

## Dispelling the Urban Myth on REITs and Interest Rates

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Recently, I have been getting quite a few inquiries regarding the impact of rising interest rates and REIT (Real Estate Investment Trust) valuations. The prevailing (and erroneous) theme, compounded by some financial analysts and the media, is that rising rates will have an adverse effect on REIT prices and thus on peoples' portfolio values.

The argument goes as follows: firstly, it is perceived that higher interest rates (hence higher mortgage rates) would affect the profitability of a REIT, impacting its bottom line and in turn the market price. Secondly, rising interest rates would negatively impact capitalization rates both in the public and private sectors and that in turn should produce lower valuations and stock prices. (In simple terms, capitalization rates, or 'cap rates', are discount rates used to value real estate and are determined by dividing the rental income after expenses (net income) by the value of the property.) Before I address both of these issues, let's first see if the historical evidence supports the above claims. Here are the results of a study recently compiled by Bloomberg analysts that looked at 9 cycles of monetary tightening (*interest rate increases*) over the last 45 years!

| TIME PERIOD           | Length of Increase | Change in Fed Policy | REIT Performance |
|-----------------------|--------------------|----------------------|------------------|
| Dec 2015 - Present    | ~1 year            | +50 bps              | +10%             |
| Apr 2004 - June 2007  | 3 years            | +425 bps             | +17%             |
| Apr 1999 - Dec 2000   | ~2 years           | +175 bps             | +14%             |
| Jan 1994 - June 1995  | 1.5 years          | +300 bps             | +6%              |
| Apr 1988 - April 1989 | 1 year             | +300 bps             | +6%              |
| Apr 1987 - Sept 1987  | 6 months           | +125 bps             | -5%              |
| Apr 1983 - Sept 1984  | 1.5 years          | +325 bps             | +20%             |
| Jun 1980 - Dec 1980   | 6 months           | +850 bps             | +35%             |
| Apr 1976 - April 1980 | 4 years            | +1525 bps            | +21%             |

1 Fed Funds Target Rate. 2 MSCI U.S. REIT Total Return Index. Represents annualized returns. Source: Bloomberg. As of December 31, 2016.

As the above table shows, over the last 45 years of REIT existence as a public investment vehicle, they have generated strong absolute returns across nine different periods of interest rate increases. Clearly, the pundits have not checked their historical data.

The reason for the value increase is quite straightforward. Rising interest rates during periods of tightening monetary policy (interest rate increases) over the last 45 years have been accompanied by improved economic growth. Higher economic growth usually means higher rents, lower vacancy rates and higher inflation. As real estate over the centuries has been the best hedge against inflationary pressures - higher REIT and private market valuations usually followed.

**What about rising mortgage costs?** As mentioned above, in the long term, higher mortgage costs are offset by higher rents and higher occupancy. Both good for income.

**What about the short-term impact?** Most REITs in the marketplace today have managed their mortgage and debt maturities in a very conservative manner. Many REITs with exposure in the U.S. were able to secure long-term mortgages (over 5 years), while predominantly Canadian-asset REITs have been able to extend their maturities via issuance of low rate debt.

Over the long term, it is earnings that determine ultimate asset prices. This is equally true for any stock, any private company, any publicly listed REIT or your own apartment building or small rental property. It is rising rents, not rising interest rates that are the best determination of the value of a building or a whole REIT.

**What are today's valuations? How do they compare historically? Is there any room to move higher?** I have argued for quite some time (since the fall of 2015 when we entered the REIT market) that the Canadian public REIT market is undervalued vis-a-vis its private market counterpart – i.e. the price of commercial real estate in real life. In one of my Lunch & Learn sessions I used the example of Hans Kuhne (a German billionaire) who, in a private deal, paid \$450 million for Royal Centre Mall (located downtown Vancouver) with a cap rate of 3% - the price, ostensibly higher, than one would pay for a similar commercial asset in the public market.

It doesn't take hundreds of millions in capital to arrive at the same conclusion - the average two bedroom apartment in Vancouver sells at approximately 2% cap rate (i.e. if you bought a two bedroom condo in downtown Vancouver and rented it out, you would make only 2% on the value of your condo). While, for example, an apartment REIT like Northview Apartments, trades at implied cap rate of 8%. This means that the valuation being applied to the underlying buildings in their portfolio is at least 30% discounted to what's happening in the "real" world (private market) based on the rental revenue they are generating.

Obviously, the assets of Northview Apartments are vastly different than luxury condos in Coal Harbour, Yaletown or Ambleside, but the fact is, that publicly listed REITs trade at a discount to their Net Asset Value (as measured by the implied national average cap rate) and at a deep discount to their replacement cost (ie what would it cost to build these buildings from the ground up today).

This trend of trading below the replacement cost is more evident in secondary markets such as mid-sized cities across Canada. Over the years, these secondary markets have not enjoyed the economic growth that Vancouver, Toronto or Calgary (till 2014) have experienced. Nor have they received the same influx of new businesses or population growth. Real estate prices and rents in these areas have remained stagnant, sometimes for over a decade. Meanwhile, according to Statistics Canada, the construction cost of an apartment building is up 66% in the last 15 years, regardless of location.

Below is a chart of Northview Apartments over the last 5 years - the stock is down approximately 25% (excluding the dividend) while the TSX is up 26%.

(As a side note, if the 8% dividend is included, the value would actually be up over this time frame, reinforcing the importance of steady income/dividend. We, however, bought it close to the bottom of its price range, so we have seen some capital appreciation in addition to the dividend payments that we have received.)



SOURCE: www. bloomberg.com

### What happened? Why is it down?

Certainly not because of rising interest rates - interest rates are actually lower today than they were five years ago. The answer lies in the economic outlook of Canada. The outlook has not been bright over the last five years because of the impact of the last commodity cycle (a significant and persistent drop in oil prices and other commodities), which started to be reflected in the prospects of our economy.

Here lies the greatest downside risk, not only to the REIT market, but also to the market in general – the possibility of an economic slowdown that would depress rents, increase vacancy rates and dampen consumer confidence. Lower income per share and lower relative values are the greatest foes of stock market valuations. There is however a silver lining, in case of a market swoon - the Net Asset Values (or the replicant values) of real estate assets provide a meaningful floor/buffer to stock price declines.

**Is now a good time to own some of the underperforming REITs (such as Northview Apartments)?** In my opinion, yes. It is not a secret that the Canadian real estate market remains greatly bifurcated between the primary markets of Toronto and Vancouver and the secondary markets of small/mid-town Alberta, B.C., Ontario, etc.

The economic uncertainty over the last 5 years has resulted in an unprecedented long-term discount of Canadian REITs to their implied values and lately to their replacement values (while prices of REITs remained stagnant or went down, construction/replacement cost of their assets/building has crept up).

In order for prices to find an equilibrium and move higher, we would need positive growth forecasts, higher commodity prices and the removal of uncertainties, created even recently by the new U.S. administration in regards to the future of NAFTA and/or the proposed border adjustment tax.

However, I perceive all the above issues as more of an opportunity than a deterrent. Warren Buffet has always maintained that uncertainty is a friend of the long-term value buyer. It may still take a while until we get some visibility in terms of our trade agreements, sustainable oil prices or economic growth spurred by increased infrastructure spending, etc. (which is why I have repeatedly said that Canadian REITs are a great asset to hold for the long-term).

If the above trends were easy to predict, and were pointing to positive economic growth from today onward, the REIT prices should be 20–30% higher than today reflecting all of these positives. Obviously, we are not there yet, but a conscious value investor should prefer it this way, like Warren Buffet, a seeker of economic uncertainty and the under-valued opportunities that are available during these times. Over 200 years ago, during the Napoleonic wars, Baron Rothschild famously quipped “Buy real estate when there is blood in the streets”. What greater uncertainty than a war raging through the continent?

Hopefully the future will spare us from such a macabre outcome, but one thing for sure, volatility is here to stay. Uncertainty will not be erased by one executive order. In the meantime, having a steady portfolio allocation to the REIT sector and focusing on cash flow is the best way to avoid getting caught trying to predict macro trends.

With more than 70% of a REIT's total return coming from the compounding of monthly income, it's important to stay invested to allow real estate to do what it's designed to do—provide stable income with capital appreciation over time. Trying to trade in and out of the REIT sector based on interest-rate movements, short term economic outlooks, or flavour of the month ideas is not only detrimental to returns but will effectively exclude you from taking advantage of the future growth prospects of Canadian economy, that, I believe, will be stronger than some of us can imagine today.

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