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Quality Is King at Agree Realty

By Emil Lee

March 22, 2007 | [Comments \(0\)](#)

I recently got an email from Joey Agree, executive vice president at Agree Realty (NYSE: [ADC](#)), a retail real estate investment trust that competes with Glimcher Realty (NYSE: [GRT](#)) and Kimco Realty (NYSE: [KIM](#)). I thought he might be a great source of information, so I asked him if we could chat and if he could help Fool readers like me with a couple primers on his company and REITs in general. The following is a phone conversation I had with Joey.

Emil Lee: Tell me about your company.

Joey Agree: We're kind of unique in the sense that our growth is through the development of new projects. A lot of REITs are growing through acquisitions; we're one of the few REITs through development. It's difficult to compare us to other REITs: Our growth is measured -- development takes a lot more time than growing through acquisitions.

Emil Lee: So is the "ultimate capitalization rate" (the [rate of return](#) you expect to earn) from development higher than if you acquired property?

Joey Agree: The cap rate is substantially higher through development. Development creates value through the entitlement process, selective land acquisitions, and through tenant relationships.

Emil Lee: How do you recommend [REIT](#) investors try to distinguish between maintenance [capital expenditures](#) (which most value investors subtract from [free cash flow](#)) and growth capital expenditures?

Joey Agree: Our maintenance capex -- two thirds [of our property leases] are triple net -- so we have limited or no maintenance responsibilities. Walgreen (NYSE: [WAG](#)), Borders (NYSE: [BGP](#)) [Agree's biggest tenants] are triple net, so typically our responsibility after store openings is simply collecting rents.

Emil Lee: So would it be fair to use fund from operations (FFO) as a proxy for actual free cash flow?

Joey Agree: Yeah -- that gets you to a cash number for a REIT. It's tough to use: When you're looking at the quality of REIT portfolio, that doesn't show up in FFO. You're looking at strictly numbers there. Since the majority of our tenants are under long-term net leases, that doesn't show up in FFO -- the credit or quality of the tenant pool.

Emil Lee: So would it make sense, for example, to say that since Agree Realty has a

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higher-quality tenant, its cash flows are more secure, and thus I can demand a lower yield from Agree's shares -- similar to how an AAA- rated bond has a lower required return than a BBB-rated bond?

Joey Agree: [Yes,] higher quality at lower cap rates. A lot of acquirers have gone to a NAV [net asset value] approach or [replacement value](#) approach. It all comes down to the quality of the tenant. That doesn't show up in the numbers. A savvy REIT investor doesn't look strictly at the numbers; they are digging into the properties of the REIT -- what kind of tenants, what kind of leases, the length of the leases.

Emil Lee: How do I value a REIT's pipeline, from an outside passive investor's point of view?

Joey Agree: [A REIT's pipeline is] not public knowledge for any REIT until projects are announced publicly. You have to look at the prior history, near term versus [long term](#) -- quality of previous projects, look backwards and make a judgment going forward. There really is no other method to look at and analyze the publicly available information.

Emil Lee: So is this kind of like looking at a [mutual fund](#) manager's track record in trying to ascertain future performance?

Joey Agree: Yes, exactly.

Emil Lee: When looking at a REIT's tenants -- for example, your biggest tenants are Sears, Walgreen, and Borders -- how important is it to try to understand each individual tenant?

Joey Agree: Walgreen, we believe, is the strongest drugstore in the country. Borders we believe is the best bookstore. We own their flagship store, we think they're a great operation - we work pretty closely with a number of retailers to help them grow and to assist in their storing strategies.

Emil Lee: Can you comment on Agree's current trading price, which seems to be at 13 times trailing FFO?

Joey Agree: The entire REIT market is interest-rate sensitive and cap-rate sensitive. Compared with other REITs, [the FFO [multiple](#)] isn't high.

Emil Lee: Do you think the replacement cost approach to valuation makes sense -- because new developments are built at replacement cost, they have to charge a rate commensurate with the replacement cost, thus setting the new price for expiring rents for existing properties?

Joey Agree: Value using replacement cost -- this goes to the inherent value created through land acquisition, entitlement, construction, and leasing of a property. With construction prices rising, as well as governmental approvals tending to be more difficult, using replacement value has become a trend with developing new properties. When people value their own portfolios, replacement value has become a factor in the cap rate equation. With the acquisition market and the amount of money chasing properties at very low cap rates, we believe instead of replacing properties, we're continually trying to add to the portfolio through development.

Emil Lee: Tell me about Agree's growth prospects.

Joey Agree: We recently [announced](#) our first project out of our Atlanta office in Barnesville, Georgia. We have a number of other projects in the Southwest and Midwest currently in the pipeline

Emil Lee: What separates you guys from the rest of the pack?

Joey Agree: Our great relationship with tenants, great track record, and a great team. Dave Prueter, SVP [senior vice president] -- he was director of national real estate for Borders

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Appraised value: Appraised value. When you apply for a mortgage loan, the loan originator will usually arrange for an appraisal to determine the fair market value of the property.

Books and Music. Vicky Umphryes was director of real estate for Home Depot. It's quality team members like these that have the relationships, experience, as well as the wherewithal to get projects completed and find new opportunities.

We work hand in hand with retailers: We're not out there speculating on land or building speculative space, we're out there working hand in hand with retailers to assist them in their route. That started 30 years ago with Kmart, when my father developed 45 Kmart stores -- this has continued for 30 years up until now with different tenants.

Emil Lee: Do you generally require a significant amount of pre-leases before developing a property?

Joey Agree: For single-tenant properties, [those are] preleased. We like to minimize our risk as much as possible.

Emil Lee: Why is your tenant occupancy (at 99.7%) so high?

Joey Agree: This is a credit to our leasing team, as well as the location and quality of our projects.

Emil Lee: It seems like there's tremendous competition for great real estate space. How do you deal with this?

Joey Agree: We've got a vast broker network, proven track record, and intimate market knowledge. Our strong relationships with retailers give us a leg up on our competition.

Emil Lee: Anything else you'd want to mention in parting?

Joey Agree: We look forward to continuing to produce quality projects -- anchored by national tenants -- at attractive returns for our shareholders. We look forward to making multiple announcements in the next few months.

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Fool contributor [Emil Lee](#) is an analyst and a disciple of value investing. He doesn't own shares in any of the companies mentioned above. Emil appreciates your comments, concerns, and complaints. The Motley Fool has a [disclosure policy](#).

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