Exploiting REIT pricing anomalies

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REIT Net Asset Values

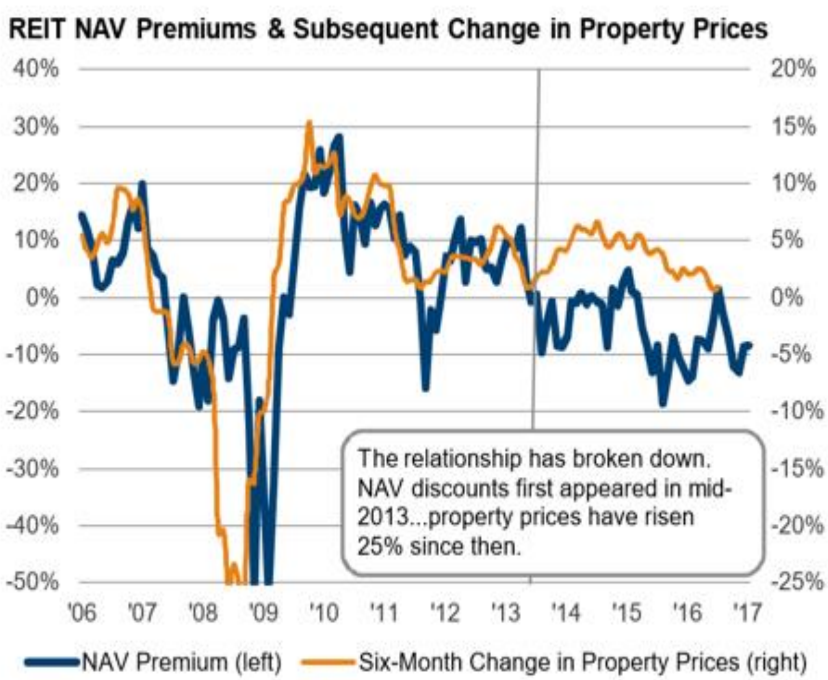
REIT Net Asset Value (NAV) is calculated by dividing its operating profit by an attributable capitalisation rate (cap rate). A higher (or lower) applied cap rate results in a lower (or higher) estimated NAV for a given level of operating profit.

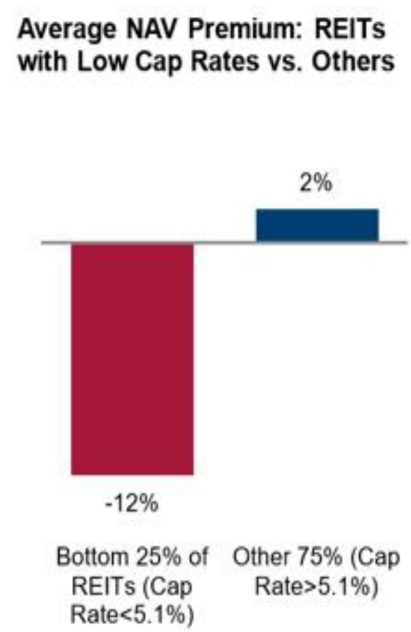
The computation of an applicable cap rate is part science and part art. However, this should not detract from the ultimate objective of NAV calculations – being the derivation of the price an asset should fetch in the market.

REIT market pricing relative to NAV

REITs in particular have traditionally traded at either discounts or premiums to NAV depending on expectations of the future direction of underlying property prices. The current discount has persisted for some time despite an extended period of rising property prices.

This position has much to do with a maximum multiple relative to cash flow or earnings that investors have been willing to pay for publicly traded REITs. This phenomenon is clearly reflected in the chart below (courtesy Green Street Advisors).





Source: GreenStreet Advisors

A possible explanation for the NAV pricing anomaly is that investors appear to have anchored REIT pricing to general equity market price multiples. At present, stock markets have capped the pricing of REITs with the current S&P 500 price multiple of 17x. The result is that the REITs with the lowest justified cap rates and highest estimated NAVs have seen their market prices being the most negatively affected.

Green Street Advisors conclude that the "tug-of-war" between physical real estate pricing and listed equity market pricing has long been a debatable matter in terms of the stock market pricing of REITs, with discrepancies now being unusually large.

What to do about it – patience and capital allocation is crucial

Stock markets may take time to correct pricing anomalies and REIT investors should exploit this by identifying exceptional REITs when they exhibit reasonable valuations. It is then crucial to apply the investment virtue of patience.

However, subscribing to this well-known mantra is meaningless if the time horizon is indeterminate and without a potential catalyst to change the status quo. In particular, investing in REITs with enticing cash flow growth prospects driven by superior fundamentals is the key to outperformance. This provides a basis to hold these positions successfully for the long term, with the goal of generating wealth over time.

Reitway Global's benchmark agnostic investment approach significantly expands our investible universe as we are not constrained by the confines of an index. In addition, our Growth At a Reasonable Price (GARP) style means that we invest in REITs with exceptional fundamentals and superior cash flow growth prospects – at the right price.

For more information about Reitway Global Property Funds, please visit our website at www.reitwayglobal.com or contact us on 021 551 3688.