Debunking the Fallacies of Listed Property

Leading up to the subprime mortgage crisis, all was uncertain but death, taxes, and the US housing market. Then that perception got blown up, and half of the financial world with it. Currently, we are seeing the parallels of debt and real estate back in the market, and people's minds have been jolted back to the dystopia of the subprime days.

The advent of the Silicon Valley bank collapse thread a series of events in America, from deposit flight to small/regional bank loan portfolios put under the microscope to reveal a pathogen: Commercial real estate (CRE), this sending news stations into a frenzy and producing mass investor hysteria.

In the first 5 months of 2023, the mid-to-large cap segment of the US equity market has seen a strong high single digit recovery from the 2022 rate hike barrage and the March banking stress, while REITs have been left behind alongside the Russell 2000, a risky small cap index. Since the start of the rate hiking cycle (up to the end of May 2023) the earnings yield of the Russell 3000 has increased by ~1.17%, the option-adjusted spread of the ICE BofA US High Yield Index expanded by ~1.69%, and the All-Equity REIT Index earnings yield by ~2.40%.

The market has placed REITs as significantly riskier than both junk bonds and equities after the events that have transpired. The culprit behind these REIT floggings has been interest rates, a factor REITs are considered hyper-sensitive to.

Debunking the fallacies of REIT weakness in high-rate environments:

1) REITs are extremely dependent on external financing, having to pay out 90% of their taxable earnings as dividends, making growth challenging in a high-rate environment.

   Repudiation—Taxable earnings for REITs are generally significantly less than adjusted funds from operations (AFFO) from which dividends are paid. Dividend payout from AFFO can be as low as 20%, leaving ample cash to retain and grow from.

2) REITs are highly levered due to the 80% loan-to-value (LTV) rule of thumb used by lenders in the real estate space. The >20% buffer narrows with increasing rates that cause the value of the asset to fall.

   Repudiation—High leverage is much more common in the private real estate space. The LTV of the REIT sector, as of the end of 2022, stood at a low 33.7%.

3) REITs are bond-like in nature due to contractual cash flows and, therefore, behave similarly to bonds.

   Repudiation—Cash flows of REITs are growing while coupons are generally constant.

Referring to the historical record of REIT behaviour in rising rate environments, we see mixed results in terms of performance:

Exhibit 1: REIT Performance During Sustained Periods of Rising Interest Rates

TIME PERIOD	U.S. 10-YEAR TREASURY YIELD			CUMULATIVE TOTAL RETURN OVER PERIOD		
	BEGINNING YIELD (%)	ENDING YIELD (%)	CHANGE (%)	REITS (%)	STOCKS (%)	DIFFERENCE (%)
December 1976-September 1981	6.9	15.3	8.5	137.4	46.0	91.4
January 1983-June 1984	10.5	13.6	3.1	35.6	16.5	19.1
August 1986-October 1987	7.2	9.5	2.4	-10.1	10.9	-21.0
October 1993-November 1994	5.3	8.0	2.6	-10.3	0.1	-10.3
October 1998-January 2001	4.5	6.7	2.1	27.4	27.8	-0.4
June 2003-June 2006	3.3	5.1	1.8	108.2	37.6	70.6

Source: S&P Dow Jones Indices LLC, Bloomberg, The Federal Reserve. REIT total returns are based on the FTSE/NAREIT Equity Index from Dec. 31, 1971, to Dec. 31, 1986, and they are based on the Dow Jones U.S. Select REIT Index after Dec. 31, 1986. Stock total returns are based on the S&P 500. Past performance is no guarantee of future results.

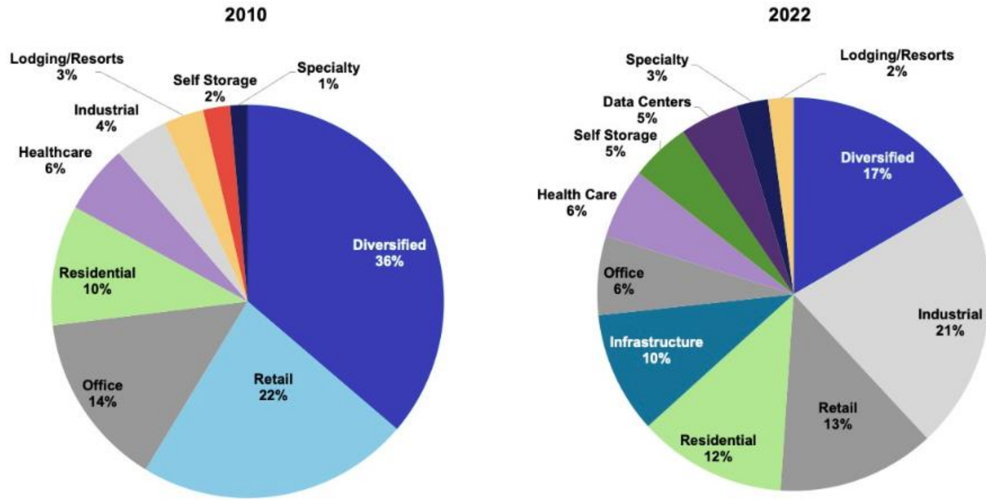
Since the seventies, including the most recent rate increasing cycle, REITs have mostly performed positively, and have outperformed equities in 3 of the 7 cycles.

The current "pathogen issue" of CRE is another concept REITs have been wrongfully sucked into. The issue is a function of highly levered private operators, low quality assets, and severe operational challenges.

Seventy-five percent of REITs in the US have the characteristics to warrant an investment grade credit rating which opens them to various channels of debt financing that are typically cheaper, with longer duration, and less restrictive covenants. Furthermore, their portfolios are generally well diversified and of a high quality.

Office and retail are facing operational challenges but have consistently become a smaller part of major REIT indices and should by no means be used as a de facto proxy for the broader REIT universe.

Exhibit 2: Property Sector Market Cap



Note: Industrial includes industrial and industrial/office mixed. Diversified is dissected in foot note[1].
Source: FTSE EPRA/Nareit Global equity market capitalization by property sector as of Dec. 31. 2010 & FTSE EPRA/Nareit Global Extended Index equity market capitalization of property sectors as of Dec. 31. 2022.

The REIT sector has evolved into a blend of real estate, infrastructure, technology, commodities. Risks have become available in all shapes and forms—providing investors with a place to hide or a place to ride.

Mental reflexes toward certain investment prospects can make a sports car seem like a jalopy. Taking the time to inspect what is going on under the hood can reveal a V8 and reshape the risk spectrum for many investors, from the short to the long-term. Global real estate is far from the run-down mall in skid row acting as a halfway house for junkies or vacant office buildings people are hitting golf balls through. *It is a vigorous ecosystem that is nuanced, growing, and evolving, bringing new risks and opportunities to be acknowledged and capitalized on.*

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Hubert holds an honours degree in financial analysis which he obtained from the University of Stellenbosch in 2019. He has passed all three CFA examinations and is currently adding to his work experience in the field to become a CFA charter holder.

From September 2020 to December 2021, he worked for The Burgiss Group where he quickly made his way up the ranks from junior analyst to auditor and then to building and co-leading the hedge fund transparency team.

For three months he wrote about financial topics for The Urban Writers before joining Reitway Global in September 2022.

Hubert is responsible for covering the specialized, storage and residential REIT sectors, globally.

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1: Top 5 diversified constituents in the 2022 index have office and retail dominant portfolios. Exception is W.P. Carey with a retail and office aggregate of 34%. Note: The top 5 is not necessarily a good proxy for the broader diversified segment, nor does it mean that the top five of 2010 owned substantial office and retail properties. It is the writer's suspicion that there was indeed a large presence of office and retail in the portfolios of diversified REITs in the 2010 index due to the greater popularity of the sectors relative to present. Unfortunately, the 2010 index constituency was unavailable.