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It's 2013 not 2007: What has changed for global REITs

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Global property investors who invested at the peak (October 2007) received a positive return for the first time in July 2013. While both the fundamentals and payout ratios from many global real estate listed property trusts (REITs) in 2007 were becoming stretched, and the magnitude of destruction the GFC caused was not foreseen, REITs were beginning to look less and less like rent collectors, and more like industrials. The question for investors is have REITs learned from the past or, is the sector doomed to a similar fate?

REITs perform multiple roles in a diversified investment portfolio. An allocation to REITs should lower volatility, provide a stable income stream, be more defensive than listed equities given the expected lower correlation; and, provide a hedge against inflation due to the nature of rental agreements. If we look at a snapshot of the global REITs market at different points in time (refer to the table below), advisers and investors can assess the key merits of holding REITs in a diversified portfolio and determine if REITs have learned from the past.

Weighted stock valuation: Global REITs market

Metrics	30 June 2007	30 June 2009	30 June 2013
Price/FFO	18.5x	12.7x	17.4x
Premium (discount)/NAV	2.5%	(15.6%)	(9.6%)
Leverage	32.9%	36.4%	34.3%
Payout ratio	67%	65%	56%
Dividend yield	3.6%	5.2%	3.3%
Valuations	Expensive	Reasonable Value	Reasonable Value
US 10 year bond yield	5.00%	3.50%	2.49%
AUD 10 year bond yield	6.26%	5.52%	3.76%

Source: UBS.

Yield: Highly sustainable

Dividend yields have returned to 2007 levels and are likely to improve, but there are a couple of important differences. Firstly, the yields are being generated with much lower payout ratios than in 2007. The lower payout ratios are indicative of the stronger balance sheets we see today as a result of substantial deleveraging since the GFC. REITs have taken advantage of lower interest rates to refinance debt at lower rates for longer; and, with the reduced payout ratios the ability to cover interest charges and meet debt covenants has been significantly improved. Secondly, the yields on alternative yield investments (we have taken the 10 year bond yield as a proxy) are also much lower than in 2007.

Valuations: Nowhere near as stretched

Given the growing support for the sector and significant capital chasing core real estate (which the listed sector owns) currently trading at prices below NAV, we have seen improved valuations - the table above shows a current discount to NAV of 9.6%. We expect that simple market forces will see prices rise and this has already started to play out. For example, on 10 September 2013 Unisuper purchased Westfield's 33.3% stake in Karringyup Shopping Centre at a 19% premium (a cap rate or yield of 5%). As at 11 September 2013, Westfield Retail was trading at a 14% discount to NTA and its average cap rate was just over 6%.

Inflation hedge: Protection in a post QE world

With inflation one potential outcome from the global QE policies, REITs may be used as a hedge against this risk. Firstly, REITs invest in real assets with prices that typically move in line with inflation. Secondly, as the global economy starts to grow, we should see improvement on a range of fronts including employment growth, business and consumer confidence, building approvals and an increase in property development, with the latter stagnant since the GFC. The benefits for REITs should be reduced vacancy rates and a greater capacity to increase rents as the demand for space rises. Both factors should in turn improve cash flow and thus increase dividends.

Conclusion

While REITs have not been a good news story for retail investors who allocated to the sector in 2007, the sector has undergone significant change and now bears little resemblance to 2007. In our view, the REITs sector in 2013 once again reflects its low risk and defensive mandate and offers good value for investors. For investors looking to diversify their portfolios or for an inflation hedge or a relatively cheap investment at a time when we are going into a period of low but sustainable global growth, now is the time to consider REITs.

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