GRANT'S
INTEREST RATE OBSERVER®
Vol. 35, No. 02c Two Wall Street, New York, New York 10005 • www.grantspub.com JANUARY 27, 2017

REIT numero uno

In response to the Bank of Mexico's spending $2 billion to defend the peso against the tweets of then-President-elect Donald Trump, alert Mexican traders produced a response plan. Rather than selling dollars, let the central bank buy Twitter, Inc., they said. Once in possession of that digital platform, let the authorities turn out the lights. No more tweets. Win! Win!

The peso and a certain flourishing, liquid Mexican real estate investment trust—Fibra Uno, the original and largest Mexican REIT, is the name—are the topics of this unfolding analysis. To anticipate, we're bullish on the stock, not-bearish on the currency.

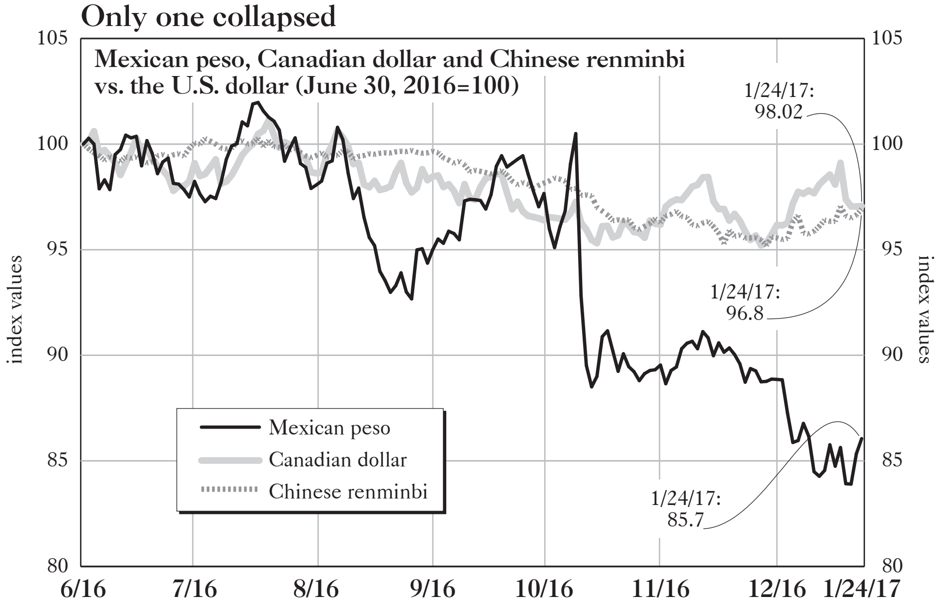
"Investors Bolt Mexico as Peso Enters Free Fall," a *Wall Street Journal* headline of Jan. 11, was our journalistic call to arms. According to the *Economist*'s Big Mac index of purchasing-power parity, the peso is undervalued vis-à-vis the dollar by 55.9%. Compare and contrast the Turkish lira, which, according to the same source, is undervalued by a mere 45.7%. Turkey, featured in a bullish vein in these pages two weeks ago, is objectively a place to bolt from, what with domestic terror attacks, a next-door civil war, the aftereffects of a failed coup, burdensome dollar debt and a president named Recep Tayyip Erdogan. Mexico is up against Donald Trump.

If, indeed, the 1994 North American Free Trade Agreement (NAFTA), which eliminated tariffs between the U.S., Canada and Mexico, is the "worst trade deal in history," as President Trump maintains (he is reported to be readying an announcement of intention to renegotiate it), the Mexican economy faces undoubted difficulties. It will not be lost on the Trump administration that merchandise exports from Mexico to the United States, expressed as a percentage of Mexican GDP, amounted to 9% in 1994 but 28% at last report.

A "border-adjusted tax" (BAT) is expected to be part of the new Trumpian order. To finance a reduction in the top U.S. corporate marginal tax rate to 20% from 35%, the administration would levy a 20% BAT on goods entering the United States. American exports would remain untaxed. Naturally, the BAT would advantage domestic production, disadvantage imports. (The policy could be sold as a U.S. variant on VAT, or value-added tax, which many of America's trading partners levy. In a VAT system, the taxes that exporters pay are typically rebated to them.) While Trump condemned the border-adjustment plan as "too complicated" on Jan. 16, on Monday, he vowed that "we are going to be imposing a very major border tax."

To a Mexican exporter, an overnight boost in American tariffs to 20% from zero would seem little short of devastating—unless it had effectively been priced into the exchange rate. "If tariffs are not exorbitantly high, they can be offset by currency devaluation," notes Frederico Meinberg, an investor in Brazil, in an email to colleague Evan Lorenz. "A 10% tariff has zero price effect if the dollar moves up by 10% or so against the peso." Since June 2016, with respect to the dollar, the peso has depreciated by 14%.

Only one collapsed



source: The Bloomberg

You don't see that kind of exchange-rate oscillation every day. You don't see it in China, despite black headlines about capital flight and bearish bets against the renminbi. Since June, the redback has registered a drop of only 3.2% against the greenback. Last week, an unnamed Chinese official complained that stiff U.S. tariffs could cut Chinese GDP growth in half. As China's exports of goods to the United States tally to just 4.1% of mainland GDP, this is a claim that might be filed under the newly minted heading of "alternative facts." Neither would the BAT be a boon for Canada, whose exports to the United States total 19% of Canadian GDP. Yet, since June, the fall of the Canadian dollar against its U.S. counterpart has registered a little less than 2%.

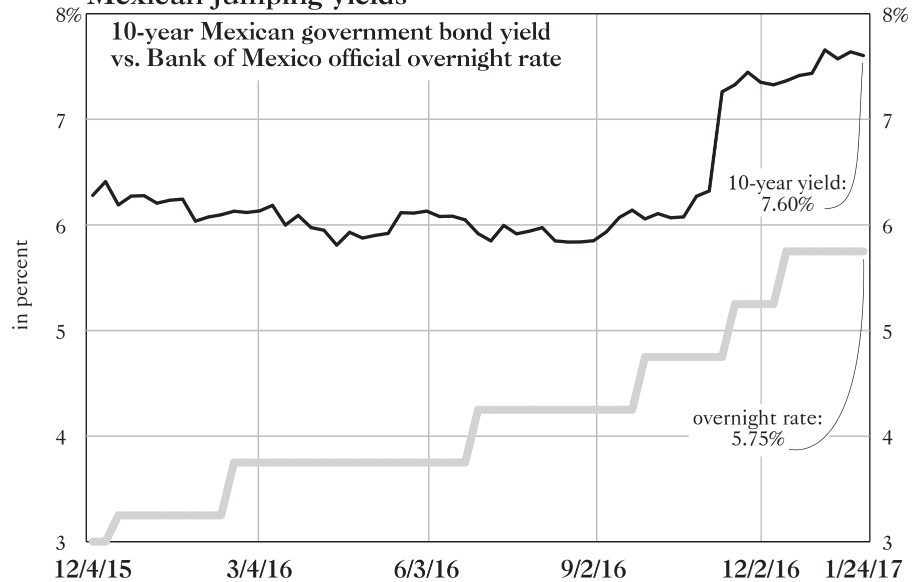
"If the GOP imposed a 20% border tax," Lorenz speculates, "the Mexican peso could be fairly priced. If not, low prices for goods and services expressed in pesos may just be the cure for the low peso exchange rate. Such prices beckon already, attests John Haskell, director of research at Explorador Capital Management, who is kicking the value tires in Mexico. In Mexico City, he says, a 40-minute ride in an Uber cab costs him $2.80 and a first-class dinner for one with wine and dessert sets him back just $40."

As might be imagined, the collapse in the peso has burdened many a Mexican household. The government's New Year's Day reduction in subsidies for gasoline and diesel fuel provoked hikes as great as 20%. "Gasolinazo," the newspapers blasted the policy—"fuel price slam." Consumer prices rose 4.8% year over year in the first two weeks of January, up from 3.2% for the full 12 months of 2016. What better economic backdrop for the emergence of Andrés Manuel López Obrador, a kind of Trump without the understatement, to follow the immensely unpopular President Enrique Peña Nieto in the July 2018 election.

In these circumstances, you might be surprised to learn that the Mexican Stock Exchange Mexican Bolsa IPC Index is trading at 23.2 times trailing earnings. It's cheaper than it was—as recently as March of last year, the IPC changed hands at more than 32 times earnings—but it's hardly value-laden. Measured year over year, the market is up by 18% in pesos and 0.3% in dollars.

Maybe investors prefer to focus on Mexico's many positives, which include a winning demographic position (lots of

Mexican jumping yields



source: The Bloomberg

young people plus a falling dependency ratio), relatively light leverage (a ratio of private-sector debt to GDP of 32.7% compared, for instance, with Russia's 56.4% and Brazil's 67.9%) and a central bank that's not averse to raising its policy interest rate to protect the currency (which protection constitutes the institution's principal mandate). Thus, the overnight policy rate of the Bank of Mexico stands at 5.75%, up from 3% at the end of 2015. Over the same span, the yield on the 10-year peso-pay Mexican government note bounded to 7.6% from 6.2%. As relatively unencumbered as they are, Mexican consumers suffer less from rising borrowing costs than do the more-leveraged American masses.

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Not until 2004 did Mexico pass a law enabling the creation of REITs, or FIBRAs (short for "Fideicomiso de Infraestructura y Bienes Raíces") as they are locally known. Like their American counterparts, Mexican REITs must pay out all but a pittance of their taxable net income (95% vs. 90% due north) and invest the bulk of their assets in real estate (70% vs. approximately 75% under American law).

Fibra Uno (FUNO11 on the Mexican Stock Exchange) is the largest REIT in Mexico and, in a March 2011 IPO, was the first REIT to sell shares to the public. As of Sept. 30, 2016, Fibra Uno managed 516 leased-up properties with a total gross leasable area of 7.3 million square meters (78.8 million square feet). The company has a pipeline of 795,600 square meters in gross leasable area under development. The portfolio is diversified geographically—situated in 30 of Mexico's 31 federal states and in Mexico City—and by property type. The rents are inflation-indexed. In the third quarter, Fibra Uno derived 27% of its revenue from industrial properties, 54% from retail space and 19% from office buildings. Wal-Mart de Mexico S.A.B. de C.V. tops the Fibra Uno tenant roll, contributing 7.5% of revenues, followed by Universidad ICEL (3.7%) and Grupo Financiero Santander Mexico S.A.B. de C.V. (2.7%).

The families Attié and El-Mann, leading Mexican investors, founded the company in 2010. It is substantially their company. Together they own around 30% of the shares outstanding and control the REIT's external advisor, Fibra Uno Administracion S.A. de C.V.

The simple presence of an external advisor introduces the possibility of a conflict of interest if, as in this case, the advisor earns fees when the REIT buys a building. Whether or not the marginal acquisition makes sense for the stockholders, it usually compensates the advisor. (The advisor earns an annual fee equivalent to 0.5% of Fibra Uno's net asset value as well as 3% of all non-related acquisitions payable in cash or shares.)

Temptation to self-dealing there may theoretically be, but there's no sign of the nefarious thing itself in the Fibra Uno financials. Thus, the REIT is conservatively leveraged, with debt weighing in at 34.3% of assets. Some 76% of debt is fixed-rate, net debt amounts to 5.6 times trailing EBITDA and operating income covers interest expenses by 2.4 times. There would be more coverage headroom except for management's decision to extend maturities. As of the third quarter, the average maturity of Fibra Uno's 62.5 billion pesos ($3.2 billion) of outstanding obligations was 11.9 years. The falling due of 5.2 billion pesos ($243 million) in 2019 constitutes the only significant near-term maturity. As to currency exposure: While 51% of borrowings are in U.S. dollars, Fibra Uno generates $1.90 of dollar-denominated rent for every dollar of debt service.

Fibra Uno's top management was investing in Mexican real estate long before the REIT came along. Hear, then, a voice of experience opine on the investment significance of Trump's election: "I do not foresee any permanent changes in the drivers of value of the Mexican real estate sector," André El-Mann Arazi, age 52, CEO of Fibra Uno's external advisor, said at a Nov. 10 investor day. "We have been successful doing real estate for almost four decades. We . . . were able to weather the storms of the 1980s and the 1990s, and we managed to grow during crises." It's no small claim: In dollar terms, Mexico's GDP collapsed by 49% between 1981 and 1986, by 32% between 1993 and 1995.

Fibra Uno says that two precepts guide its approach to real estate management. No. 1, and conventionally, location is the sine qua non of value creation. No. 2, and unconventionally, below-market rents protect against the vicissitudes of the cycle. Affordable rents assure full occupancy in good times. In bad times, they serve to anchor tenants who otherwise would be tempted to move into cheaper quarters.

It helps, these days, says Jorge Humberto Pigeón Solórzano, vice president of investor relations, that less than 32% of Fibra Uno's rents are denominated in dollars, a significantly smaller percentage than that of most large Mexican landlords. As a rule, Pigeón tells Lorenz, 10%–15% below-market rent is the company's pricing target. The break in the peso/dollar exchange rates has deepened the discount to 25% and more: "With the depreciation of the peso, we have become way cheaper."

"The strategy appears to be paying off," Lorenz observes. "In the first place, Fibra Uno's retail, industrial and office portfolios have occupancy rates of 93.8%, 96.3% and 90.6%, respectively, compared with overall market vacancy rates of 91.1%, 91.7% and 89.3% in those same segments. That's as things stood on Sept. 30. Leases are expiring this year and next. In 2017, the expirations represent 12.6% of existing rental revenues. In 2018, expirations represent 13.4% of current rental revenues. Then, too, as mentioned, there is a substantial development pipeline. I asked Pigeón about the demand for new space."

"We have a couple of shopping malls that we are developing," he replied. "People are giving us money ahead of knowing what the final design of the shopping mall is and knowing where their store will be located to make sure they are not left out of a shopping mall. This is unusual relative to history. Usually you start with about 35% of the shopping mall committed when you start the development. In one case we actually have a waiting list for the space."

It speaks to Fibra Uno's reputation and scale that its management can strike special deals with long-term investors. For instance, at year end, the company entered a joint venture with Helios, a consortium of five Mexican pension funds. The investors will contribute cash up to 3.8 billion pesos while Fibra Uno furnishes real estate worth 3.7 billion pesos. Fibra charges a 1.25% management fee for the life of the fund, a 3% development fee for the total cost of the project and takes 20% of any profits above a 10% hurdle. "The actual cost of the projects given the price we bought them at is about 4 billion pesos," Pigeón relates. "We are getting in fees about 4 billion pesos over [10 years]. That means we are investing with zero capital, and we will own a project that will be worth, probably, $1 billion, and we will own 60% of that." For perspective, the hypothetical 3.7 billion pesos would represent 2% of third-quarter assets.

"A lot of times," Pigeón goes on, "investors ask us if we have a contingency plan for the Trump effect. The answer is that we don't need a contingency plan, because we are built for this. We know that this is going to happen at some time, because this is a cyclical business. How do you protect yourself? Having affordable rents. Having good locations. Having prudent leverage." And, Pigeón adds, by having undrawn credit facilities with 7.1 billion pesos ($330 million) and $410 million of capacity. "It is completely unused precisely to take advantage of opportunities if they present themselves in times of crisis" (which time, incidentally, is not now; crumbling peso or no, the Mexican real estate market, like the Mexican stock market, offers few fire-sale prices.)

Meantime, Fibra Uno goes about its business most efficiently. In the third quarter, its management posted a 71% operating margin (operating income divided by sales), compared with an average of 54% for all other Mexican REITs.

Priced for the worst?

source: The Bloomberg

Since the peak of 47.89 pesos each on Nov. 7, 2014, Fibra's share price has dropped by 37%. In dollar terms, the stock is quoted 12% below the 2011 IPO price and only 12 cents above the all-time low carved out on Jan. 11; today's market cap is $4.6 billion. Daily average volume tops $9.4 million. Since the 2011 IPO, the company, in peso terms, has expanded trailing 12-month operating income by 2005% and assets by 1454%.

The shares are priced at 15.1 times trailing price to funds from operations per share to deliver a yield of 6.5%. With 12 buys, eight holds and one sell, the Street (we must admit) is more bullish than not. In a Nov. 10 report, a team of J.P.Morgan analysts estimated that Fibra Uno's net asset value was 37.36 pesos per share—at its current price, the stock is trading at a 19% discount to that NAV. Bloomberg records no insider activity.

"This is a company that easily has 50% upside in the long run in their underlying capital appreciation from these levels as cap rates compress," Haskell, who holds shares in Fibra Uno through Explorador, tells Lorenz. "You are harvesting that nearly 7% dividend and then add to that the fact that the currency is 22 pesos per dollar—nearly trading at Tequila crisis levels. In real terms, it is substantially undervalued. On a four- to five-year basis or whatever long-term basis should provide a tailwind, call it an extra 5% currency return for the next five years."

Grant's concurs.

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