

Can REITs Sustain Double-Digit Returns?

by Ralph Block

Any investment that has delivered average annual total returns of 10.7 percent, 11.5 percent, and 11.9 percent over the prior 10-, 20-, and 30-year periods¹ with modest risk and fairly low correlations with other equities and bonds is entitled to attention from investors and financial advisers. How have equity REITs been able to post such an outstanding track record? What are some risks investors need to be aware of, and what is the total return REIT investors can reasonably expect to earn over the next few years? This article will address those questions.

Stellar Returns Explained

We know that dividend yields have long been an important part of investors' total returns. REITs, of course, are dividend stocks for two reasons. By law, REITs must pay out at least 90 percent of their pre-tax net income to shareholders. And commercial real estate is a higher-yielding investment for which most of the returns are expected to come from current income. Therefore, much of REITs' total returns over the last three decades can be attributable to their relatively high current dividend yields; over the last 10 years, yields have averaged approximately 5.7 percent, according to NAREIT data.

REIT organizations have also been able to make their shares more valuable over time. REITs can no longer be regarded merely as passive owners of

real estate. Most are actively managed real estate businesses that acquire, manage, develop, and sell commercial real estate properties and have competitive advantages compared with passive real estate investors. Accordingly, REITs have usually been able to provide mid-single-digit growth in free cash flows

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and dividends. Also, as quality commercial real estate in a good location tends to grow in value over time—sometimes even at rates exceeding inflation—the per share net asset values of REITs have likewise grown.

Most of the strong long-term performance of REIT shares likely can be explained by a combination of above-average dividend income (let's say

5 percent) and growth in free cash flows and property values (perhaps another 3 percent to 4 percent). However, another significant contributor has been the increasing acceptance and popularity of REIT shares over the years, particularly since the modern REIT era began in 1992. The total equity market cap of all equity REITs rose from \$5.6 billion at the end of 1990 to more than \$400 billion at the end of April 2011, driven by greater institutional and individual investor interest in REIT stocks.² This was the result of stronger and deeper management teams, wider real estate sector choices, rising share liquidity, increasing desire for dividend income, and a great track record of performance with low correlations and modest risk.

Just like the commercial real estate that they own, REITs have for the past several years been valued at higher multiples of free cash flow than in most prior years, and that probably provided another 2 percent of total returns. REITs and commercial real estate have become increasingly accepted as desirable and attractive asset classes, but like large-cap stocks, they are more efficiently priced today.

Measuring Risk in a Different Way

Many financial advisers measure risk in terms of standard deviations and volatility. But what could cause future total returns for an individual REIT—or the entire REIT industry—to disappoint investors or even go negative for a few

years? One risk, which REIT investors saw up close and personal from 2007 to 2009, is economic recession, particularly if accompanied by credit contractions. Those recessions that merely reduce demand for space—whether for apartments, retail stores, office buildings, or industrial facilities—will cause cash flows to flatten or be slightly negative for a year or two. However, really serious economic contractions, particularly if accompanied by a collapse in the credit markets, can wreak havoc with REITs and their stock prices. Many REITs were required to recapitalize in 2009–2010, driven by plunging commercial real estate values and the risk that mortgage and bank loans might not be renewed.

Another, although more transitory, risk is REIT shares losing favor with investors at times. REITs are a unique blend of commercial real estate and equities, and we know that investment preferences can change quickly. Commercial real estate markets were doing reasonably well in the late 1990s, but the prospects of 8 percent to 10 percent returns paled in comparison with those offered by tech stocks, and investors dumped REIT shares. Although more popular now, REITs undoubtedly will go out of fashion again. Real estate and REITs are cyclical, but timing cycles is difficult.

One more risk for REIT investors is rising interest rates. Historically, real estate has been bought and financed with debt. Even though the vast majority of REITs finance their properties with long-term debt (and don't use it excessively), a rise in short-term or long-term interest rates can negatively affect the prices of commercial real estate, increase shareholder return expectations (depressing current prices), and even cause growth rates to slow. That said, the 10- and 20-year correlations of REIT stock prices with various bond indices have been modest, perhaps

because rising interest rates are usually accompanied by stronger economic conditions that boost property owners' cash flows.

Finally, REIT stocks' volatility has increased since the industry has become widely accepted, especially as REIT shares have recently become the occasional plaything of hedge funds and

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other short-term, performance-oriented investors and speculators. But REITs are now in the big leagues, and those who seek the benefits of REIT investing will have to endure the manic-depressive nature of today's equities markets.

Double-Digit Days Are Over?

Can investors reasonably expect to enjoy double-digit returns in REIT shares as they have over the past 10, 20, and 30 years? Probably not. REITs and commercial real estate no longer wallow in the sleepy backwaters of the investment world. Because REITs are priced more efficiently today, we cannot count on multiple expansion or a revaluation of commercial real estate asset values to boost returns. However, I believe REIT investors would not be irrational to expect 7 percent to 8 percent total returns, even in periods—like we are experiencing now—when inflation is modest and the U.S. economy plods along in new-normal mode.

The silver lining to the Great Recession is that commercial property development has abated and is likely to remain quite modest for some time. Lenders are more conservative today, and property development financing remains problematic. Therefore, even a modest economic recovery will enable most property owners to grow property-level operating income by 3 percent to 4 percent in each of the next few years, as occupancy rates firm and landlords slowly regain pricing power. Free cash flow and dividends can increase by at least 5 percent to 6 percent per year, at least through 2012. This, together with today's dividend yields of 3 percent to 4 percent, can produce total returns of 7 percent to 8 percent annually, even allowing for some earnings' multiple compression.

The REIT industry has matured. REIT stocks, now more than ever, are important choices for individual and institutional investors. Although we should, of course, understand the risks and cyclicity of commercial real estate and REIT shares, we should not ignore their total return potential, both on an absolute and risk-adjusted basis, and their ability to diversify investment portfolios.



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Endnotes

1. REIT data as of June 30, 2011, from NAREIT (National Association of Real Estate Investment Trusts), www.reit.com.
2. NAREIT's *REITWatch*, June 2011, <http://returns.reit.com/reitwatch/rw1106.pdf>.