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Is There Life In Real Estate Securities after the QE Drip Gets Turned Off?

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In the early part of 2013, the real estate sector continued its impressive run of positive monthly returns and remained one of the favoured asset classes as investors sought the security of the cash flow that REITs can offer.

After posting a healthy gain of 7.7% for the month of April 2013, the sector's run of ten consecutive months of positive monthly returns ended abruptly in May 2013 off the back of the US Federal Reserve's (the Fed) comments on the commencement of tapering its Quantitative Easing Programme (QE). The sharp sell-off in REITs pushed the global Index into negative territory for the first month since May 2012 – up to that point the index had returned 39.5%, in Australian dollar terms, for the ten month period. While markets and investors grappled with, and reacted to, news on QE tapering for the best part of six months, by year end the definitive comments from the Fed delivered certainty and went a long way to restoring confidence. The question for investors now though is: what does a post QE world look like for real estate securities?

In our view, while QE tapering will continue to be a consideration for investors it should not be a distraction. Given the current interest rate environment, the strength of balance sheets for REITs, together with the sound underlying fundamentals for the sector, REITs offer a compelling investment opportunity and a good hedge against inflation in 2014 and beyond.

Interest rates

There are concerns that we are in a rising interest rate environment driven by the commencement of the US tapering. More specifically, the focus has turned from "tapering fixation" to the Fed's timetable for raising short term rates. The market has accepted that the tapering program will continue, with most US economic data points indicating an improving economy. The weak December payroll number spooked the market a little, with debate around whether this would slow the tapering program. The debate was substantially, and reasonably quickly, quelled however, with the Fed reiterating tapering will continue unless there is a significant detraction in the data.

When tapering was first put on the agenda in May/June 2013, the US ten year bond rate spiked to 3.0% and the REIT sector was sold down over the second half of 2013. The announcement that tapering would commence in January 2014 gave the market some certainty, with the bond rate holding around the 3% level. In late January 2014, the Fed announced the continuation of tapering and the market expected rates to spike once again. However, due to the concerns about emerging markets the ten year bond rate moved down to around 2.7%.

Looking forward, once the 10 year bond rate returns to the 3.0% level we expect interest rates to move at a measured pace and remain at around the current level for an extended period. While the US is recovering, the economic data is far from robust but is showing signs of improvement. The fall in the US unemployment rate has largely been driven by more people leaving the work force rather than the creation of new jobs. We are not seeing any upward pressure on the inflation rate, with wage rates remaining stable. This coupled with a stronger US dollar sees the US import deflation. We believe that inflation is in check and this should keep rates reasonably stable and help to support real estate valuations in both the direct and listed markets.

REIT Balance Sheets
While the REITs balance sheet story has been well documented, I think it is worth repeating. The balance sheets of REITs have been significantly repaired post the GFC. Secondary assets have been sold, debt levels have been reduced, debt tenure has been extended and payout ratios have decreased. All of which means more funds are being retained for reinvestment into the business. Strategically, the business models have returned to a more traditional focus on real estate, with funds management being the main earnings driver outside of owning and actively managing real estate. Importantly, development is now being approached with higher risk/return parameters. This has given greater clarity to the cash flow from these entities and substantially improved transparency on the growth drivers.

This all means that in periods of correction, the REITs are now much better positioned to weather the sort of markets we saw following the GFC.

Underlying Real Estate Fundamentals
Looking more specifically at the underlying real estate fundamentals, both the market and the REITs themselves, are in a good position to benefit from a recovery. Following are some key considerations.

- **Demand for physical real estate**
  There has been unprecedented pickup in demand for physical real estate assets by sovereign wealth and pension funds post the GFC. These investors are attracted to the cash flow the assets deliver and the protection that owning hard assets provides against the volatility we have seen in the equity markets. However, demand of this nature is generally limited to the bigger ticket quality assets, with long dated leases, no major capital expenditure requirements and tenants with good credit covenants.

  To date, demand has been for prime real estate but we have seen groups such as Blackstone, enter into large portfolio trades from distressed vendors primarily in secondary retail and industrial. They have been happy to earn the high yield these assets offer, offset against cheap debt. However, as core assets have been acquired we have seen demand move away with investors reducing their total return expectations even in a rising interest rate environment. Interestingly, we have also seen a greater preparedness to take on more releasing/redevelopment propositions.

  This is a positive for the sector, as the sector generally holds the type of assets these investors are looking for – and this goes a long way to supporting asset valuations. If the situation arises where there is a disconnect between where the sector is priced and where the physical property market is trading, this will give rise to a new round of M&A activity with REITs being taken private.

- **Public/Private pricing**
  We are we seeing examples of this activity, with recent transactions highlighting the gap in pricing between the public (listed) and private (unlisted) markets. For example, in Australia we have seen the recent acquisition of the Commonwealth Property Office Fund by Dexus Property Group in conjunction with the Canadian Pension Plan Investment Board in Australia. This is a good example of a sovereign wealth fund acquiring a portfolio of critical mass in a market they regard as strategic, in conjunction with a well credentialed joint venture partner on the ground with the capacity to manage the assets for them.

More recently, Taubman Centres in the US sold a 49.9% stake in a Class A mall to TIAA-CREF and APG. Taubman acquired this stake to take them to 100% ownership in December 2012 on a cap rate of 4.6%. While the cap rate of the sale ofthe same stake in January 2014 has not been disclosed, it has been estimated to be at a 4.2% cap rate. This was in an environment where the US ten year bond yield has moved from 1.6% to 3.0%, which underscores the demand for prime real estate assets, but also makes the Taubman portfolio look quite cheap given its portfolio trades on approximately 6% at current prices. This indicates that there is a large disconnect between public and private market pricing and while the demand for core real estate continues, valuations in the listed sector should be supported for some time.

- **Level of new supply**
  Globally real estate markets are experiencing low levels of new supply. This trend in low levels of new supply goes back to post the Asian and dotcom bubbles in the early 2000's. This is particularly evident in the office space sub-sector. At that time, there was a glut of supply which took a number of years to work through. This created a very different approach to development funding, with both debt and equity investors looking for projects to be substantially de-risked before providing finance. This basically meant unless a developer was prepared to build off their own balance sheet (and not many were that well capitalised) they needed a building contract (locking in building costs) and a signed tenant for approximately 70% of the building (locking in cash flow post completion) to gain funding.

  Not surprisingly, post the GFC this scenario has not changed and, with banks already holding large exposures within their existing real estate loan book, the banks have not had the appetite to fund new development. The impact on office construction in the US space reflected this, with construction peaking at 4.6% of existing inventory in Q4 2000, before falling to 1.5% post the dotcom bubble and picking up to 3.0% pre GFC. Construction currently sits at 1.3%. While the recovery in the US is not broad based, West Coast markets, primarily Los Angeles, San Diego and San Francisco, as well as New York City are experiencing falling vacancies and a pick up in asking rents.

  In Australia, we have experienced the same phenomena across retail and industrial. Tenant demand for retail space has been quite subdued given market conditions. This has in turn kept development in check, while industrial tends to be driven by tenant demand rather than speculative development.

Conclusion

REITs have come a long way in the last seven years in the post GFC world and we believe that the sector will deliver solid results in the post QE world. As we move into 2014, the sector is well positioned to provide a hedge against inflation and to deliver strong relative performance with quality companies in the sector offering secure underlying cash flows, strong capital structures and portfolios of high quality assets. For unhedged global REITs, we expect the sector to deliver absolute returns between 10% to 12% off the back of an uptick in global economic growth that should drive occupancy rates and rents. On the domestic front, we regard the falling Australian dollar as a key positive for the sector and forecast absolute returns in the range of 8% to 10% for AREITs.

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