Can REITs Avoid the Rates?

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Property Investments

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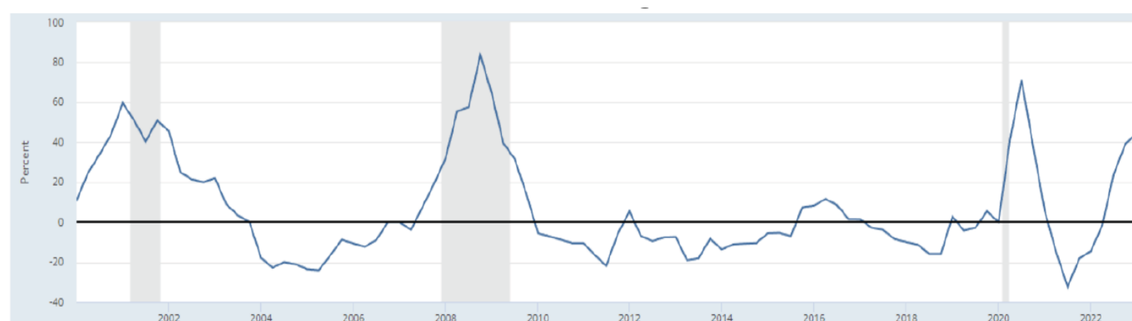
Last month the global real estate community was shaken when property mogul Sam Zell passed on at the age of 82. Sam was a pioneer of the global REIT industry and listed many US REITs, including Equity Residential, Equity Lifestyle, Equity Commonwealth REIT, and Equity Office Properties, of which the latter was ultimately sold to Blackstone in 2007 in a $39bn landmark deal at the top of the market. Mr. Zell was known for many things, including massive infrastructure investments, being direct in his language, and taking friends on long-distance motorcycle journeys across the world. However, he was also known as the 'grave dancer' – a guy who could dodge major economic downturns by selling assets just before the market crashed.

This brings us to our discussion regarding global commercial real estate (CRE) markets. In our first quarter Nimble Wisdom Quarterly_Q12023 report, we stated that "the collapse of Silicon Valley Bank and Credit Suisse (via acquisition by UBS) has made us more concerned about the heightened risk of a 'credit crunch' in CRE markets where lending standards must tighten across the board." Recent data released by the Federal Reserve confirmed this, showing that, for the second quarter of the year, 46% (net) of banks tightened lending standards to large and mid-market firms, up from -1.5% a year ago (Chart 01 below). This comes as many real estate borrowers face challenges making interest payments in a rising interest rate environment, while office use has declined and property values have decreased on recession concerns.

Chart 01

Net % of domestic banks tightening lending standard to large and mid-market firms



Source: Board of Governors of the Federal Reserve System (US), retrieved from St. Louis Fed

Small and mid-sized banks have a sizeable 67% share of all CRE lending, increasing the risk of widespread failures across the system. Anecdotally new lending for office portfolios has all but dried up, and lenders are highly circumspect when lending against retail and apartment buildings.

For those fortunate enough to refinance loans, all-in funding costs have risen sharply from c.2.8% to c.5.3% over the past 18 months. For property developers, if funding is available at all, rates are approaching 7% in the US and 5-6% in Europe and Australia. Higher funding costs have significant implications for CRE markets; property valuations fall as cap rates rise, and unless rents rise fast enough to compensate via higher yields, new development activity grinds to a halt.

We have already seen both implications play out over the last three quarters – Prime industrial property net operating income (NOI) yields in key developed markets have moved 155bps from 3.5% to just over 5.0%. We have seen portfolio values decline 14-18% among listed REITs over the last eight months and expect some more downside (3-8%) over the next two quarters. Outside of Germany, where transaction volumes have been extremely thin, residential property NOI yields have risen c.150bps from 4.0% to 5.5%, and we expect further cap rate expansion as rental growth slows and supply peaks in the third quarter of the year. Due to poor lending appetite from the banks, retail and office portfolios have not traded, and we may see a few more quarters of price discovery, with a wide spread between opportunistic bidders and 'soon to be desperate' sellers. However, certain sectors have seen only a mild valuation adjustment backed by strong market fundamentals. The rapid rise of Artificial Intelligence (AI) has driven strong demand for Datacentres, and a scarcity of new build and defensive demand dynamics has fuelled the Self-Storage sector, while high wage growth and low unemployment has been a major driver of the Single-Family Residential sector.

Ultimately, we believe the REIT sector remains well-positioned to weather the storm. The weighted average loan-to-value (LTV) ratio for global REITs is a relatively comfortable

33% and well below pre-2008 global financial crisis ratios of 46%. With further portfolio write-downs expected, we see LTVs approaching a manageable 38-40% over the next few quarters. In addition, with only 9% of debt expiring each year over the next two years, refinancing risk is not a major concern for us outside of the office and retail portfolios (18% of the REIT investment universe). Lastly, due to low vacancies of 5.3% and stable supply and demand dynamics in most property sub-sectors, NOI growth remains respectable at 6% for 2023, but due to limited acquisition activity and higher funding costs upon refinancing, this number should slow down to around 4% in 2024. We see a slowdown in demand, and valuations could come down further, but with an expected shallow recession on the horizon, there may be no need for 'grave dancers.'

To commemorate Sam Zell's massive contribution to the REIT sector, we leave a link to a 1982 article he wrote about distressed property markets, aptly titled The Grave Dancer.

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