

Is Now the Time for Commercial Real Estate?



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Executive Summary

- Commercial real estate has historically been a low-volatility, low-correlation asset to add to a diversified portfolio.
- It has been a tumultuous few years for commercial real estate, with both volatility and correlation spiking up.
- There is an exceptionally large overhang of debt issued by investors in real estate as well as a lot of speculation regarding what will happen if and when borrowers cannot refinance.
- The public real estate companies may be in a position to benefit if there is substantial forced selling of real estate by overleveraged private owners.
- Allocation to real estate should be treated as opportunistic equity exposure. The risk is too high to treat it otherwise.

The Basics

A Real Estate Investment Trust (REIT) is a company formed for the purpose of investment in Real Estate. As with many companies, the primary method of investment in REITs is to buy stock. Thinking of REITs as just another sector of the broad market, Real Estate Investment Trusts are only a small slice of the larger stock universe. Less than 2% of the Russell 3000 is composed of REITs and less than 1% of the S&P 500.

However, there are two important reasons why these stocks deserve consideration as their own asset class. First, these companies typically generate income from tenant leases. This means that unlike the stocks of companies who must sell their products each day, REIT cash flows are typically much steadier and more predictable. The second reason is legal - the law requires that companies structured as REITs pay out at least 90% of their income to shareholders. Given these two differences, there is logic to treating them as a hybrid asset class, which should theoretically have some of the capital appreciation potential of stocks with the income component of bonds.

A potential third distinction to be made between real estate stocks and non-real estate stocks is the presence of the private market. Roughly 10% of commercial real estate is owned by publicly traded companies with the remainder being owned by private companies. Unlike the market for non-real estate companies, the primary asset of real estate companies is property. With a private market in which real estate can change hands regularly, there is a ready benchmark for how much a company's assets - and the company itself - are really worth.

The Past

Theoretically, the returns of Real Estate Investment Trusts should fall in between that of stocks and bonds. In actual practice, however, this occurs only in the very-long-term and even then, with occasional aberrations. [The graphs below use the S&P 500 Index as a measure of stock performance, the

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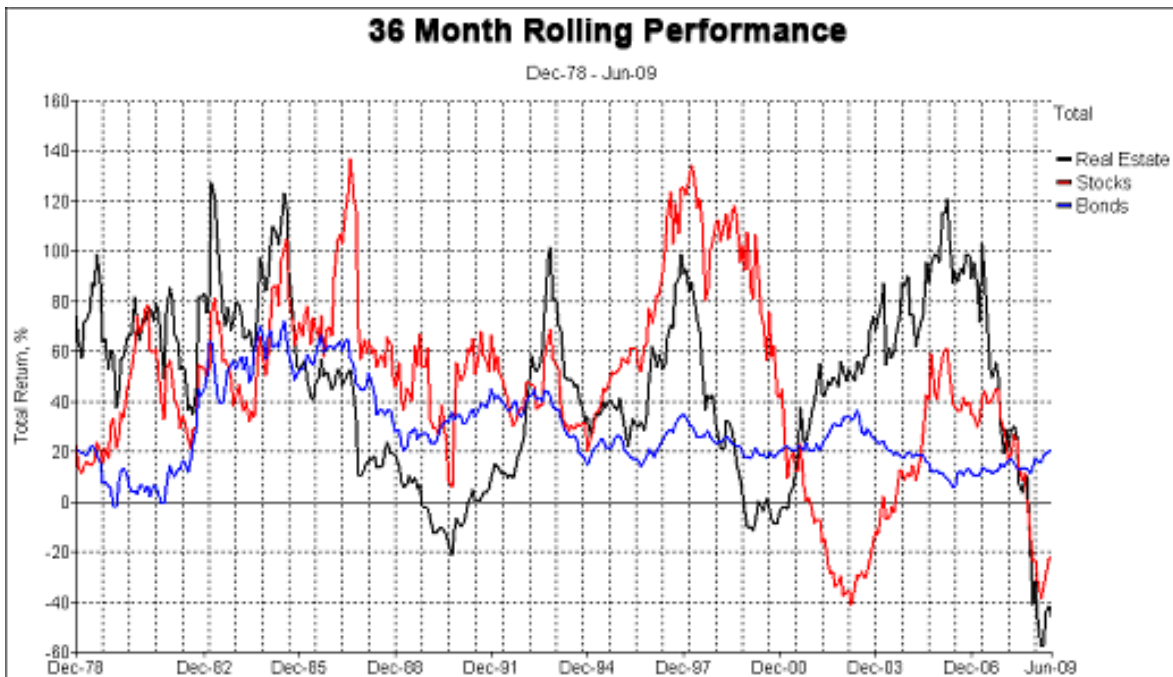
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NAREIT Composite index as a measure of REIT stocks and the Barclay's Capital Aggregate Bond Index as a measure of bond performance. Note that all three are domestic indices.]



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Over shorter time frames, REIT stocks rarely behave so nicely.

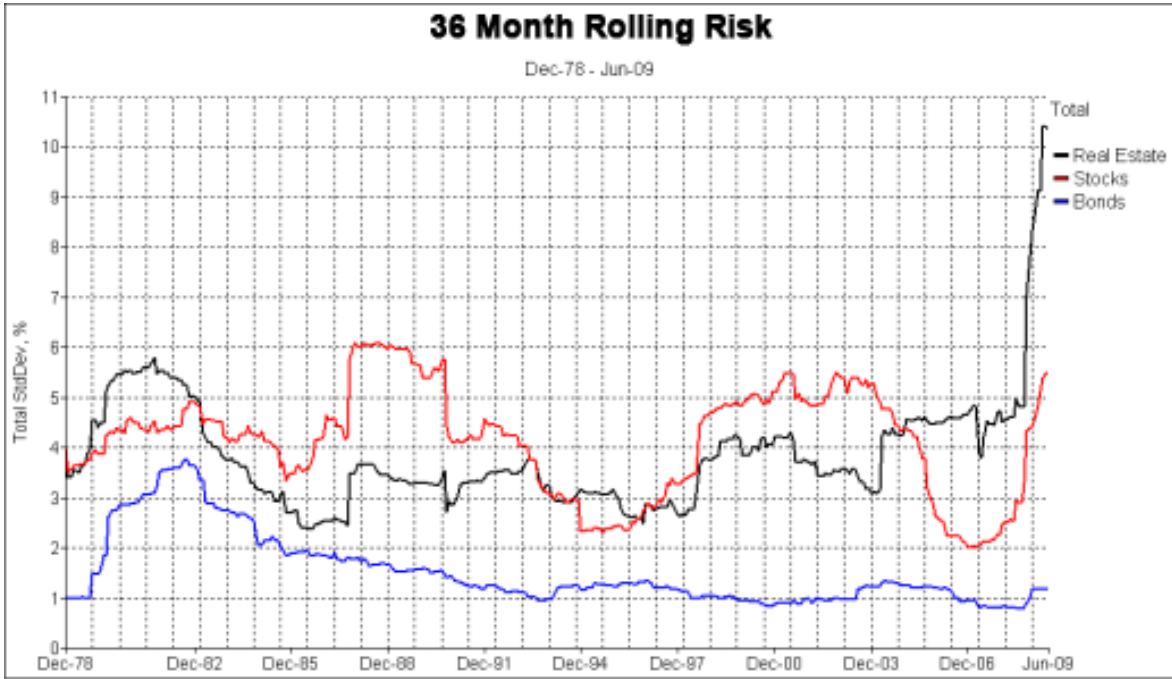


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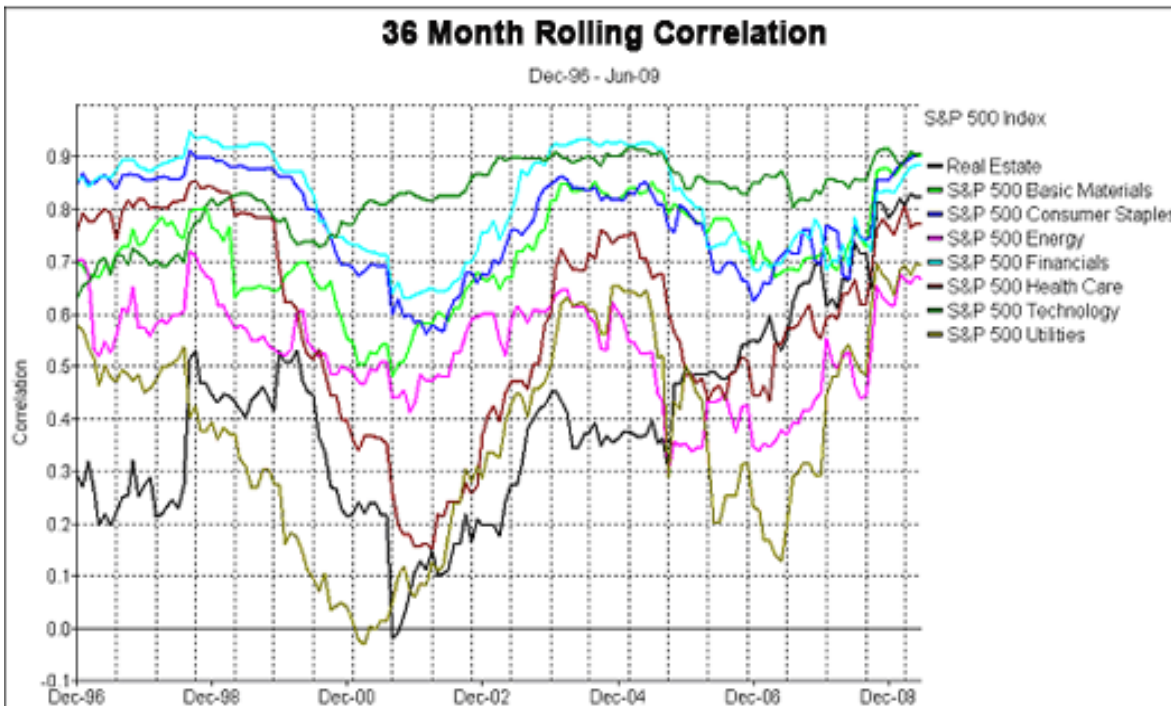
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Similarly, it seems fair to assume that the risk of these securities would be less than that of stocks but greater than that of bonds. While this has often been the case, the chart below shows that the volatility of REIT stocks can vary greatly and is currently at unprecedented levels.



In deciding whether or not REITs deserve to be treated as a separate asset class, another issue is whether or not their addition diversifies a portfolio. Historically, the case could be made that Real Estate was uncorrelated enough to the broader universe that it could be a diversifier. Right now, that argument is thin for any sector without predicting a return to normalcy – and this includes real estate.



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The Present

Given the historical statistics above, it just does not make sense to treat real estate as an uncorrelated conservative alternative to stocks. But they do still require special consideration in the broader space of stock investments and have unique attributes that must be taken into account.

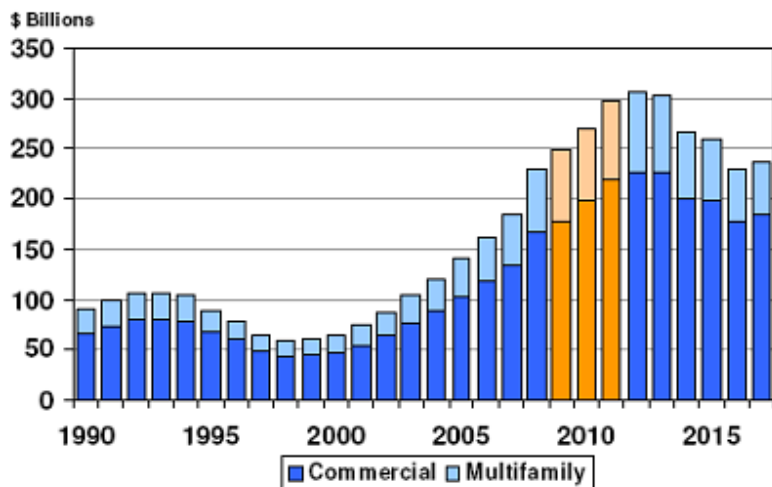
Commercial real estate by nature is linked to the broader economy. Bankrupt companies don't pay rent and struggling companies don't increase their demand for space. In this way, commercial real estate acts as a leveraged investment in the economy during times of stress. Incidentally, this is part of the explanation for why the correlation has risen between REITs and the broad market.

The credit-oriented nature of the crisis weighs heavily on commercial real estate. In recent years, the steady cash flows of these companies combined with easily available credit created an opportunity for companies like these to greatly enhance their returns. Rather than pay cash for a property paying a small percentage of the purchase price, a company could easily pay half and finance the rest at very low rates, nearly doubling their return. The strategy made perfect sense as long as the economy remained strong but with a clearly weaker economy, the players of this game may be in dire straits.

To illustrate the potential problems, the chart below (courtesy of Advisor Perspectives) shows the loans of these companies maturing by year. The average commercial real estate loan matures in 5-7 years, so we are just entering the peak period of loan maturity. The question of what will happen when these loans mature is significant and as yet unanswerable.

On average, vacancy rates are higher, lease income is lower, property values have fallen and credit is more expensive and difficult to obtain. Presumably, some portion of these loans will not be able to be refinanced. Assuming government intervention is nonexistent or not substantial enough to refinance all of these loans, the properties underlying these loans will have to be sold at discounts to recover some portion of the lenders' capital.

**Commercial and Multifamily Mortgage Maturities
Loans Maturing By Year**



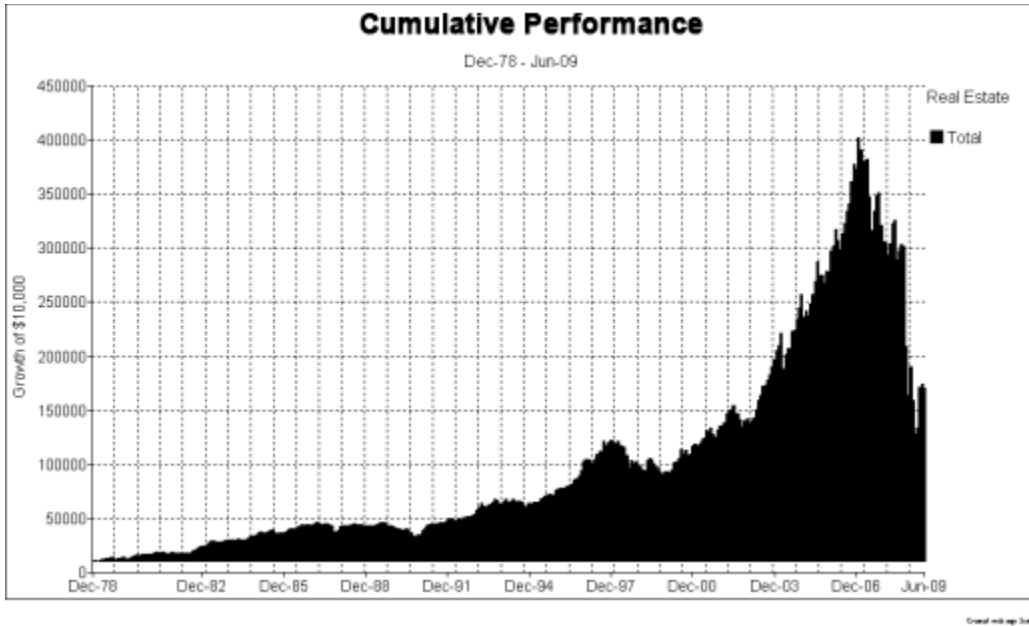
Most market participants seemed to understand that the highly-leveraged real estate strategy would be unsustainable when the economy slowed. As a result, as the current crisis developed, the market compensated, or perhaps overcompensated, for the issue. In the two years from February 2007 to February 2009, real estate stocks lost more than two-thirds of their value. There has since been a fairly strong recovery but certainly not enough to recover what was lost. Is this just the beginning of an amazing opportunity or simply a return to fundamental value? The answer is likely somewhere in between; the private market all but closed and is currently useless in providing guidance as to the real value of these companies.

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The Future

In short, the future is murky for REITs. In the near term, it is impossible to say whether they will be able to ride out the storm that is the mountain of debt maturities that are coming. For that matter, the possibility of another downturn in the economy creating an even larger storm cannot be entirely ruled out. The only thing that seems to be certain is that the volatility and correlations of commercial real estate rule them out as an income-producing hybrid asset.



One potential bright spot for investors is that most of the public companies did not borrow as heavily as their private counterparts. In addition, they have the option of raising new cash through the equity markets. The mid-year rally in real estate shares created a perfect opportunity for public companies to raise capital in the equity markets. Public companies raised almost \$16 Billion in the second quarter – more than double what was raised the prior year on larger initial capitalizations – which was primarily used to pay down debt. More heavily leveraged private companies did not have such an opportunity and will likely be doing the majority of the forced selling.

In the near term, this forced selling will likely lower all asset prices, as well as the value of both public and private companies. In the intermediate and longer terms, those companies with the strongest balance sheets and best access to cash and credit should be in the best position to profit by buying distressed properties. The public companies clearly have an edge in this regard.

On balance, real estate right now is clearly not the diversifier or reliable income-producer that it once was and should be treated as an opportunistic sector allocation. But even then, the potential short-term downside is large. For all but the most aggressive (and optimistic) investors, the most prudent answer is to avoid the sector altogether or invest in a diversified alternative fund that has an allocation to REITs.

-- Benjamin King - Senior Research Analyst