REALASSETS ADVISER

REAL ASSETS ADVISER - OCTOBER 1, 2018: VOL. 5, NUMBER 9

REITS ON THE COMEBACK TRAIL: AFTER A WEAK FIRST QUARTER, REAL ESTATE INVESTMENT TRUSTS HAVE BEEN DEMONSTRATING THEIR GLORY DAYS ARE NOT SO FAR BEHIND

BY JOSEPH DOBRIAN

Publicly traded REITs went on a years-long tear following the economic meltdown of 2008, but by the beginning of this year, they appeared to have cooled off. Now, market-watchers seem to agree that dip in performance was like a dip on a ballroom dance floor: noticeable, but quick.

Some observers believe the recent popularity of large-cap growth stocks has led to overvaluation of that segment, which has made REITs' performance look paltry by comparison. Whether the party continues for growth stocks, it does not appear REITs as a category are weakening. As always, investing in REITs is a matter of choosing those you expect will perform best in accordance with your investment strategy. The answer to the question, "Will REITs come back?" appears to be, "They have never been away."

Brad Case, director of research for the National Association of Real Estate Investment Trusts (Nareit), acknowledges 2018 started poorly for REITs, with large-cap growth stocks dominating the market, but REITs outperformed the S&P 500 through the spring. REIT total returns averaged 4.18 percent in June, compared with 0.65 percent for the broader stock market. In May, REITs returned 3.60 percent, compared with 2.82 percent for the market; in April, 0.52 percent for REITs and 0.38 percent for broad stocks; in March, 3.71 percent for REITs compared to –2.01 percent for broad stocks. He sees room for this performance to continue.

“I see no REIT segment that is overvalued, or that has been caught up in hype,” says Case. “A stock price does not make sense unless its earnings justify it. Investors who pull their eyes away from the bright lights and look at stocks that might be undervalued can avoid a downturn that may happen pretty soon.”

Case suggests the business cycle that drives the stock market might be concerning at the moment, but not the cycle that drives REITs. A stock-market downturn similar to the tech crash of the late 1990s is unlikely, but investors might want to look at a category with different return drivers. A simple but effective way to estimate REITs’ valuation, explains Case, is to compare the spread between average REIT dividend yields and the yields on fixed-income securities, such as 10-year Treasuries. He notes the dividend yield spread dropped March through June, from 1.64 percent to 1.11 percent. That, he says, is what happens when investors buy REIT stocks when they are undervalued, and hold them. The current yield spread suggests REIT total returns can be expected to average more than 12 percent per year over the next three years.

Nareit reports the self-storage sector currently leads the REIT market, with a 15.1 percent return in second quarter 2018. Healthcare and lodging/resorts were close behind at 14.21 and 14.14 percent, respectively. Freestanding retail, regional malls and industrial REITs brought up the rear, but still returned more than 9 percent each.

Moreover, the U.S. Consumer Price Index has risen for six months in a row. Investors seeking a hedge against inflation will probably be drawn to REITs because when consumer prices rise, commercial rents usually do, too.

Cedrik Lachance, director of REIT research at Green Street Advisors, asserts REITs have underperformed for the past 12 to 18 months overall, but he has seen considerable volatility and, in some cases, considerable differences between shareholder returns and property fundamentals. In the latter case, industrial REITs have seen spectacular rent growth; that category is still growing by at least twice the rate of inflation. Manufactured housing is a strong performer, while retail has been in decline, largely due to the growth of e-commerce. Student housing has seen double-digit increases in property values, while office has been flat.

“It is important to think of REITs as real estate,” advises Lachance. “If we bought a building today, given how real estate is trading versus bonds, we would expect to be flat, maybe very slightly below our purchase price, 12 months from now. Real estate is fairly priced, but REITs are trading at a slight discount to private market value.”

Self-storage REITs have been especially attractive, Lachance explains, because of the product’s penetration rate. Households using self-storage have risen from 3 percent to 9 percent in the past 25 years. Yields have slowly come down in this category, but cash flows continue to grow. Office, retail and industrial REITs are pricier, and attract deeper-pocketed investors. Overall, the performance of REITs will depend on interest rates and GDP growth, which could benefit some sectors more than others.

Scott Crowe, chief of investment strategies for CenterSquare Investment Management, acknowledges REIT performance hit a plateau in 2016, but he adds the category overall appears quite healthy. Investors may have been spoiled by the double-digit returns of the early 2010s, he explains. Cap rates were sky-high coming out of the financial crisis, but yield-attracted investors bid up the values and compressed those rates.

“The consensus fear that higher interest rates will lead to lower values is unfounded,” asserts Crowe. “Spreads to interest rates remain very high. The market was concerned about future rises in interest rates and prepared for them. What has really been driving the plateau is that supply has caught up with demand. That took a while, due to risk aversion coming out of the crisis. The growth rate for the average real estate asset has fallen from about 4.5 percent to about 2.5 percent — sub-inflation growth, in other words.”

Another factor in the plateauing of REITs is obsolescence risk, notes Crowe, which makes investors cautious of some real estate types, especially retail. Much of existing retail real estate will have to be shuttered and repurposed over next few years, he predicts.

Similarly, online bookings have negatively affected hotels because the enhanced ability to shop around puts more power in the hands of the consumer. In sum, commercial real estate generally has been treading water since 2016. While the glory days are probably over for this cycle, a new cycle will soon begin, and REITs are exceptionally well positioned as alternative investments, much as they were for the tech downturn. Investors who maintain their allocation in REITs, Crowe insists, will be pleased by their resilience as the end of this cycle unfolds.

Paul Curbo, managing director and portfolio manager for real estate securities at Invesco, attributes REITs’ weak performance in the first quarter to higher interest rates, as well as relatively uninspiring earnings guidance from several companies for the coming year. In the second quarter, the market seemed to adjust to the change in interest rates, and REITs have been outperforming the pessimistic predictions. In general, he reports cash flow growth of 6 percent to 7 percent this year, coupled with a dividend yield of 4 percent.

That weak first quarter provided opportunities for well-capitalized investors to privatize REITs that were trading too low relative to asset value; conceivably, some such opportunities still exist. Private equity investors, therefore, might consider increasing their allocations to REITs.

“Relative to other investments, REITs’ second-quarter performance was pretty good,” says Curbo. “The weak first quarter is not indicative of a downturn. The markets tend to overreact to a rise in interest rates. REITs are not bonds or utilities; they do provide some cash-flow growth. However, we have to acknowledge, from a supply/demand perspective, that we are later in the cycle. For many property sectors, current supply is meeting demand; this results in some deceleration in growth, from a cash-flow perspective.”

Performance has been strongest for REITs that specialize in sectors with shorter lease terms, such as lodging and self-storage, notes Curbo, as opposed to healthcare or triple-net-leased properties. Shopping center REITs started the year badly because of increases in bankruptcies and store closures, but that sector, too, has rallied, with new, innovative retailers replacing obsolete concepts and adapting to the growth of online sales. Secondary and tertiary locations and markets are hardest hit; class A regional malls and shopping centers are less affected.

Curbo also sees opportunity for REITs that focus on niche properties. The growth of cell towers is limited because many communities do not want them built, so owners of existing wireless infrastructure should be able to command high rents. Single-family rental properties are becoming more institutionalized, more securitized, and better received in the public markets. Demand is increasing for manufactured housing — modular and mobile homes — that present affordable options for retirees and young people. Curbo sees considerable growth potential in that category.

Looking forward, he says, there is a balanced market for traditional property sectors, with a positive long term for healthcare and senior housing, but concerns in the short term because supply is currently running ahead of demand. REITs, in general, appear healthy, and demand for domestic commercial real estate may be growing in response to talk of trade wars with foreign countries.

While January and February 2018 were dreadful months for REITs, notes David Lari, a partner in the law firm of Cox, Castle & Nicholson, they were bad for most investment classes, and REITs seem to have rebounded. He characterizes the current situation as a stabilization of real estate prices in general, rather than a down cycle. Sellers are still looking to increase pricing, Lari says, but in some cases the asking prices are higher than the asset was worth a year ago. This bid/ask disparity seems to be plaguing both commercial and residential real estate in many markets.

“Despite the growing number of national institutional investors, real estate remains a regional industry in some ways, sometimes asset-by-asset,” Lari explains. “Retail a year or two ago was expected by some people to spiral down, but it has shown success in value propositions that are reconfigured. A lot of it comes down to what an investor plans to do with the asset and whether they buy prudently, with a strategic vision and game plan.”

Lari suggests retail REITs might be struggling a bit now, but many of them are rethinking retail, turning their assets into holistic experiences rather than mere shopping destinations. Healthcare REITs, he says, have generally strong fundamentals, with an aging population that is living longer and has more access to medical facilities. Healthcare, he notes, was one of the few asset classes that did relatively well in the late downturn.

Market watchers generally seem to agree, while REITs have a reputation for volatility, real estate as a category has more stability than many others, such as the tech sector. Real estate has fluctuations, but they are much more gradual.

Probably, the best stratagem for large investors is to factor in not only the asset class and size of the REIT, but also the track record and prior successes of the management team. Strong acquisition and asset-management personnel, and high-quality corporate governance, make a tremendous difference no matter the REIT’s area of specialization. By examining the totality of the REIT — its business plan and its leadership, as well as its underlying assets and its preferences within an asset class — an investor will find it relatively easy to choose winners.

Some observers believe real estate transaction activity might become robust, with some closure of the bid/ask gap. The price of trophy assets in gateway cities has for the past few years been set by foreign investors, especially from Asian countries, but that money has slowed somewhat of late. On the other hand, interest from institutional investors is still high, and sellers may be recognizing that a little correction in their pricing expectations might be called for. On the development side, land prices have risen along with the cost of labor, materials and capital.

Overall, real estate should be a strong sector for years to come and, given the volatility of the broader equities market, REITs may still be viewed as one of the safer investment vehicles.

Joseph Dobrian (jdobrian@aol.com) is a freelance writer based in Iowa City.