Federal Realty Investment Trust

NYSE: FRT

Short Pitch

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Industry Overview

- Real Estate Investment Trust (REIT)
  - A stock that invests in real estate
  - REITS invest in different types of real estate, such as shopping malls, office buildings, apartments, hotels, etc.
- Two types of REITS: Equity and Mortgage REITS
- REITS must derive 95% of their income from property rent, mortgages, and dividends.
- REITS are required by law to pay dividends.
  - avoid federal corporate income tax
  - pay 90% of their income out as dividends

Business Overview I

- Federal Realty specializes in redeveloping, remerchandising, and revitalizing community shopping centers and mixed used centers
- Their goal consists of acquiring, owning, managing, and redeveloping high quality retail assets
- Dominant property type is residential and community shopping centers with a grocery store as the anchor
- They operate in strategically selected metropolitan markets

– Northeast, Mid-Atlantic Regions as well as California

– densely populated affluent communities

Business Overview II

- Federal Realty relies on a “low risk, high reward strategy based on the locations of their properties.
- Regularly paid dividends since their founding in 1962
- 40 consecutive years of increased dividends
  - This differentiates them from other REITS in the industry.
  - Dividends in 2007 were $2.44 per share
- 18.1 million square feet of space
- 77% of earnings growth comes from remerchandising and redevelopment
- 95.0% leased
  - Down from 96.7% in 2007

Sample of Properties

- Mount Vernon Plaza, Alexandria, VA
  - Average rent: $14.57 per square foot
- Barracks Road Shopping Center Charlottesville, VA
  - Average rent: $18.60 per square foot
- Pentagon Row, Arlington, VA
- Bethesda Row, Bethesda MD

- The last two are “mixed use”
  - Retail, residential, and office space


RadioShack
7702B-H


Michaels


Barnes & Noble

Financials

- Valuation Metrics
  - PEG Ratio: 1.47
  - Trailing P/E Ratio: 18.43
  - Forward P/E Ratio: 10.45
- 52 Week Range: $36.92 - $95.00
  - Beta: 1.31
- Current Ratio: 0.363
- Profitability Ratios:
  - Return on Equity: 10.25
  - Profit Margin: 21.24
  - Operating Margin: 40.41%

One Year Chart

Thesis Points

- Federal Realty's business model results in several flaws.
- Rental income coming from tenants is in jeopardy.
- They rely on too much debt to finance their operations.

Business Model

- Business model makes logical sense in theory,
  - “Remerchandise, Redevelop, and Revitalize” are the objectives of their business model.
  - In reality, Federal Realty is not fully executing their business model
- New mix of retailers
  - a more diverse mix of brands
  - Wider array of services to allow customers to do more at one center
- Reconfiguration
  - Extensions
  - Additional Construction

Business Model

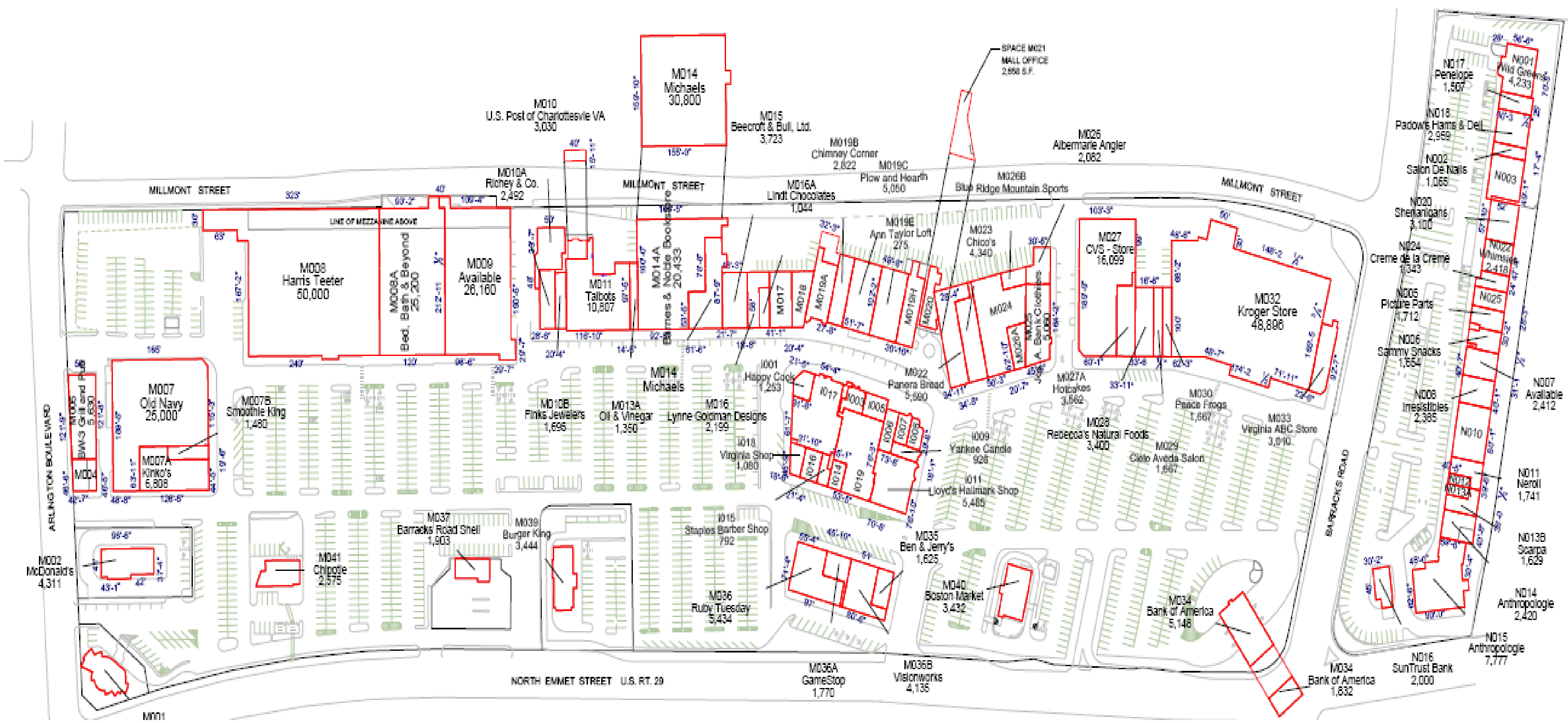
- Overlooks critical aspects of redevelopment
  - These aspects are major enough to the point where they harm the center in the long run.
- Reconfigure shopping centers to allow excessive cut-through traffic
  - Not considerate toward pedestrians
  - Difficult to travel within shopping center when customers want to leave a particular section.
- New retailers are not placed in the optimal space within the shopping centers
  - Optimal space refers to where they can generate the most sales
  - Result is that it creates different zones that customers prefer to shop in.
  - Concentrate mostly on filling the space as opposed to finding the optimal location within center for each retailer

Business Model

- Discourage the presence of small businesses
  - Results in higher rent
  - Not have the means to advertise like national retailers
- No provisions for “big box retailers”
  - Lack of superstores and major discounters like Wal-Mart, Target, etc.
  - “Retailers at our properties also face increasing competition from outlet stores, discount shopping clubs, superstores, and other forms of marketing of goods and services…This competition could contribute to lease defaults and insolvency of tenants.”
- Locations of their Centers are Questionable
  - seem to rely on college students in Barracks Road
  - Military and tourist attractions near Mount Vernon

Site Plan: Mount Vernon Plaza

Site Plan: Barracks Road



Rental Income

- Rely heavily on cash generated from operations through rent.
  - The cash generated from operation is then paid out to shareholders in the form of dividends
  - Creates an incentive to not decrease rent
- If tenants default on their rents, it would reduce rental income.
- Place their centers in densely populated urban areas so that tenants can appreciate higher sales and so that FRT can charge higher rent.
  - Charlottesville is obviously a college town
    - $62,000 income
  - Mount Vernon features a military base and a significant low-income population
    - ~$113,000 income within a five mile radius

Rental Income

Leases signed in 2005-2007 show double-digit cash rent increases

- economic environment is ripe for tenants to default on rent
  - Weed out underperforming stores
  - Resulting in additional vacancies
  - Lower cash flows

- Higher bankruptcies and lower occupancy levels
  - Based on VAR at Mount Vernon, there have been vacancies even at “well located properties in densely populated affluent areas”
  - Federal Realty does not seem to renegotiate leases with tenants as it depends on them to pay dividends and store closures

Increased Leverage

- Entered into a $200 million unsecured loan on November 9, 2007
  - Used it to repay $150 million in notes at 6.125% that matured on November 15, 2007.
- $175 million debt matures on 12/1/ 2009
  - Difficult to pay this off, pay dividends, as well as finance basic operations at the same time without going into debt.
- Throughout 2008, they issued $92 million worth of debt
  - Resulting in $788 million of payments to cover interest expense

From annual report:

“Our organizational documents do not limit the level or amount of debt that we may incur. We do not have a policy limiting the ratio of our debt to total capitalization or assets.”

Current Ratios

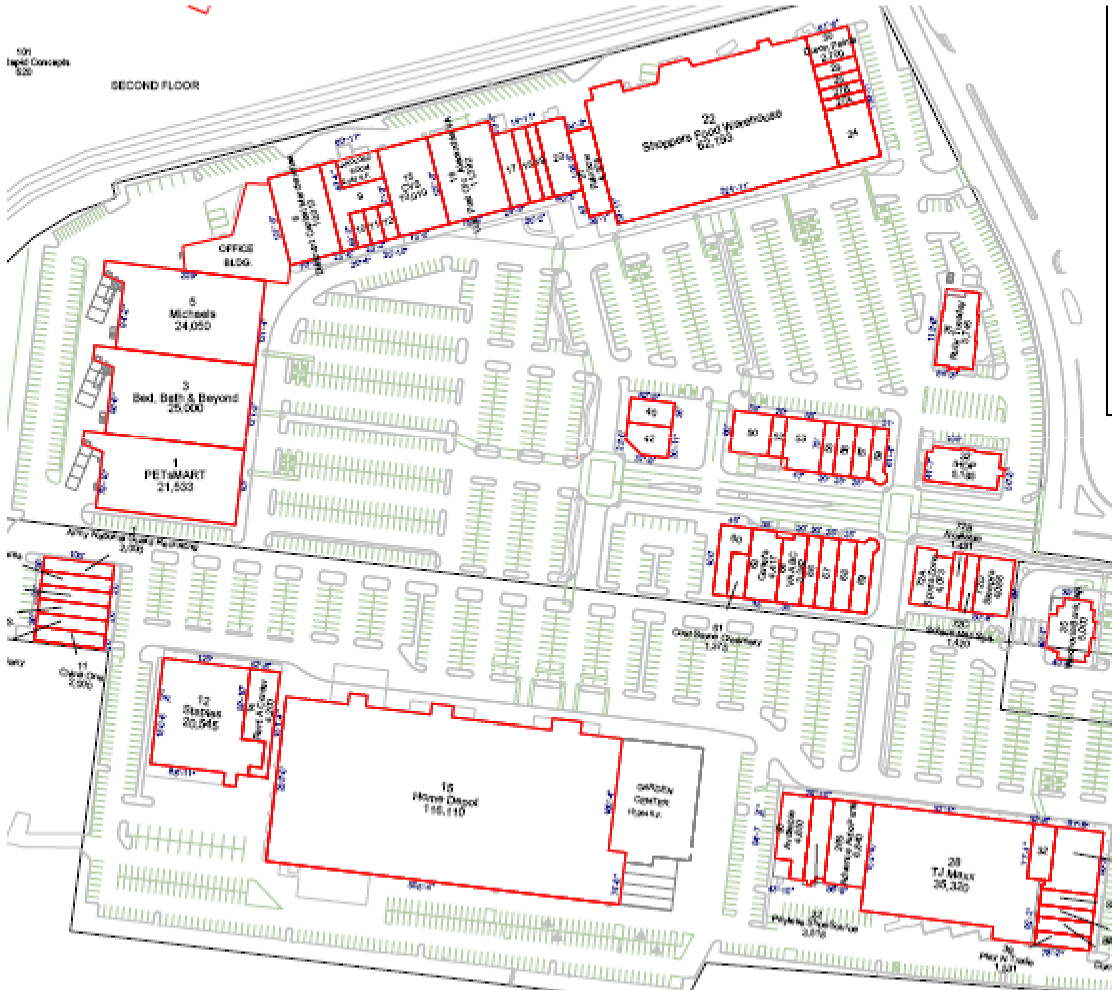
- Federal Realty's relies on too much debt to finance their operations.
  - Current Ratio for FRT: 0.363
  - Problems making interest payments
- Competitors are better positioned to make interest payments for their debt than FRT
  - Simon Property Group: 0.728
  - Regency Centers Corp: 0.767
  - Glimcher Realty Trust: 0.815
- Relative to their competitors, FRT has taken out too much debt

- We believe that it will be difficult to fund our expected growth with cash from operating activities because, in addition to other requirements, we are generally required to distribute to our shareholders at least 90% of our REIT taxable income each year to continue to qualify as a real estate investment trust.

Value Added Research

- Manager at CVS
  - Relationship between the landlord and tenants is normal and there does not seem to be a drastic change from before and after the redevelopment
  - Rent is always increasing irrespective of sales
  - Location “sucks” because it is hidden and no one can see our store from the main roads
  - Other tenants have a meager effect on sales
- Supervisor at Carters (a children’s clothing store)
  - Ice cream shop occasionally draws parents and children to our store
  - No obvious incentives that FRT creates to help increase sales
  - Depend mostly on regular customers to get through recession

Site Plan: Mount Vernon Plaza



Value Added Research

- AT&T Store
  - Located in the better part of the shopping center as there is nothing good by the CVS
  - Sprint, Radio Shack, and Ice Cream Store draw customers to our store
  - Diverse Customer Base

Value Added Research

- Overpriced in general for UVA students, but adults in Charlottesville may be able to afford it
- Only cater to people with money, not generally to UVA students
  - Usually only go to one store because you cannot shop at others due to prices
- Difficult to get around within shopping center; not pedestrian friendly (emphasis added)
  - Impossible to cross street to get to different part of center on foot
- Placing two grocery stores apart is the only strategic thing that they did.

Value Added Research

- Only go to Barracks for certain stores
  - Kroger, Five Guys, Chipotle were the apparent favorites
  - Bank of America, Wachovia and Post Office could have been catalysts to draw UVA students into Barracks
- Would not spend a significant amount of time there
  - Mall attitude died out before college
  - UVA students generally have better things to do than hang out at a mall

Value Added Research

- Objection to Anthropologie: EXPENSIVE (emphasis added). Tara Thai is not unique because there other Thai restaurants closer than Barracks.
- Not enough stores that are cheaper
  – Kohls, Forever 21
- Barracks does not feature anything that makes Charlottesville unique
  – Prefer the Corner or the Downtown Mall.
  – Needs less national restaurants and more local restaurants
  – “If I was showing someone around Charlottesville, I wouldn’t take them to Barracks because they can see those stores anywhere.”

Executive Summary

- Business model has several defects.
- Rental Income is not sustainable
- FRT relies on debt to finance their operations.

Questions