Don't Alter Your REIT Portfolio (Yet) Out Of Recession Fears

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Summary

- REITs can (but don’t have to!) suffer in recessions.
- Valuation at the start of a recession is an important indicator of the expected performance of REITs during the recession.
- REITs are well prepared for an eventual downturn.
- We currently don’t expect a recession anytime soon.

According to research by State Street, real estate is one of the worst performing sectors during economic slowdowns and recessions. Is this always the case? What does the current valuation tell us about the expected performance of REITs should a recession happen overnight? Are REITs in better or worse shape than they were in the past? Is a recession really imminent? Stay tuned for an answer on all these questions and the implications for your REIT portfolio.

Past recession performance

As we said, research shows that real estate performed badly during past recessions.

Exhibit 1: A sector roadmap for business cycles
The State Street research goes back to 1961. Although Global Industry Classification Standard (GICS) sector classification has become widely recognized and tracked by market participants, its performance history is limited, going back to 1989 and covering only three recessions.

To get a comprehensive account of sector performance over multiple business cycles, State Street leveraged the performance data of the Kenneth French 48 SIC-based (Standard Industrial Classification) industry portfolios back to 1961 and mapped them to GICS sectors based on the latest GICS sector definitions. That way they created a longer sector performance history that covers seven recession and recovery periods, 12 expansions and 11 slowdowns.

**Exhibit 2: Recession performance**
Exhibit 3 shows aggregated Z-scores for the different sectors during recessions, recoveries, expansions and slowdowns.

Exhibit 3: Sector Z-scores for business cycles

During recessions, some businesses perform much worse than others because demand for their products and services is primarily driven by the health of the economy. Unfortunately, many economy-sensitive businesses happen to be major tenants for certain REITs.

In addition to the drop in many REITs’ stock prices, dividends also can prove to be quite vulnerable during a recession. From May 2008 through March 2009, approximately 30% of all REITs suspended, cut, or switched to paying part of their dividend in company stock.

REITs’ relatively high payout ratios and dependence on raising equity and debt to fund their business needs got them into trouble during the credit crisis when affordable capital was hard to come by.

It’s more than a decade ago we had a recession and recently the yield curve inverted which is often seen as a sign of a fast approaching recession. Should we rush to sell all our REIT holdings or does the story not end here?

Not all recessions are alike

Many consider 1991 to be the year in which the current Modern REIT Era got its start. In the Modern REIT Era, the REIT industry has been transformed from a relatively small group of companies heavily represented by mortgage REITs into a much larger marketplace consisting primarily of publicly traded equity REITs, with mortgage REITs and public, non-listed REITs making up a smaller part of the market. The catalyst that triggered the dramatic change in the industry was the credit crisis that grew out of the commercial real estate market collapse of the late 1980s. The collapse destroyed the savings and loan industry and also shut down commercial real estate lending by banks and insurance companies. With no credit available through their normal lending channels, privately held
property companies took a huge step in a new direction to get the capital they needed: they went public. Because investors were still suspicious of the commercial real estate market, the new public companies chose, in increasing numbers, to become REITs.

While 1991 is a logical point to mark the start of the Modern REIT Era, there is an equally good argument to be made for 1993 as the beginning of the new era of REITs. The UPREIT model set the stage for the transformative year of 1993, when the REIT IPO trickle turned into a flood. The IPO of Kimco Realty Corporation (KIM) and two others in 1991 showed the way, establishing the claim for 1991 as the new industry’s inaugural year. Those IPOs were followed in 1992 by six more, including Taubman Centers (TCO) – the first UPREIT.

The UPREIT model was critically important, because it set the stage for the transformative year of 1993, when the REIT IPO trickle turned into a flood. The three IPOs of 1991 and six IPOs of 1992 were followed by 45 in 1993; 43 in 1994; and another 59 through the remainder of the decade. The listed REIT industry’s equity market capitalization grew from $16 billion at the end of 1992 to $125 billion at the close of 1999. The period of exceptional growth that began in 1993 ultimately provided the REIT industry with the scale that made it possible for all types of investors – from individuals to institutions – to invest in REITs. That pivotal year helped set the stage for REITs to move from a niche investment to a mainstream one.

Whatever the start date, there have only been two recessions during the Modern REIT Era: the dotcom bubble and the Great Financial Crisis.

In those periods the S&P 500 lost from peak to trough respectively 49% and 57%. Given the observation that real estate is one of the worst performing sectors during recessions one could expect real estate to do even worse than the S&P 500. This was exactly the case during the Great Financial Crisis: the FTSE NAREIT All Equity REITs Index lost 63% in the period the S&P 500 lost 57%.

But the picture was totally different in the recession following the dotcom bubble: while the S&P 500 lost 49% real estate rose by 45% in the same time period!

The main reason for the difference in performance of REITs during those two recessions is valuation.

When REIT dividend yields are large relative to bond yields, that’s typically a signal that REITs have become undervalued and are likely to outperform in the future.
Baa-rated bond yields have typically been about 125 basis points higher than equity REIT dividend yields, and the spread between them has usually been between 80 and 180 basis points.

Deviations from the historically normal 80-180 basis point spread between REIT dividend yields and Baa-rated corporate bond yields have generally provided a surprisingly reliable valuation signal and a surprisingly reliable predictor for future performance. The reason is simple: given the extremely steady pace of REIT dividend distributions, major changes in the yield spread arise primarily because REIT stock prices have been driven too high or too low relative to their future performance expectations.

Prior to the dotcom bubble REIT dividend yields even surpassed the yield on Baa corporate bonds! On the other hand did the housing bubble drive the valuation of REITs to an all-time high just before the Great Financial Crisis.

**Exhibit 4: REIT valuation**

![REITs vs Baa corp bonds](image)

Currently, the Baa-rated corporate bond yield is 4.67%, meaning that the REIT-Baa spread is rather small at just 95 basis points. REITs are cheaper than the average valuation during the modern REIT era.

Cohen & Steers also investigated the performance of REITs during the Modern REIT Era. U.S. REITs have outperformed the S&P 500 by more than 7% annually in late-cycle periods since 1991 and have offered meaningful downside protection in recessions,
underscoring the potential value of defensive, lease-based revenues and high dividend yields in an environment of heightened uncertainty.

**Exhibit 5: REITs and recessions**

![Graph showing REITs performance during recessions](image-url)


REITs tend to have predictable, lease-based revenues. In tough times, you can always put off upgrading your smartphone or buying a new car. But if you’re an office tenant with a 10-year lease, you’re contractually obligated to pay your landlord regardless of economic conditions. As a result, REITs have historically generated more consistent earnings growth than most sectors in the stock market.

**Exhibit 6: Stable earnings growth**
It’s of course important to note that this can vary significantly depending on the property type. For example, hotels are highly cyclical due to their one-day leases and reliance on business and leisure spending. By contrast, cell tower leases are typically structured as 25–30 year leases, with 10-year non-cancellable terms and 5-year rolling opt-outs, providing stable, long-term cash flows. Furthermore, demand for tower space has little to do with the business cycle, driven instead by the ongoing expansion of wireless networks to satisfy customers’ increasing data usage.

Another difference between the two most recent recessions is the impact on dividends. During the first recession dividend growth slowed but didn’t become negative as was the case during the Great Financial Crisis.

Exhibit 7: REIT dividend growth and recessions

REITs are well prepared for a downturn

REIT balance sheets are stronger than they have ever been as most companies have spent the past decade reducing leverage and extending maturity durations.

**Exhibit 8: Reduced leverage**

**Shareholders’ Equity to Total Assets**
All listed U.S. equity REITs

![Shareholders Equity to Total Assets Chart]

Source: S&P Global Market Intelligence, Nareit T-Tracker

**Exhibit 9: Extended maturity durations**
Weighted Average Term to Maturity
All listed U.S. equity REITs

Is a recession imminent?

When we look at James Picerno’s Recession Probability Estimate, we can only conclude that a recession is not around the corner.

Exhibit 10: Recession Probability Estimate
And what about the inverted yield curve?

Economist Campbell Harvey is credited with discovering the predictive power of yield curve inversions in his 1986 PhD dissertation. He found that an inverted yield curve was bad news for the economy, foreshadowing a recession.

He looked at two parts of the yield curve, the 5-year note minus the 3-month bill, and the 10-year bond minus the 3-month bill. The crucial thing is to use a very short-term interest rate.

So when the 10-year bond minus the 2 year note inverts this is of no importance.

Campbell Harvey stressed in a recent interview that the inversion importantly needs to last for a quarter. If it's a day, so what? GDP is measured quarterly, so we need to measure this quarterly also.

So currently there has not yet been a yield curve inversion so we can only conclude again that a recession is not around the corner.

This means there is no need for REIT shareholders to rush to sell all their REIT holdings at once out of fear for a recession.
This also means there is no need yet for REIT shareholders to tilt their portfolio away from recession sensitive REIT sectors like lodging and shopping centers.

We advise to remain well diversified across REIT sectors by buying (or continuing to hold) diversified ETFs like the iShares U.S. Real Estate ETF (IYR) or the Vanguard Real Estate ETF (VNQ). Those ETF are of course tilted towards the bigger names while there is value to be found in nice smaller REITs like Urstadt Biddle Properties (UBA) or EPR Properties (EPR) to name a few.

**Conclusion**

REITs can (but don’t have to!) suffer in recessions. Current valuations should provide a margin of safety. This margin was totally absent at the start of the Great Financial Crisis.

REITs are well prepared for a downturn as most REITs have spent the past decade reducing leverage and extending maturity durations.

We currently don’t expect a recession anytime soon and think it is a bad idea for REIT shareholders to rush to sell all their REIT holdings at once or to tilt their portfolio away from recession sensitive REIT sectors.

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**Lbermudez**
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