.3%	0.7%	1%	7%
Feb 2012 - Mar 2012	2	1.8%	2.4%	0.6%	1%	7%
May 2013 - Dec 2013	8	1.7%	3.0%	1.4%	-10%	15%
Feb 2015 - Jun 2015	5	1.6%	2.4%	0.7%	0%	3%
Oct 2016 - Dec 2016	3	1.6%	2.6%	1.0%	-5%	9%
<b>Average</b>	<b>4</b>			<b>1.0%</b>	<b>-1%</b>	<b>8%</b>

Short bursts in interest rates defined as at least 0.5% rise in the 10-year yield within 12 months. REIT preferred total return based on the Wells Fargo Hybrid & Preferred Securities REIT Index (WHPSR). Source: Bloomberg.

See Note A of the Notes on Frequently Asked Questions on page 17 of this presentation, which includes important information about the relevant indices presented and certain periods which were omitted from this calculation, along with the rationale for such omissions.

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## IV. FREQUENTLY ASKED QUESTIONS

### 1. What happens to REIT preferreds when rates rise?

**During Extended Periods of Rising Interest Rates, Performance Has Historically Varied – But Has Been Consistently Positive Over the Following 12 Months**

#### Performance of REIT Preferreds During and After Extended Periods of Rising Interest Rates

Period	# of months	10-year Treasury Rate			REIT Preferred	
		Start rate	End rate	Difference	During rising rates	6-month after
Oct 1998 - Dec 1999	15	4.4%	6.4%	2.0%	-9%	25%
Jun 2003 - Jun 2006	37	3.1%	5.1%	2.0%	21%	8%
Aug 2012 - Dec 2013	17	1.5%	3.0%	1.6%	-3%	20%
<b>Average</b>	<b>23</b>			<b>1.9%</b>	<b>3%</b>	<b>18%</b>

*Extended rise in interest rates defined as at least 1.5% increase in 10-year yield over more than 12 months. REIT preferred total return based on the ICE BAML REIT Preferred Securities Index prior to 2000 and based on the Wells Fargo Hybrid & Preferred Securities REIT Index (WHPSR) subsequent to 2001, as the WHPSR began in January 2001. Source: Bloomberg.*

*See Note B of the Notes on Frequently Asked Questions on page 17 of this presentation, which includes important information about the relevant indices presented and certain periods which were omitted from this calculation, along with the rationale for such omissions.*

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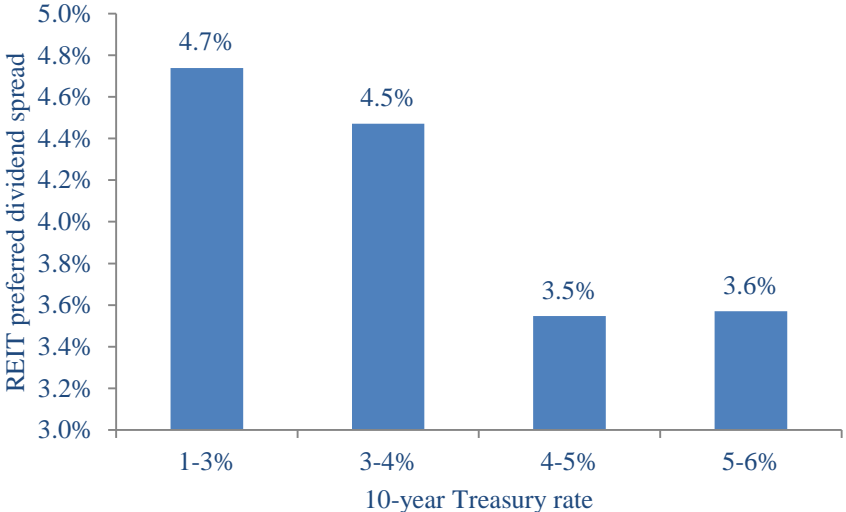
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IV. FREQUENTLY ASKED QUESTIONS

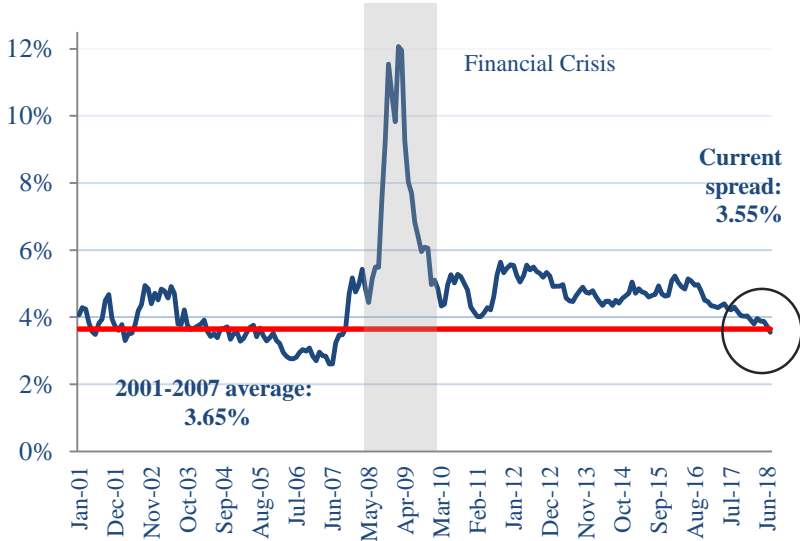
1. What happens to REIT preferreds when rates rise?

As Treasury Rates Rise, REIT Preferred Spreads Generally Tighten

Data from January 2001 – July 2018, excluding 2008-2009



REIT Preferreds have Historically Carried an Average Spread of 365bps to 10-Year Treasury Rates



REIT preferred dividend spread based on Wells Fargo Hybrid & Preferred Securities REIT Index, which started in 2001. Data as of 7/31/18. Source: Wells Fargo, Bloomberg. See Note C of the Notes on Frequently Asked Questions on page 17 of this presentation, which includes important information about the relevant indices presented and certain periods which were omitted from this calculation, along with the rationale for such omissions.

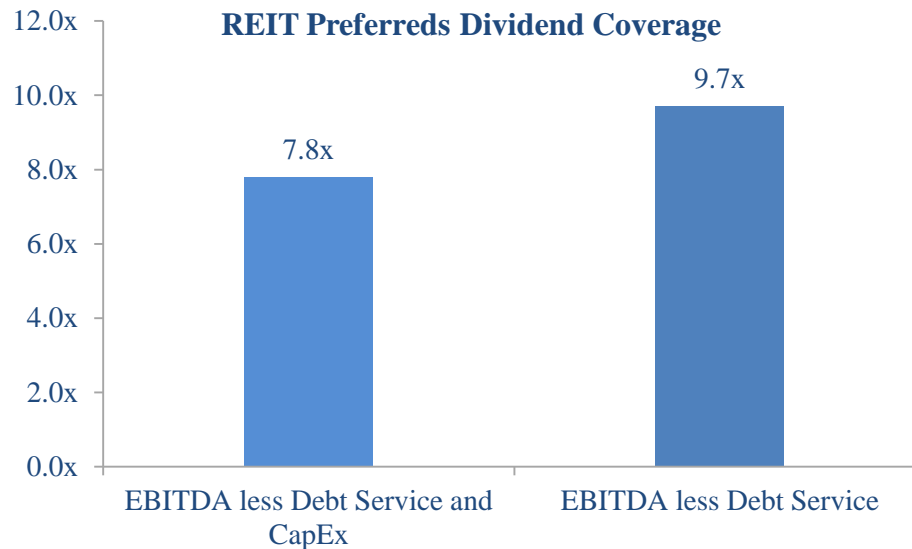
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## IV. FREQUENTLY ASKED QUESTIONS

### 2. How well do cash flows cover REIT preferred dividends?

- After deducting for senior debt service (a priority financial claim), we calculate that REIT cash flows exceed preferred dividend distributions by an average 9.7 times.
- After deducting for senior debt service and maintenance capital expenditures (a financial, but non-priority claim), we calculate REIT cash flows exceed preferred dividend distributions by an average 7.8 times.



Coverage represents the average of all U.S. REITs that issue preferreds. Source: Bloomberg, company filings. Data as of 1Q18.

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## IV. FREQUENTLY ASKED QUESTIONS

### 3. What is the taxability of REIT preferred dividend distributions?

- REIT preferred dividends are generally taxed at ordinary income rates
- Selected dividends may be comprised of capital gains distributions, returns of capital or qualified income
- Ultimate determinant of taxability of REIT preferred dividends is dependent upon company-specific operating income levels, transaction activity, and tax-basis in underlying properties
- REIT preferreds benefit from the recent Tax Cuts and Jobs Act (TCJA)
  - Pass-through business income tax rate for U.S.-based investors would be lowered through the creation of a new 20% deduction for individuals, estates, and trusts of their Combined Qualified Business Income Amount (CQBIA).
  - As a consequence, REIT dividends would generally be taxed at a top rate of 29.6% (or 33.4% when including the ACA surtax on all investment income) – a 10% lower rate for those investors in the highest income tax bracket.
  - For non-U.S. based investors, the TCJA reduces the withholding tax rate applicable to REIT capital gain distributions. The withholding tax rate declines to 21% (the highest corporate tax rate in effect for 2018), from 35% previously.

#### Illustration of Dividend Income Tax Savings under TCJA

	Old Tax Rates	TCJA Tax Rate
Hypothetical Dividend Income	\$100	\$100
Less: 20% Pass-Through Income Deduction	--	(\$20)
Taxable Dividend Income	\$100	\$80
Highest Marginal Income Tax Rate	39.6%	37.0%
Dividend Income Tax	\$39.60	\$29.60
<b>Dividend Income Tax Rate</b>	<b>39.6%</b>	<b>29.6%</b>

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## IV. FREQUENTLY ASKED QUESTIONS

### *4. What is the liquidity of REIT preferreds and where are sources of industry growth?*

- North American market capitalization at about \$46 billion\*
- Average daily volume for U.S. listed REIT preferreds is about 20bps of par value outstanding\*
- With approximately 20 trading days in a month, ~4-5% of the asset class in the U.S. is turned over per month on average\*
- As REITs grow their asset base through acquisition and development, they require more capital issuance
- Industry growth also occurring as more companies convert to a REIT structure or spinning out their real estate, such as Outfront Media, Lamar Advertising, Gaming & Leisure Properties, Iron Mountain, American Tower, Equinix, Weyerhaeuser, Uniti Group, and Four Corners Property Trust
- To date, preferreds have not been issued from overseas REITs, a possible long-term growth driver to the universe

*\*Based on LDR proprietary database of REIT preferreds. As of 7/31/18*

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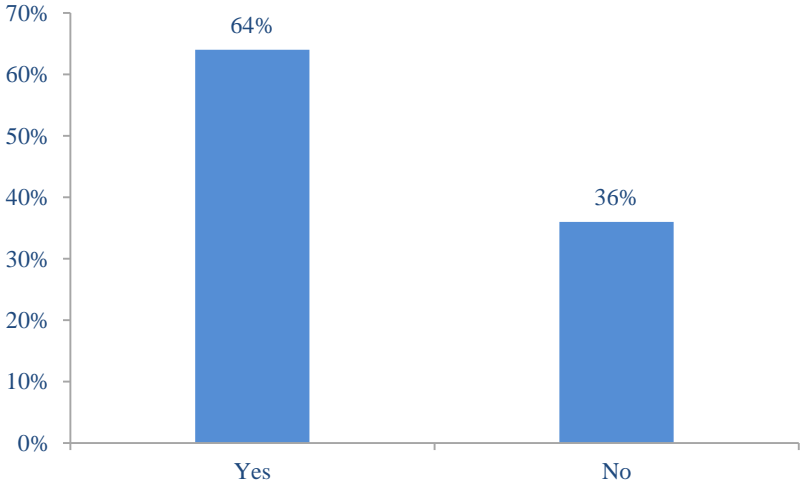
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IV. FREQUENTLY ASKED QUESTIONS

5. Do REIT preferreds offer covenant protection that limit the use of excess leverage?

- No, but REIT preferreds are beneficiaries of any unsecured debt covenants that inhibit leverage levels above certain thresholds. As such, REITs generally carry relatively low leverage.
- We calculate that ~64% of REIT preferreds contain Change of Control provisions, which offer a level of credit protection pursuant to a leveraged-buyout, merger or other defined corporate transaction. Investors can convert these preferred shares in a defined change of control transaction into cash or common stock.

Percentage of REIT Preferreds with Change of Control Provisions



Source: Company filings, Data as of 7/31/2018

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## NOTES TO FREQUENTLY ASKED QUESTIONS

**Note A.** REIT preferred total return shown on page 10 are based on the Wells Fargo Hybrid & Preferred Securities REIT Index (WHPSR) instead of the ICE BAML REIT Preferred Securities Index because the WHPSR index includes REIT preferreds across all credit ratings, which in our view, is more representative of the asset class performance in reaction to macro catalysts. If the ICE BAML REIT Preferred Securities Index were used, the results would likely have been different than those presented in the table on page 10. See the definition of both indices in Use of Indexes section below. Moreover, the table on page 10 omits two time periods that satisfied our criteria for abrupt increases in interest rates because we believe performance of REIT preferreds was primarily driven by macroeconomic factors other than interest rates (including them would have favorably skewed our results for REIT preferreds). Specifically, we omitted the period before the bursting of the “tech bubble” from April 1999 to June 1999, during which REIT preferreds rose 2%, and fell 12% in the subsequent six months, along with the broader market. We also omitted the period from January 2009 to March 2009, right after the great financial crisis. The asset class rose 18% during that period and rose another 30% in the subsequent six months. REIT preferred performance from January 2018 to present (during which 10-year U.S. Treasury yields have risen by ~50 bps) was also excluded, as subsequent returns are definitionally not available.

**Note B.** REIT preferred total return shown on page 11 are based the ICE BAML REIT Preferred Securities Index for the 1998-1999 period because the Wells Fargo Hybrid & Preferred Securities REIT Index (WHPSR) was unavailable before its inception in 2001. The subsequent two time periods use the Wells Fargo Hybrid & Preferred Securities REIT Index because it includes REIT preferreds across all credit ratings, which in our view, is more representative of the asset class performance in reaction to macro catalysts. If the ICE BAML REIT Preferred Securities Index were used, the results would likely have been different than those presented in the table on page 11. See the definition of both indices in Use of Indexes section below. Moreover, in the table on page 11 of this presentation, the period of August 2012 to December 2013 was omitted. Even though this time period meets our criteria for an extended period of rising interest rates, much of this increase was attributable to a short term burst from May to December 2013, which is shown on the prior page. We have also excluded asset class performance from July 2016 to present (during which 10-year U.S. Treasury yields have risen ~150bps) as subsequent returns are definitionally not available.

**Note C.** REIT preferred spreads shown on page 12 are based on the yield on the Wells Fargo Hybrid & Preferred Securities REIT Index (WHPSR) instead of the ICE BAML REIT Preferred Securities Index because daily yield data is published by Wells Fargo, whereas it is unavailable on a historic basis for the ICE BAML REIT Preferred Securities Index. If the ICE BAML REIT Preferred Securities Index were used, the results would likely have been different than those presented in the graph on page 12. See the definition of both indices in Use of Indexes section below. Moreover, in both graphs on page 12 of this presentation, yield spread data during the financial crisis is excluded from the REIT preferred spreads relative to Treasury rates graph because spreads widened considerably during the financial crisis (similar to most asset classes). We view the significant widening of credit spreads as not representative of historical trends and averages.

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### Use of Indexes

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

### Index Definitions

ICE BAML REIT Preferred Securities Index is a market-cap weighted index that tracks the performance of \$25-par, investment-grade rated, fixed rate REIT preferred securities. The index began in January 1997; therefore, all references herein to the ICE BAML REIT Preferred Index performance “since inception” refers to data starting from January 1997.

ICE BAML Fixed-Rate Preferred Securities Index is a market-cap weighted index that tracks the performance of \$25-par, investment-grade rated, fixed rate preferred securities from all sectors.

ICE BAML BB US High Yield Index is a market-cap weighted index that tracks the performance of USD-denominated BB-rated corporate debt publicly issued in the U.S. market with at least 1-year remaining term.

ICE BAML BBB US Corporate Index is a market-cap weighted index that tracks the performance of USD-denominated BBB-rated corporate debt publicly issued in the U.S. market with at least 1-year remaining term.

The S&P 500 Total Return Index tracks the performance, including dividends, of 500 large U.S. publicly traded equities. It is generally considered to be representative of U.S. stock market activity.

The FTSE NAREIT All Equity REITs Total Return Index is a free float adjusted market-cap weighted index that includes all tax qualified REITs listed in the U.S.

Bloomberg Barclays US Aggregate Bond Index is a broad-based index that measures the investment grade, USD-denominated, fixed-rate taxable bond market. It includes Treasuries, government-related and corporate securities, mortgage backed securities, asset-backed securities, and commercial mortgage backed securities (CMBS).

Wells Fargo Hybrid and Preferred Securities REIT Index (WHPSR) tracks the performance, including dividends, of preferred shares and depository shares of preferred securities issued in the U.S. by REITs. The index began in January 2000. All WHPSR metrics presented as “since inception” herein refers to data starting from January 2000.

iShares National Municipal Bond ETF is an exchange-trade fund that seeks to track the investment results of the S&P National AMT-Free Municipal Bond Index, which is composed of investment-grade U.S. municipal bonds.

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### **LDR Proprietary Database of REIT Preferreds**

LDR seeks to track performance and various valuation metrics for all REIT publicly-traded preferreds issued in North America that are currently outstanding. This database does not include \$1000-par institutional preferreds, as they are not exchange listed. Otherwise, LDR believes that its database captures the universe of publicly-traded REIT preferreds in North America that are currently outstanding. However, the LDR proprietary database does not include historical data, so references to historical yields and returns prior to 7/31/18 are based on relevant indices as noted. Overall issuance data, where noted, includes U.S. and Canada-issued fixed-rate and convertible REIT preferreds. Yield data includes only U.S.-issued fixed-rate preferreds. All pricing and trading data for the database are derived from Bloomberg.

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