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Horns of a Dilemma

A flurry of insider sales bolsters the case that REITs are overdone, argues Lehman Brothers' David Shulman. Not so fast, counters ING Clarion's T. Ritson Ferguson, who concedes the stocks may not be cheap, but stresses it's not yet time to head for the hills.

By Barry Vinocur

Lehman Brothers' REIT research team recently published a report on second quarter 2003 insider sales and buying activity. In a note catchingly titled "1-800-DUMP-'EM," David Shulman and fellow analysts, Stuart Axelrod and David Harris, reported insider sales at 23 of 33 REITs in their coverage universe.

Backing option-related transactions out of the mix, the Lehman analysts noted selling outpaced buying by a 12:1 ratio. "When option-related sales are stripped out, insider sales for the second quarter totaled $42.0 million," they reported.

Lehman's Shulman

Shulman and his colleagues pointed out that in spring 2002, as the Morgan Stanley REIT Index was setting new highs, insider sales activity accelerated. Similarly, in the period from April through June of this year, with RMS again setting new highs, insider sales "swelled" to more than double the first quarter 2003 level. Insider buying, the Lehman analysts added, was "miniscule" by comparison.

"Despite the upbeat tone at the June NAREIT meeting and the continued appetite for REITs by the public, insiders are voting with their wallets by selling," Shulman and his colleagues wrote.

Not surprisingly, the Lehman note generated a good deal of buzz, as well as a fair amount of media attention. But there's more to this tale than what found its way into those media reports.

Shulman has been bearish on the stocks for some time. Discussing REITs with an *Associated Press* reporter the day the 1-800-DUMP-'EM report was issued, he commented, "I wouldn't be rushing into them. They're very overpriced."

Buy-siders we spoke with agreed that insider selling isn't a bullish indicator. That said, several of those buy-siders stressed that insider selling needs to be put in the proper context.

Said one veteran portfolio manager, "The first thing we look at is what percentage of the insider's holdings the sale represents. Next, we look into the reason for the sale." The portfolio manager added, "Large sales by key insiders are more of a concern than smallish sales, which can be for any number of reasons ranging from paying taxes, to school tuitions, to buying a vacation home, to diversification." No less important, he stressed, is how one defines "insider." He commented, "The term 'insider' is pretty broadly applied in this context, so it's important to look at who's doing the selling. Oftentimes, it's someone who, in the scheme of things, we don't consider to be a 'significant' insider. However, if it's members of the senior management team and they're selling in size, it's definitely red flag time."

Another veteran buy-sider told us, "The sales suggest there's not as much value in the stocks today, but that's not the same thing as saying they're 'very overpriced.' We don't agree with that view." The buy-sider added that, in general, managements aren't very good at getting the stocks "right." He noted, "The market is forward looking and that's something that most real estate people have a hard time with."

T. Ritson Ferguson, chief investment officer for ING Clarion Real Estate Securities in Radnor, Pennsylvania, agreed that insider selling isn't a bullish signal. However, he took issue with Shulman's characterization that the stocks are "very overpriced." He added, "That's definitely not our view."

According to Ferguson, ING Clarion's numbers at June 30 showed the stocks to be changing hands basically at 100% of NAV (not the 16% premium that Shulman suggests). "We were at a 0.3% premium," Ferguson said. His group views NAVs within plus or minus 10% of "par" as being "noise." Ferguson's conclusion: The NAV metric is neutral for now.

[Ferguson added that recent suggestions that buy-siders are arguing for higher NAVs to "justify" continued buying in the face of stretched valuations doesn't hold water, in his view. He explained that in March, he and his colleagues conducted a thorough review of the cap rate assumptions they were using to calculate their NAVs. After lengthy discussions with the acquisition people on the "direct" real estate side of Clarion, Ferguson said he and his colleagues concluded they needed to adjust their cap rates down to reflect then-current market conditions. "Our conclusion was the cap rates we were using to calculate our NAVs were between 50 and 300 basis points too

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high, depending on property type, etc." Ferguson explained that as a result of that analysis, they lowered the cap rates they were using by between 25 and 150 basis points. "We saw that move as conservative," he stressed, adding that, if anything, cap rates have drifted lower since then. "We're comfortable that our numbers remain conservative."]

After NAV, Ferguson looks at FFO multiples. Though FAD multiples would be a better metric, Ferguson explained there isn't a satisfactory FAD data set going back far enough to be able to do that analysis. Looking at FFO multiples, as of June 30, he said the stocks were trading at 10.4x their forward (4 quarters) FFO multiple. Relying on Goldman Sachs data, Ferguson explained that the average, going back to approximately 1985, is roughly 11.0x. "It's been as low as 8x (i.e., late 1999) and as high as 14x to 15x," he said. So on that score, Ferguson believes the stocks look neutral to slightly cheap.

ING Clarion's Ferguson

The last metric he looks at is yield spreads. Noting that "everything looks cheap to Treasurys," Ferguson pointed out that the current spread is roughly 300 basis points. In the past, he added, a 200-basis-point spread was regarded as being huge. Over roughly the past year, the spread has been in the range of 250 to 350 basis points, so again, he sees a neutral signal.

Looking at the three broad valuation metrics, Ferguson says you cannot argue the stocks are cheap. At the same time, he stresses there's nothing that causes him to conclude, "It's time to run for the hills."

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