The More It Drops, The More I Buy

Dec. 18, 2019 8:00 AM ET111 comments
by: Jussi Askola

Summary

- A lot of individual REITs have sold off materially over the past weeks.
- One common factor that is negatively impacting all these REITs is the recent rise in interest rates.
- We believe that fears are overblown and explain how you can profit.

The REIT market sold off by ~5% over the past weeks and many individual names dropped by significantly more than that. Interestingly, it is many of the so called “blue-chips” that dropped the most:

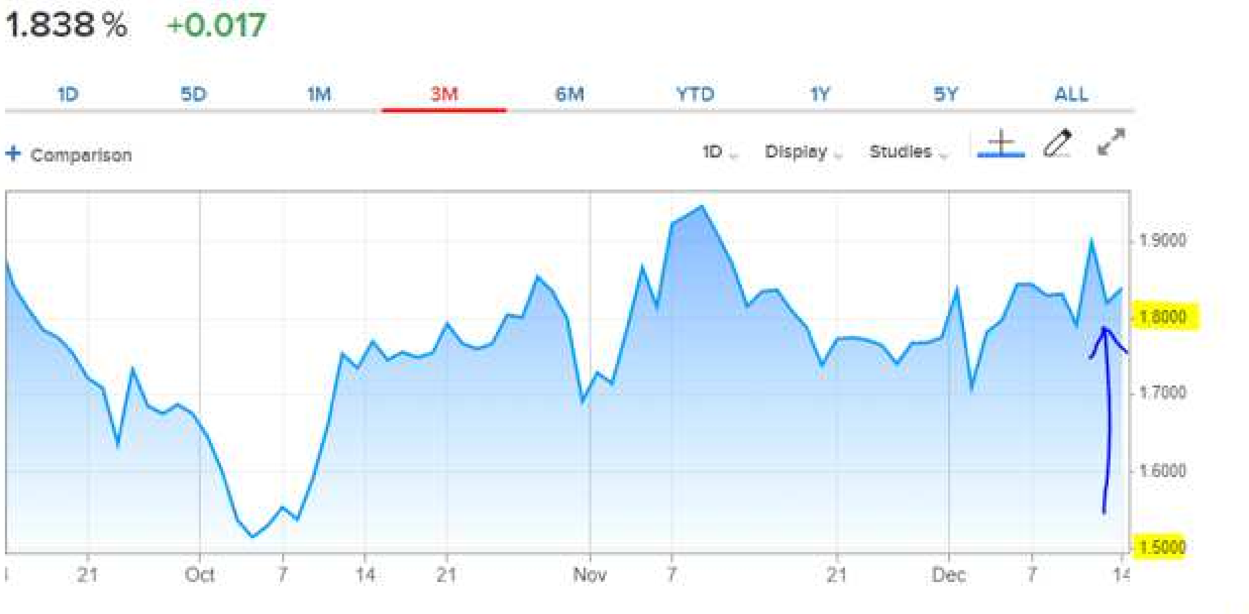
- Ventas (VTR) is down by 25%.
- Public Storage (PSA) is down by 21%.
- Digital Realty (DLR) is down by 20%.
- Realty income (O) is down by 15%.
- CyrusOne (CONE) is down by 30%.
- Welltower (WELL) is down by 20%.
- EPR Properties (EPR) is down by 17%.
- Omega Healthcare (OHI) is down by 10%.
- Innovative Industrial Properties (IIPR) is down by 40%.
- American Tower (AMT) is down by 15%.

And I could go on and on. These are all high-quality companies, and despite fairly resilient fundamentals in most cases, they have dropped quite significantly over the past weeks.

What is Happening?

There are many reasons for the sell off of individual REITs, but one common factor that is weighting on all of them is the recent rise in interest rates.

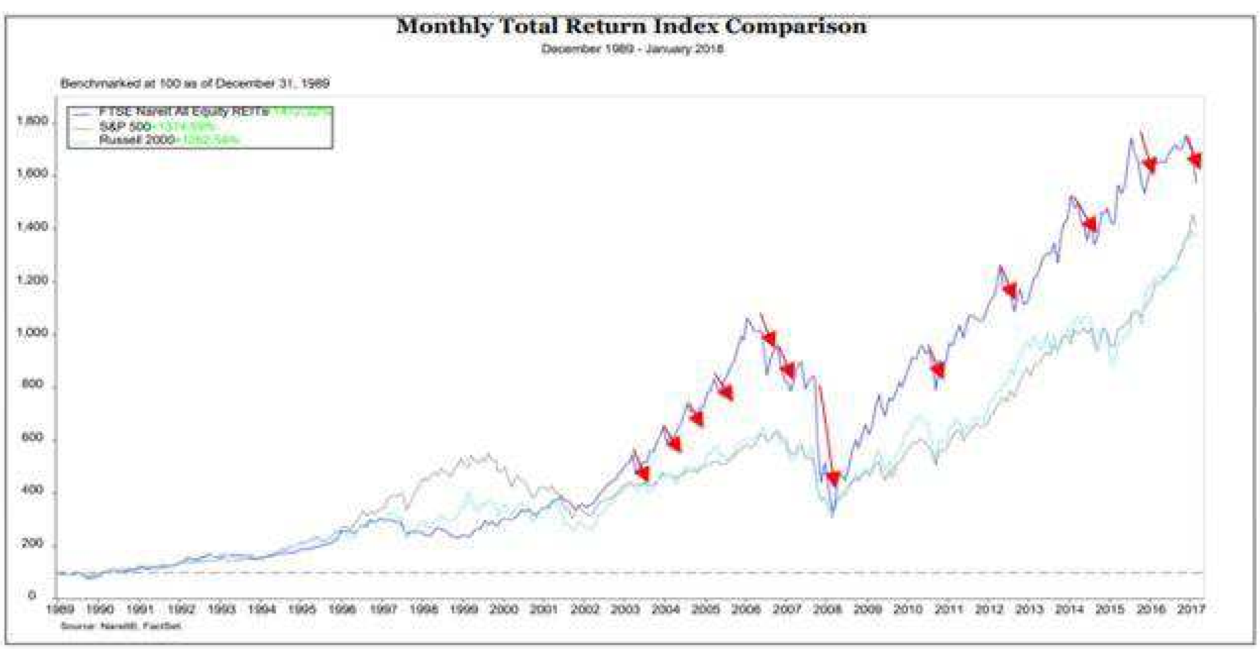
Over the past few weeks, the 10-year treasury has risen from 1.54% to 1.84% on hopes of an acceleration in economic growth and a resolution of the trade war.



REITs were hated for most of 2016, 2017 and 2018. Rising interest rates caused a lot of concerns to investors and REITs repeatedly sold off with each rate hike announcement. With the recent increase in rates, investors are seeing flash backs of the past years and selling off in anticipation of more pain ahead.

Is Now Time to Step in?

REITs have over their multi-decade history suffered hundreds of sell-offs varying in intensity and duration; but they have always eventually recovered to new highs and outperformed broader equity markets.



Source: NAREIT

We find that this is especially true when the sell-off was caused by interest rate fears. We have seen the same pattern occur over and over again and have repeatedly called it out on Seeking Alpha:

> **REITs sell off leading to interest rate hikes, and quickly recover their losses thereafter.**

Therefore, when REITs sell off due to interest rate fears, it has generally been a great time to load up of them. Most recently, we saw this happen in late 2018 when REITs dropped due to interest rate fears. We encouraged readers to buy the drop in December and it only took a few weeks for the market to recover all the losses and much more:

In today's day and age, most analysts are focused on the next quarter's earnings, the month-to-month performance of their portfolio and tiny changes to interest rates. With more information than ever before at our finger tips, we are often compelled to transact more than we should and tend to lose track of the bigger picture. It leads to what we like to call the trader mentality, which happens to be the opposite of the landlord mentality.

At High Yield Landlord, we have been loading up on select REIT opportunities after the recent drop. Below, we explain why these small changes in interest rates are irrelevant to most REITs.

REITs and Interest Rates: Why Fears are Overblown

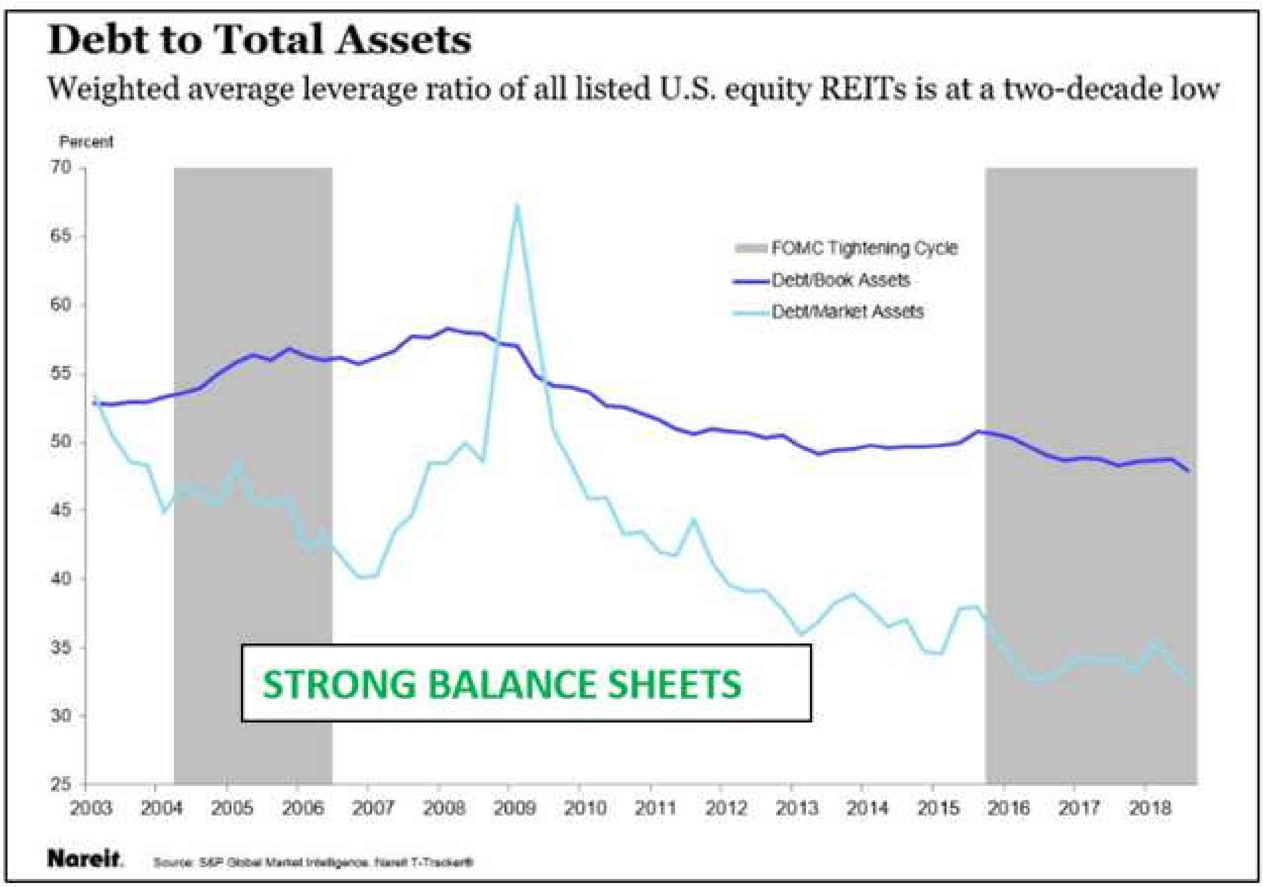
The common wisdom of the market is to avoid REITs in times of rising interest rates as it may result in higher borrowing cost and lower NAVs.

Yet, when you study **market history** and **current fundamentals**, we come to very different conclusions. Contrary to popular beliefs, we find plenty of evidence that REITs can perform very well during times of rising interest rates.

Since 1992, REITs generated positive total returns i n 87% of the periods of rising rates. Moreover, **in more than half of the cases, REITs also outperformed the S&P500 (SPY).** While it may surprise many of you, it really shouldn't.

Rising interest rate are generally the result of strong economic growth and inflation - which are both beneficial to REITs. It leads to higher rents, occupancy rates, and ultimately greater cash flow and property values for REITs. If economic growth re-accelerates in 2020, this is a positive to REITs. It is crazy to think that a strong economy (which leads to rising rents) would be a negative for real estate owners.

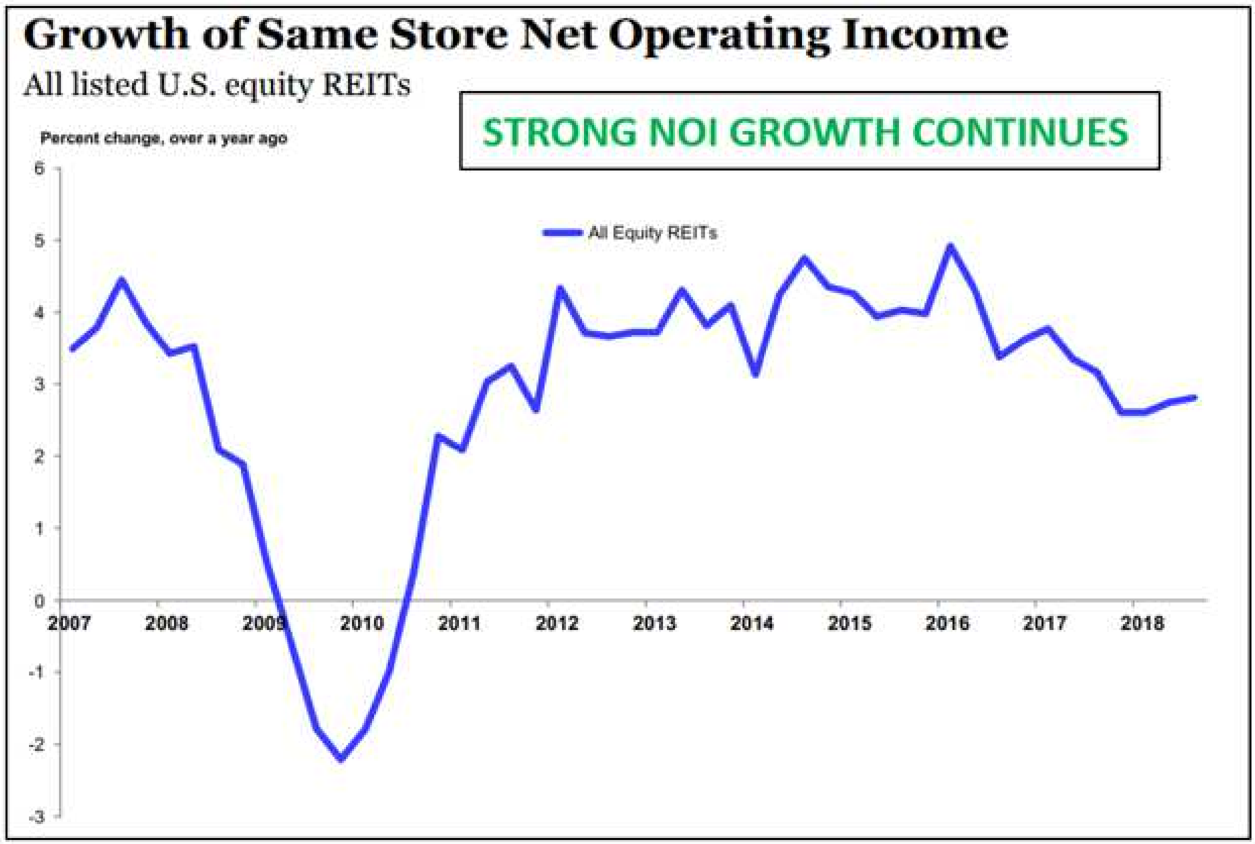
This is especially true today when you consider that REITs enjoy healthy fundamentals. Most importantly, leverage is at an all time low:



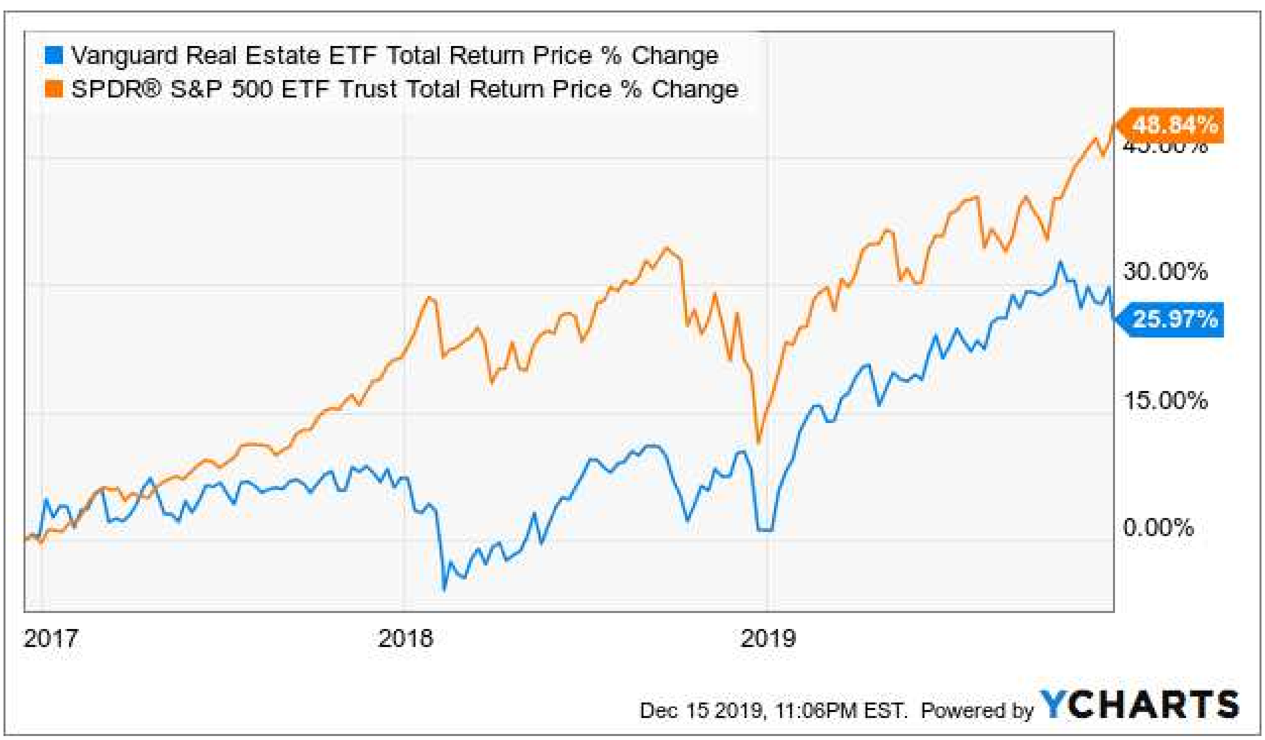
source

REITs have steadily fortified their balance sheets since the great financial crisis - leaving the industry in a financial position it has ever seen before. The average debt-to-assets is very reasonable at just ~35% and most of this debt is long-term fixed-rate. As such, the exposure to interest rate movements is minimal today.

Moreover, NOI is also growing at a very healthy pace for most property sectors:



Finally, REIT sector valuations remain very reasonable today. REITs are up significantly in 2019, but investors forget that REITs were hated for most the past 3 years. As a result, the total returns of the past three years were actually well below average:



REITs have now recovered by 25% in 2019 - but considering that they barely budged for 3 years prior to that – we believe that valuations remain quite reasonable.

/

- REITs trade at roughly 18x FFO – which is in-line with their historical average.
- Stocks trade at over 23x Earnings – which represents a 30% premium to their historical average.
- The 10-year Treasury is at 1.9% - the lowest in many years.

Moreover, undervalued opportunities remain abundant in the small-cap segment of the REIT market. This is because most of the index money has flown straight to the large caps and pushed their FFO multiples to new highs - while smaller caps were left behind at just 12x FFO.

The difference in small-cap vs. large-cap REIT valuations has rarely been this large… creating an opportunity for active REIT investors.

REIT Price/FFO By Market Cap		
Market Cap	**Mean Price/FFO (2019Y) End of February**	**Number of REITs**
Micro Cap	12.7X	13
Small Cap	12.4X	61
Mid Cap	16.3X	72
Large Cap	19.3X	25
REIT Average	15.1X	171

source

Therefore, we believe that most investors are **irrational to sell off REITs solely based on a tiny bump in interest rates.** We see it as an opportunity to increase positions in some of our favorite names discussed at High Yield Landlord.

Some of our top ideas at present that reflect our value approach to REIT investing include Brookfield Property REIT (BPR) and EPR Properties (EPR). Both of them pay higher income than REIT indexes (6-8% yield), grow at a faster or similar rate, and have greater FFO multiple expansion potential. It is by targeting this type of situations that we aim to outperform the large REIT ETFs such as VNQ ETF (VNQ).

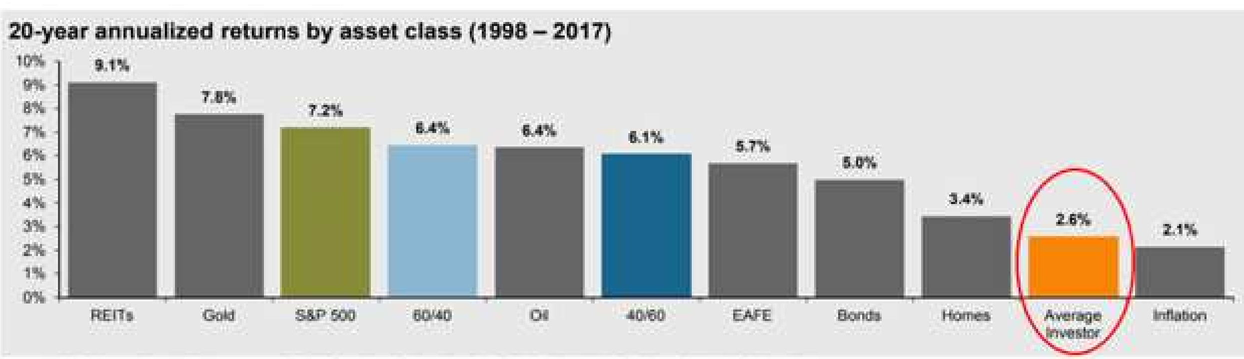
Our Core Portfolio currently has a 7.75% dividend yield with a comparable 69% payout ratio despite a yield that's almost double the index. Beyond the dividends, the core holdings are trading substantially below intrinsic value at just 9.5x FFO - providing both margin of safety and capital appreciation potential (REITs trade on average at over 18x FFO).

	High Yield Landlord	VNQ
Dividend Yield	7.75%	3.95%
Payout Ratio	69%	~70%
FFO Multiple	9.5x FFO	~18x FFO

Closing Notes: REITs Are Wonderful — if you know what you are doing...

In a recent survey, 97 percent of investors indicated that they intend to increase capital allocation to real estate in the next 18 months. When you consider what we presented in this article, this is not really surprising.

Nonetheless, it is important that you know what you are doing. Buying REITs just to sell off a few days later when interest rates move up is clearly a losing strategy. Note that because of such poor behavior, the average investor has earned only 2.6% annual returns over the past 20 years:



Source: J.P. Morgan Asset Management; (Top) Barclays, Bloomberg, FactSet, Standard & Poor's; (Bottom) Dalbar Inc.
Indexes used are as follows: REITS: NAREIT Equity REIT Index, EAFE: MSCI EAFE, Oil: WTI Index, Bonds: Bloomberg Barclays U.S. Aggregate Index, Homes: median sale price of existing single-family homes, Gold: USD/troy oz., Inflation: CPI. 60/40: A balanced portfolio with 60% invested in S&P 500 Index and 40% invested in high quality U.S. fixed income, represented by the Bloomberg Barclays U.S. Aggregate Index. The portfolio is rebalanced annually. Average asset allocation investor return is based on an analysis by Dalbar Inc., which utilizes the net of aggregate mutual fund sales, redemptions and exchanges each month as a measure of investor behavior. Returns are annualized (and total return where applicable) and represent the 20-year period ending 12/31/17 to match Dalbar's most recent analysis.
Guide to the Markets – U.S. Data are as of March 31, 2018.

J.P.Morgan Asset Management

In comparison, passive REIT indexes returned 12.5% per year and outperformed almost all other asset classes:

source

Then taking it one step further, active and more entrepreneurial REIT investors who target market inefficiencies have managed to reach up to +22% annual returns over the same time period:

source

This is what we aim to do by specializing in REIT investing. Our objective is to maximize performance by following an active approach to REIT investing with a special focus on value and high yielding opportunities.

Disclosure: I am/we are long EPR; BPR. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.