The Global Real Estate Return Expectations Debate

At MitonOptimal, we subscribe to a dynamic strategic asset allocation process and debate the real/absolute return prospects for each investable asset class in our regulated universe. Each member of the team makes a contribution per asset class which is followed by a debate and a team decision. The results are used to run our optimization process for the ZAR/USD/GBP portfolios. Part of the process is to gather views from our underlying managers to complement our own process and debate. To illustrate our challenges, I will share some of my preparation for medium term (4-5 years) global listed real estate projections.

We approach the process by debating the fundamentals of each asset class within the business cycle, understanding the current yield and earnings projections and looking to the past for guidance on performance in all business cycles.

Firstly, we will look at the projections of STANLIB – a large South African Asset Manager. Their total return expectations are divided into a bull, bear and base case scenarios where they make assumptions on the US 10-year bond yield, the expected exit yield and expected earnings growth over 1 and 4 year periods.

Total return expectations – Global Property ($)

1 Year	Bull Case	Base Case	Bear Case
Total Return (Income and Capital)	**20.20%**	**13.46%**	**6.12%**
Assumption 1: US 10 Year Bond Yield (Current 2.71%)	2.50%	3.00%	3.50%
Assumption 2: Exit Yield (Current 4.44%)	4.04%	4.29%	4.60%
Assumption 3: Earnings Growth	5.00%	5.00%	5.00%

4 Years (Lower for Longer Interest Rates)	Bull Case	Base Case	Bear Case
Total Return (Income and Capital)	**8.88%**	**7.60%**	**6.40%**
Assumption 1: US 10 Year Bond Yield (Current 2.71%)	3.00%	3.50%	4.00%
Assumption 2: Exit Yield (Current 4.44%)	4.59%	4.84%	5.09%
Assumption 3: Average Earnings Growth	5.00%	5.00%	5.00%

Source: STANLIB, January 2019

At first sight, their base case scenario of 13.46% over a one-year period appears very bullish. However, when one considers a base 'date'- in this case, early January 2019 - it is fair to reason that after a poor 2018, where US REITs returned -4.55% and non-US REITs returned -6.7%, a 13% absolute return in the following 12 months is not inconceivable. When one considers the January 2019 performance, nearly 10%, it feels as if most of the returns for the year are in the bag! However, using 1 January 2018 as your base, one immediately realises that this was merely a recovery rally from a low base (US REITs up 5.8% and non-US REITs up 2.1% over 13 months) and that the 11-12 month projections remain realistic.

We also consider Marriott's, one of the oldest financial services businesses in South Africa, forward-looking expectations which are assumed to be a longer term absolute return expectation for the Global REIT Index, yielding between 4.5% and 6.5% p.a. This return is made up of a yield of 4.5% with an annual property rental growth of 1% to 2% over time. If a US Dollar Cash rate of 2% p.a. is assumed, this expectation would reflect a Cash plus return of between 2.5% and 4.5% p.a.

We also pay attention to long-term returns in bear and bull markets to remain in-check with reality. When using December 2007 as a base for longer term past performance, it is clear that US REITs experienced a long-term bull market post the credit crisis (Cash plus 5% p.a.), while non-US REITs simply recovered to their starting value pre-global credit crisis. This pattern is very much the same for US equities versus the European/UK and Emerging Market equities.

US REITs vs non-US REITs

An analysis on any asset class must address current fundamental risks and realities. Presently, one of our preferred global real estate managers is Catalyst. We have summarised the Catalyst fundamental outlook (not withstanding all the known risks such as higher US interest rates, global political instability, etc.) as follows:

- Global real estate operating fundamentals, although moderating, remain healthy overall. Positive GDP growth, low unemployment, wage growth, and moderate inflation all contribute towards a healthy economic backdrop.

- On the whole, supply of new real estate remains manageable relative to demand. However, there are certain sectors in specific geographies that face some excess supply over the next few years. The most notable cases of markets with significant supply are offices in New York and Singapore, and apartments in certain US Sun Belt markets. However, markets where excess supply is expected remain limited to a handful of instances. New supply has been curtailed in this cycle by increasing construction costs and tighter development financing underwriting standards.

- REITs generally own higher quality portfolios today compared to a decade ago.

- Balance sheets are, on average, a lot healthier today than they were towards the end of the previous cycle. For example, in the US, the REIT sector loan-to-value (LTV) ratio was approximately 40% ten years ago, whilst it is currently around 30%. Debt-to-EBITDA has come down from 7.5x to 5.5x over the past decade. Not only is leverage overall lower, but in terms of debt, it is longer, expirations are staggered over multiple years and a high proportion of debt cost is fixed for the long term. In addition, most REITs have diversified their sources of funding to include not only bank financing, but also access to capital markets, private placements, preference shares and securitized markets.

- Over the last year we have seen a pick-up in REIT privatizations as investors took advantage of the disconnect between pricing in the public (listed) and private markets.

- Finally, valuations of the global listed real estate sector currently seem fair. The current estimated Funds Available for Distribution (FAD) yield of 5.25% is attractive, especially when taking into account that the growth in this yield over the medium term is forecast to be well ahead of expected inflation.

Considering these views, my expectation for a medium term (4-5 years) US$ cash plus return for global real estate lies between 3.5% and 4% p.a. Let's see if the rest of the team agrees!

Roeloff Horne
Director and Head of Portfolio Management (SA)

www.mitonoptimal.com