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Mexican yield exports

In America, a 56 basis-point rise in the 10-year Treasury yield has deflated the prices of real-estate investment trusts by 7%. Lucky us. In Mexico, a 450 basis-point rise in the local equivalent of America's federal funds rate has produced a markdown in dollar-denominated REIT prices of 49%.

High yields where you might not expect to find them is the subject at hand. Skipping down to the bottom line, we reiterate our bullishness toward Fibra Uno (FUNO11), Mexico's first listed REIT, and likewise build a bullish case for Mexico's second-ever-listed REIT, Concentradora Fibra Hotelera Mexicana S.A. de C.V., a.k.a. Fibra Hotel (FIHO12; both on the Mexican Stock Exchange). The first yields 6.7%, the second, 10.5%—facts known only to the studious few, as Bloomberg substantially understates (because it miscalculates) those returns. With publication of Vol. 36, No. 9 of *Grant's Interest Rate Observer*, the secret is as good as out.

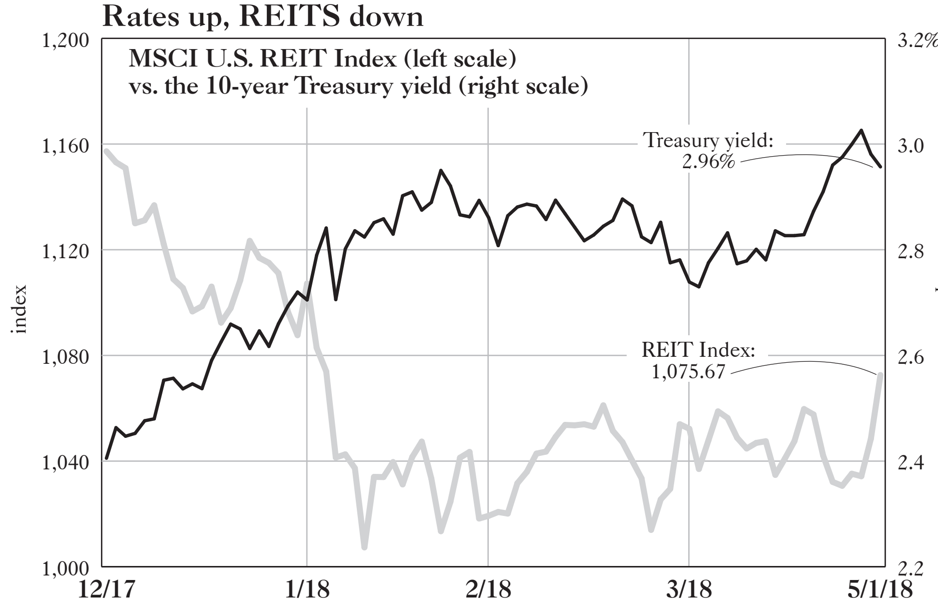
Mexico may not be the first country with which you associate the happy concept of "income on which to build a safe and carefree retirement." As detailed in these pages on March 23, Pemex, the state-owned oil company, seems poised to weigh on both the quality of Mexican sovereign credit and the level of the peso-dollar exchange rate. Then, too, the Bank of Mexico has been tightening monetary policy since December 2015. High interest rates may well be the appropriate corrective for Mexico's inflation problem, but the process of lifting them makes waves. So do Mexican politics—an especially contentious presidential election is slated for July 1—and so, for that matter, in its capacity as change agent for the Mexican economy, does the administration of Donald J. Trump.

The "worst trade deal in history," the North American Free Trade Agreement may be—the president of the United States himself says so—but it's been a boon for trade, especially, though hardly exclusively, for Mexico's. Since the 2016 U.S. presidential election, the S&P 500 has rallied by 24%. Over the same span, Mexico's main market is flat in peso terms, down by 4% in dollar terms. You wonder how it will all play out. Yes, President Trump could unilaterally pull America out of NAFTA and Mexico, the top importer of American corn, could retaliate with punitive tariffs on American grain. Maybe it won't come to that. The White House must realize that American farmers might retaliate in their turn. They vote, too.

If Mexican political polls are credible, the coming presidential election is virtually decided. It will be Andrés Manuel López Obrador—in a landslide. AMLO, as Mexico's leftist firebrand is known to his friends and foes alike, promises to rattle the establishment in ways not altogether clear and with consequences not entirely predictable (*Grant's*, April 6).

Not every contingency is bearish. "I think AMLO reduces the room for the political maneuvering of Trump and vice versa," John Haskell, director of research at Explorador Capital Management (and an owner, through Explorador, of both the aforementioned REITs), tells colleague Evan Lorenz. "They are two very strong-willed lead-

Rates up, REITS down



source: The Bloomberg

ers appealing to a populist segment of the population. The risk of an escalation in rhetoric and policy increases. What we have now . . . is the potential chance, not necessarily a foregone conclusion, that there is some sort of resolution or an announcement of a resolution soon. That would be likely driven by the desire to resolve trade and investment discussions prior to AMLO's taking power with the knowledge in the U.S. that it would be much less certain of an outcome or more complicated to negotiate with AMLO."

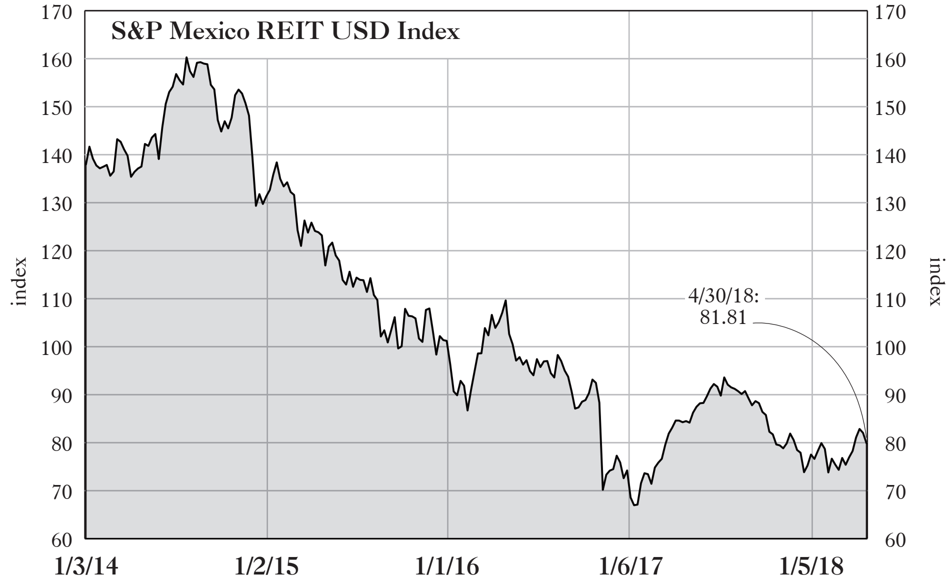
If the Republicans are counting on a successful NAFTA renegotiation to help them win the midterm elections, they'd better get hopping. By law, Congress requires an economic-impact statement on the probable effects of any trade settlement, and the lawmakers get (are required to have) 90 days before a scheduled vote in which to deliberate.

The risks of a bad outcome are clear enough. It takes a little imagination to map out the possible gains attending a trade settlement that (let us assume) thrills nobody. One might say that resolution is better than irresolution, and one may also speculate, or hope, that AMLO's bark is worse than his bite. It would be a blessing for the bulls, observes Sheila McGrath, the Evercore ISI analyst who covers REITs in the United States and Mexico, if the Mexican populist proved no more toxic for Mexican stock prices than the American populist has, to date, for American ones.

Nor is AMLO necessarily the single dispositive factor in the Mexican investment equation. Inflation and interest rates likewise play their part. The year-over-year change in CPI seems to have peaked in December 2017 at 6.85%, the final month of a year that featured a reduction in government fuel subsidies and, as a direct result of that policy shift, a surge in gasoline prices. Now consumer inflation is rising at a rate of less than 5%, and the Bank of Mexico is projecting a fall to 3% by the first quarter of 2019. It may be that the central bank's tightening cycle is over.

No investment paradise is Mexico, but many a rich nation would gladly trade its demographics and consumer-debt profile for their own. In addressing investors and analysts on an April 20 conference call, Luis Gutierrez, CEO of industrial-property manager Prologis Property Mexico S.A. de C.V., summed up the Mexican business opportunity in these few words:

Value restoration in Mexico



source: The Bloomberg

"a rising middle class combined with growth in higher-wage sectors continued to drive consumption."

To listen to Gutierrez, Mexico needs more warehouses. According to Chicago-headquartered real-estate brokerage firm JLL, Mexico needs more retail shops. And on the authority of CBRE Group, Inc. Mexico, the country needs more office space. Enter, here, the Mexican REITs.

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"South of the border," relates colleague Evan Lorenz, "REITs go by the acronym FIBRAs, short for Fideicomiso de Infraestructura y Bienes Raíces. Like their American cousins, FIBRAs must pay out most of their income (95% vs. 90% due north) and invest most of their assets in real estate (70% vs. 75%). As an asset class, FIBRAs are newcomers: The appropriately named Fibra Uno, the first such company to come public, debuted in March 2011."

The MSCI U.S. REIT Index is priced to yield 4.5% and no more, its year-to-date tumble notwithstanding. Compare and contrast that with the 6.7% on trailing distributions that Fibra Uno offers (*not* the 1.1% that Bloomberg erroneously thinks it offers).

Since we wrote last year, Fibra Uno has generated a total dollar-denominated return of 24.4%, including reinvested dividends, besting the S&P 500's 18.6% over the same period (*Grant's*, Jan. 27, 2017). With 8.3 million square meters of gross leasing area, the REIT is a little more than half the size of American mega-REIT Simon Properties Group, Inc. Unlike mall-focused Simon, Fibra Uno is broadly diversified across office, retail and industrial properties, with those segments contributing 24%, 51% and 26%, respectively, to first-quarter 2018 sales.

First-quarter gains in revenue and net operating income came in at 16% and 14%, respectively, said the first FIBRA, though there was no such proportional rise in earnings per share ("certificate" is how "share" is rendered in the Fibra world, but "share," a near synonym, has three fewer syllables). Net operating income per share actually declined by 6.5% in the first quarter owing to a 22% leap in shares outstanding. As REITs may not retain earnings to fund their growth, and as Fibra Uno is developing the equivalent of 12% of its existing portfolio, management issued the new stock.

"This year, however," Lorenz comments, "should be a turning point as properties with 594,023 square meters of area are slated to be completed between the second and fourth quarters. Based on the lease agreements, Fibra Uno estimates that the annualized revenues from these properties may reach 1.5 billion pesos ($80 million), an amount equal to 10% of 2017 total sales."

As for inflation, and such benefits as inflation-indexed rents may deliver to the landlord, wait till next year. In the first quarter, rental income did increase by 4.4% on a like-for-like, year-over-year basis. Welcome as that lift was, it was less than the aforementioned 6.85% jump in the December 2017 CPI. Because of the typical one-year lag between the rise in CPI and the echo of that rise in the tenants' rent bill, according to management, Fibra Uno will be reaping the inflation-related dividends in 2019.

Headstrong Mr. Market may be, but a stockholder-minded management may set the old gentleman a constructive example. Thus, in the first quarter, the Fibra Uno front office activated its first-ever stock repurchase program; through April 27, it had acquired 9.6 million shares, a drop in the bucket, to be sure—0.24% of the total outstanding—but it may help to send up a shareholder-friendly signal.

"Although we are consistently recycling assets above our own stated NAV [net asset value], there continues to be a divergence between the public and private markets, where the public markets continue to trade at a substantial discount to NAV [and] where the private market remains solid with tight cap rates," CEO André El-Mann Arazi said on the company's April 27 earnings call. "Our company's performance remains reflective of what is happening in the private markets. Therefore, we activated our share buyback program. You can expect Fibra Uno to continue to be active in this market to the extent that we find it the most effective way to use the recycled capital."

As of March 31, Fibra Uno's net debt of 62.3 billion pesos amounted to 5.3 times trailing earnings before interest, taxes, depreciation and amortization. It's a ratio that should improve as projects under construction begin generating lease income. Operating income covered net interest expense by 2.9 times in the first quarter; maturities average 11.9 years.

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"A double-digit yield, a lightly-leveraged balance sheet and trading at a discount to replacement cost—you might be excused for thinking that no stock left has one of those attributes, much less all three," Lorenz writes. "And, yet, there is Fibra Hotel—'Hotel,' we'll call it for short—the second FIBRA to come to the market with a Nov. 30, 2012 IPO—and, unfortunately for the mega-cap investors in the *Grant's* readership, a comparatively illiquid one."

Today, Hotel's portfolio consists of 12,723 rooms across 87 hotels in 26 of Mexico's 31 states. Hotel owns, rather than leases, 83 of those properties, which means investors should benefit from any appreciation in the value of the real estate. The company generates revenue by these methods:

- charging customers a daily room rate (71% of first-quarter revenues),
- selling food and beverages (16%),
- leasing buildings to other hotel operators (13%).

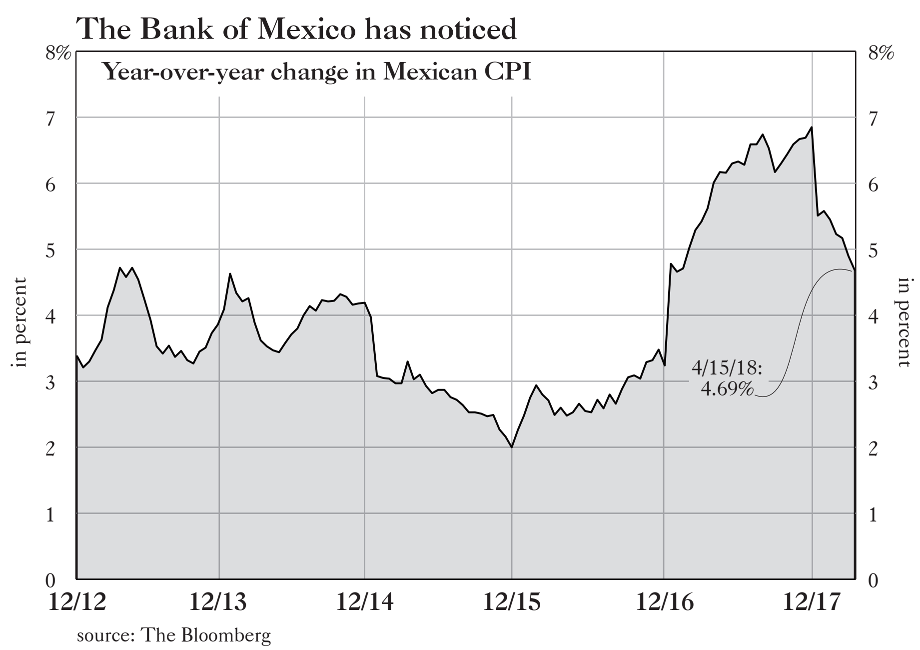
Limited-service or select-service hotels, which typically lack restaurants and conference rooms and target domestic business travelers, accounted for 73% of room revenues. Company-owned hotels include One Xalapa (limited stay), Fiesta Inn Buenavista (spartan service) and the Sheraton Ambassador in Monterrey (full service). One resort, the Fiesta Americana Condesa Cancun, generates 80% of corporate-lease income.

"Lodging is, of course, a more cyclical business than other classes of real estate," Lorenz observes. "Office tenants sign multi-year contracts, hotel customers leave every day. When economic activity falls, business travelers take fewer trips and households tighten their belts. That said, Fibra Hotel has two offsets. Hotel REITs tend to use less leverage than their non-travel-based peers. Green Street Advisors reminds us that American hotel REITs are less encumbered than the average American REIT—expressed as a ratio of debt to EBITDA, 3.3 times vs. 5.7 times. Based on analyst estimates for 2018 EBITDA, Fibra Hotel is leveraged 1.3 times."

The peso exchange rate has a kind of gyroscopic effect on Hotel's tourist business. "The Mexican peso, where it is today relative to where it was a few years ago, represents a substantial depreciation," Haskell observes. "The way I think about it is, the U.S. tourism industry will possibly suffer from less discretionary spending, but the Mexico story and its relative appeal to other warm, beachfront locations is still quite compelling. It's just cheap, and there is safety in cheapness."

Following Fibra Hotel's 2012 listing, a flurry of FIBRA IPOs followed. As money poured into the Mexican real-estate market, prospective returns on mature properties plummeted. "Fibra Hotel decided that given limited acquisition opportunities and the pricing for existing buildings to pursue new development," says McGrath, who rates Fibra Hotel a buy. "That is consistent with their wanting to have a high-quality portfolio.

"The negative is, when you do development of hotels, they take a while to ramp up," McGrath goes on. "You have a stabilization period. If you did a single-tenant industrial or office building, you get it preleased, you complete construction and you open it up. You are expensing the interest, but you are capturing the fact that you preleased the building. With hotels, you can't prelease. It takes a while to stabilize, but as soon as you get the certificate of occupancy you



have to start expensing [rather than capitalizing] the interest expenses. Because of the longer-term nature of the stabilization of hotel assets, that whole process was a drag on their near-term earnings growth, so the stock underperformed."

FIBRAs are a new asset class, and the Mexican market (unlike some markets an American could name) is skeptical of show-me stories. Perhaps for this reason, Hotel's shares have been especially hard-hit: From a peak in dollar terms in 2013, the shares have lost 71% of their value. The selloff accelerated following the Aug. 15, 2017 announcement of Hotel's acquisition of Fiesta Americana Condesa Cancun.

"This all-inclusive resort, ranked No. 14 out of the 180 hotels available in Cancun by TripAdvisor, Inc., is, by all accounts, a good asset," Lorenz relates. "A guest pays $125 per night for all the food, drink and entertainment that he or she can pack away. The property gives Fibra Hotel an important dollar-generating income stream, which may allow the option to issue dollar-denominated debt at a cheaper cost than peso-denominated loans; for these, Hotel has been paying around 8%.

"The market could hardly have objected to the price that Hotel paid—2.9 billion pesos, representing a 9.5% cap rate," Lorenz continues. "The problem lay rather with how the management financed it (and financed the development pipeline as well). Brute stock issuance was the method—327.7 million shares on Sept. 15, 2017 at 13.75 pesos per share. Unfortunately, Hotel would not receive income from the resort until the first quarter of 2018 and, as noted, development projects take time to get going. In consequence, dividends per share plummeted—measured year-over-year, by 37% and 6% in the third and fourth quarters of 2017, respectively. On Feb. 27, Hotel changed hands at 10 pesos per share."

Nothing is for sure in this risky world, but it's not impossible that that's as bad as things will get (at least, in the current cycle). In the first quarter, revenue and net operating income showed year-over-year growth of 33% and 62%. Despite a 66% upsurge in shares outstanding, the 0.295 peso-per-share dividend was 21% higher than the year-earlier payout. Furthermore, the distribution was covered by funds from operations.

True, the Cancun asset chipped in just 10% of total revenues in the first quarter, but it's on track to deliver a much higher percentage of earnings. Because Hotel outsources the management of the Cancun property, it also outsources the associated management costs. While the company-wide adjusted EBITDA margin averaged 26.2% in 2017, Cancun's adjusted EBITDA margin is projected to reach the treetops of 85%.

For what it might say about long-term prospects, four of the company's 87 hotels are still in development. Of the 83 hotels that currently generate income, Hotel classifies nine as being still in the formative, shakedown phase of their commercial lives. Their seasoning will fatten the bottom line.

Fibra Hotel trades at 11.63 pesos per share to yield 10.5% on projected 2018 distributions (Bloomberg thinks the figure is 1.3%). Under Mexican law, FIBRAs may repurchase 5% of their outstanding shares (and then, if they cancel those shares, another 5%; and so forth). Hotel's buyback program, begun at year-end, has so far netted 12.3 million shares, or 1.5% of the total. "We continue to view this as an attractive investment alternative as we can acquire the best hotel assets in the market for $0.60 on each dollar [of] historic cost," CEO Simón Galante Zaga said on the April 19 earnings call. (Shares have subsequently rallied, thereby narrowing Fibra Hotel's discount to historical cost to 38%.)

Fibra Uno, with a $6.5 billion market cap, is slightly less cheap but is the most liquid way to play Mexican real estate; its daily average totals $12.4 million. Fibra Hotel, with a $510 million market cap, averages just over a half-million dollars' worth of volume a day. Better if it were the other way around, but you can't have everything, even in Mexico.

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