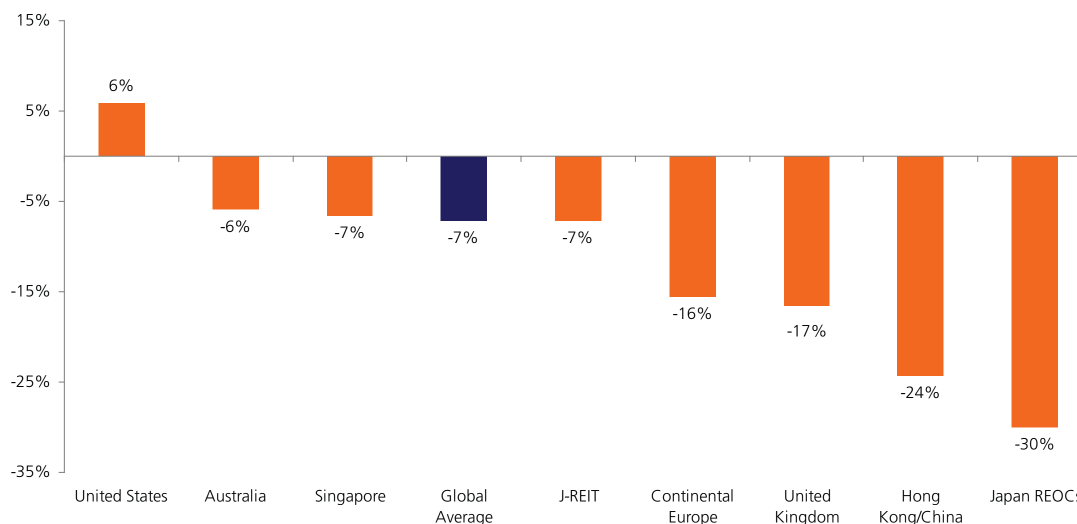
REIT Premiums to NAV – Cause for Concern?

Introduction

Investors have become increasingly optimistic on the prospect for global real estate securities since values troughed in March 2009. With the rebound in listed real estate prices, listed market valuations in the U.S. have moved to a premium to underlying NAV (Exhibit 1).[1] While globally listed real estate values were at a modest discount as of end April, should investors be concerned when listed real estate trades at a premium to underlying NAV, or should premium valuations be interpreted as signs of optimism for the future outlook of commercial real estate? We consider the example of the U.S. in this paper since it represents the single largest market in a global listed real estate portfolio and was valued at a modest premium to NAV as of end May 2010.[2]

Exhibit 1: NAV Premium/Discount by Region*



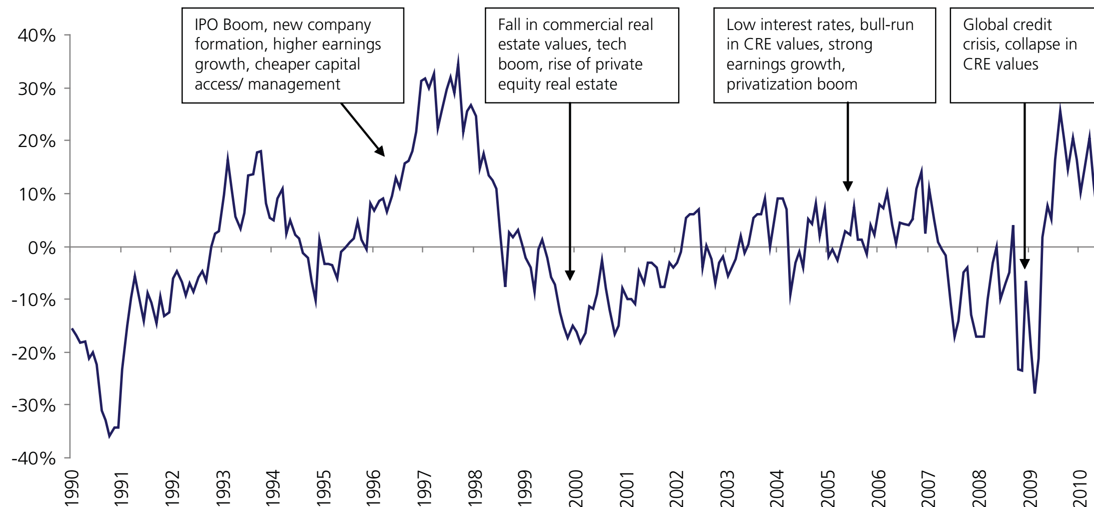
**Information is the opinion of ING CRES as of 05/31/2010, which is subject to change and is not intended to be a forecast of future events, a guarantee of future results, or investment advice. Forecasts and any factors discussed are not necessarily indicative of future investment performance.*

A Brief History of U.S. REIT Cycles

History shows that U.S. REITs have fluctuated between periods of premium and discount to private market values. Since the emergence of the modern REIT era in the 1990s, REIT valuations have been through several distinct cyclical phases where valuations rose and fell and were subsequently reflected in discounts or premiums to NAV (Exhibit 2). Structurally, there are significant reasons why REITs should be valued at premiums to NAV over time - liquidity, access to more capital sources, transparency and strong management teams are good reasons why investors would opt to pay premium valuation for this form of real estate ownership. In reality, cyclical factors such as the capital markets, investor sentiment, the state of the economy and the direction of real estate fundamentals have influenced REIT pricing relative to underlying private real estate values.

The early 1990s saw the birth of the modern REIT from the ashes of the collapse of commercial real estate values. An economic recession led property fundamentals to weaken and high debt levels quickly eroded real estate values (wherein debt levels overwhelmed residual equity). The impact was severe on financial institutions, as well as commercial real estate, forcing government intervention in the form of the Resolution Trust Corporation (RTC) that aimed to wind down distressed real estate assets in an orderly manner. The 1990s saw REITs play a significant role in recapitalizing commercial real estate. REITs were able to attract significant capital to their clean balance sheets and attractive capital structure, and accordingly investors began to price them for accretive acquisitions in a capital constrained environment. As the economy recovered and earnings grew, REITs consistently stayed at premium valuations to NAV through the mid-1990s, reflecting the cost of capital advantage of the public companies (Exhibit 2).

Exhibit 2: U.S. NAV Premiums and Discounts, 1991-2010



Source: Green Street Advisors, ING CRES through 5/31/2010. NAV premium/discount is not necessarily indicative of future performance.

The REIT valuation up-cycle of the mid-1990s ended in the late 1990s as investors moved their focus towards the fast growing technology and Internet sectors in their search for growth. The decline in REIT pricing also presaged the recession of 2001 and the subsequent decline in commercial real estate values. REITs also lost their premium valuation as the advantage they enjoyed in preferred access to capital ended. Private real estate buyers began to access cheaper equity and debt in scale and REITs were no longer able to rely on the accretive acquisition spree from the RTC. As a result, over the next few years, REITs were valued at discount to underlying NAV.

Since valuations are cyclical, investors may interpret a move to premium valuation as a signal to underweight or take profit from REITs, arguing that NAV premiums preclude a decline in performance. Our analysis over three periods when U.S. REITs remained at double-digit premium valuations suggests that performance was not only positive in the 12 months following but was superior to that of broad equities (S&P 500 Index) as well as private real estate NCREIF Property Index (NPI). To test our hypothesis, we isolated the periods when REITs were trading consistently in double-digit premiums and calculated total return performance for the following 12 months. The results can be seen in Exhibit 3. U.S. REITs generally outperformed both the S&P 500 and the NCREIF Property Index across all three periods, with the exception of June 1996 to May 1998 when broad equities outperformed. The data suggest that double-digit NAV premiums for REITs have not been a signal for underperformance and, to the contrary, been followed by robust total return performance.

Exhibit 3: REIT NAV Premium Valuation and Relative Performance

	12 Month Coincident Performance		
NAV Premium Period	**NAREIT**	**S&P 500 Index**	**NCREIF Property Index**
January 1993 - March 1994	15.7%	12.9%	5.0%
June 1996 - May 1998	37.0%	52.1%	10.8%
July 2003 - November 2004	21.0%	13.2%	17.7%

Source: ING Clarion Real Estate Securities, as of 5/31/2010.

The U.S. commercial real estate cycle entered one of its greatest bull markets following the unprecedented loosening of monetary policy in the wake of September 11, 2001. Interest rate sensitive assets, such as real estate, began to price into their growth forecasts the unprecedented lowering in borrowing costs. With their transparency and attractive capital structure, REITs benefited. Additionally, the lower cost of capital led to a spate of go-private transactions led by private sponsors that underpinned higher valuations for REITs – there were 44 privatization transactions between 2004 and 2007. During this period, REITs enjoyed premium valuations as investors bet on continued merger activity, the use of debt to generate accretive earnings in the backdrop of a 'Goldilocks' economy of low interest rates and benign inflation.

The largest valuation increase in U.S. commercial real estate was ended by the greatest global financial crisis since World War II, which began in 2007. Although the crisis affected all asset classes and caused a very deep recession, its impact on real estate was particularly severe. Fueled by access to cheap credit, commercial real estate valuations had risen disproportionately to fundamentals as investors bet on financial engineering to generate returns, rather than increases in operating income. The Great Recession shut down the credit markets and the debt dependent real estate sector was cut off from a key valuation prop. Investors employing higher amounts of leverage were hurt increasingly more as real estate values fell and triggered loan covenants. REIT investors immediately felt the stress on commercial real estate valuations and from early 2007 REITs entered a historically deep bear market. The bear market, the longest and deepest in U.S. REIT history, ended two years later in the spring of 2009 as signs of thaw emerged in the credit markets and companies began to recapitalize. During the downturn, REIT stock prices were valued at steep discounts to NAV.

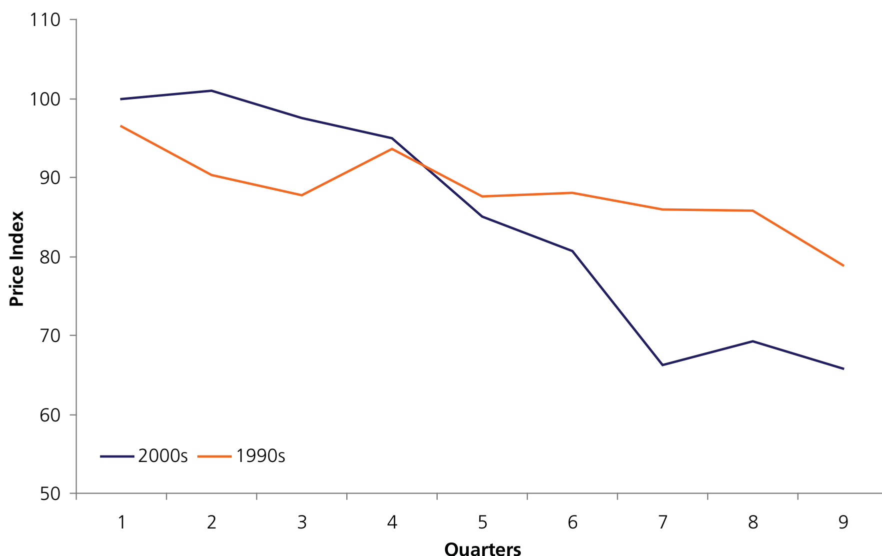
Looking Ahead to the Next Real Estate Up-Cycle: Similarities to the 1990s

As the recovery cycle in real estate unfolds, investors face many similarities to conditions that existed in the 1990s. Although history rarely repeats itself, there are some close parallels in the post-2009 era to the conditions that led to the birth of the modern REIT era and the re-emergence of real estate as a vibrant asset class in the 1990s. Then, as now, REITS are valued at premiums to NAV, property fundamentals are bottoming but still weak, credit is scarce for private real estate sponsors, and several government programs are in place to support commercial real estate values. We examine each of these issues in the following pages.

The Origins of the Current Crisis in Commercial Real Estate

The crisis in commercial real estate in the early 1990s was precipitated by a decline in property values. Over a two year period, U.S. commercial real estate values as measured by the MIT Center for Real Estate Transactions-Based Index (TBI)[3] fell by over 20%. The current crisis in real estate has very similar footprints to that of the 1990s. In the two years since 2008, the MIT TBI has fallen by over 35% (Exhibit 4), a deeper fall than in the 1990s. The loss in value has been exacerbated by the heavy use of debt. Falling real estate values have endangered debt refinancing (especially where asset values have been eroded significantly) and have forced lenders to take large write-downs. Moreover, deteriorating property fundamentals has made debt service problematic for assets with declining cash flows.

Exhibit 4: Comparison of Price Returns for U.S. Real Estate, 1990-1992 and 2008-2010

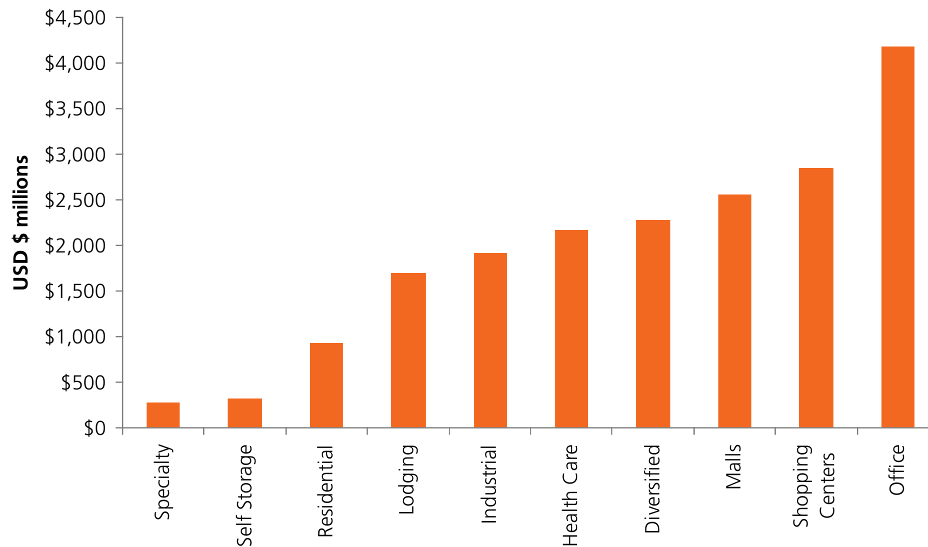


Source: NCREIF, ING Clarion Real Estate Securities, as of 12/31/2009.

REITs Lead Recapitalization of Commercial Real Estate

A capital constrained environment has led to a gridlock in transactions as neither buyer nor seller is able to determine the true underlying value of the property in the absence of debt financing. Private sponsors of real estate have been particularly hard hit by the decline in debt financing. In this capital constrained environment REITs have been able to tap the public markets to re-capitalize their balance sheets. Similar to the 1990s, listed real estate companies have been extremely successful in gaining access to capital and restoring balance sheets ahead of private owners. There is a strong parallel to the 1990s. Between 1993 and 1995, U.S. real estate companies raised approximately $15 billion in secondary equity in addition to IPOs that raised approximately $15 billion, thus bringing a total of $30 billion of new equity to the U.S. real estate market. In 2009, U.S. REITs have raised close to $20 billion in fresh equity and over $10 billion in debt financing (Exhibit 5). Furthermore, as of the end of May 2010, U.S. REITs have raised an additional $6 billion in equity and just under $9 billion in debt. The ability for REITs to tap cheaper capital during a credit constrained period positions them well to take advantage of any buying opportunities that may arise. Investors expect some of the better capitalized REITs to take advantage of their balance sheets to find accretive acquisitions. Premium valuations can therefore exist when public companies have the capital market tailwinds.

Exhibit 5: U.S. REIT Equity Capital Raised in 2009

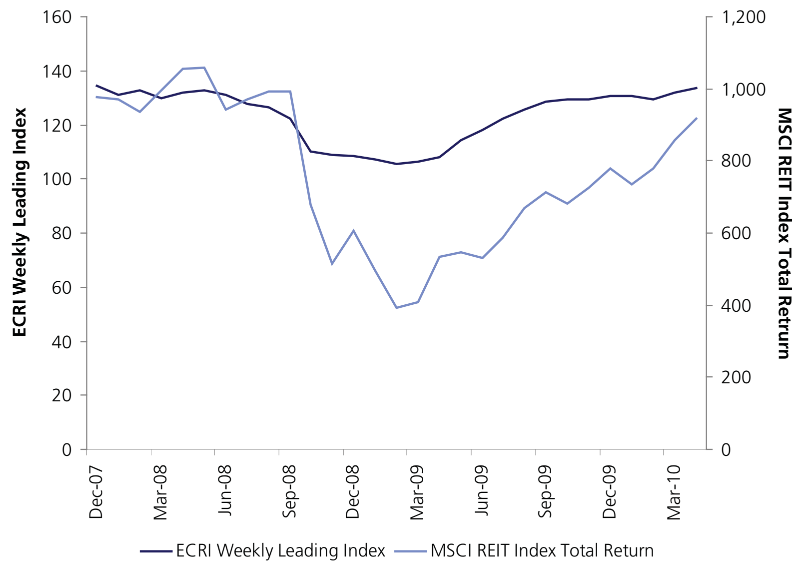


Source: ING Clarion Real Estate Securities and NAREIT as of 12/31/2009.

REITs Price in Improving Economic Outlook

Improvements in the underlying economy also support the notion that property fundamentals are in the process of stabilizing. As forward looking economic indicators in the U.S. began improving from early 2009, REITs began to rally anticipating the improvement in underlying demand for commercial real estate (Exhibit 6). An analysis of the Economic Cycle Research Institute (ECRI) Weekly Leading Index (WLI) and U.S. REIT returns as referenced by the MSCI U.S. REIT Index reveals a high correlation of 0.55 between 2007 and the middle of 2010, which demonstrates that REITs correctly began to anticipate the economic recovery from mid-2009. For investors, the improvement in forward looking indicators was an early sign that stabilization in demand fundamentals was imminent. A quick way to anticipate and participate in the expected stabilization and recovery in real estate demand was through exposure to REITs. The subsequent rally and premium valuation is therefore a reflection of the growing confidence in the emergence of recovery in the U.S. economy and increasingly, of sustainability of growth that should result in improved real estate demand.

Exhibit 6: ECRI Weekly Leading Index and MSCI REIT Total Returns, 2007-2010

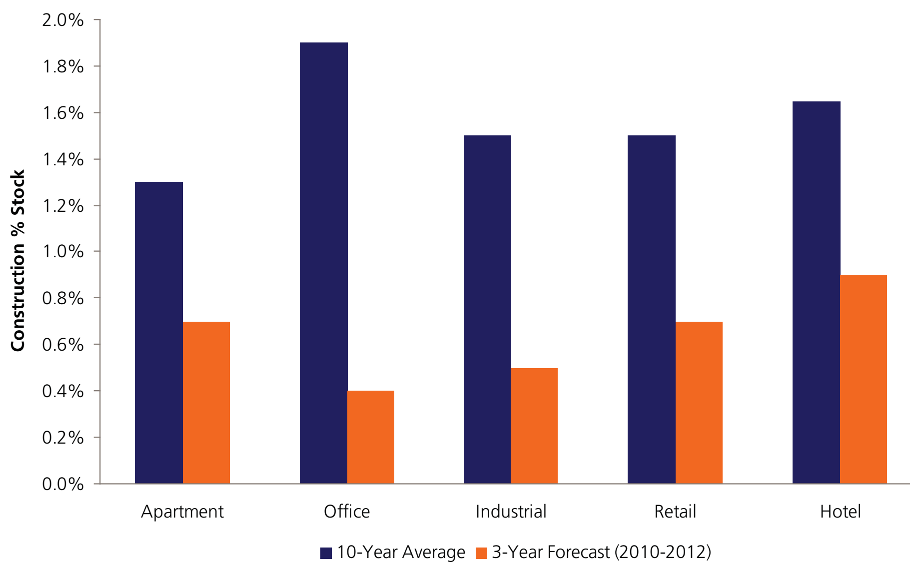


Source: Thomson Datastream, ING Clarion Real Estate Securities, as of 4/30/2010.

Favorable Supply and Demand Fundamentals Underpinning REIT Values and Support Higher Earnings

A key determinant of real estate demand and pricing has been the equilibrium level between supply and demand. Historically, recoveries have been stymied by the availability of excess supply that has suppressed demand and therefore prices. In the current downturn, there has been very little excess supply to threaten a recovery in demand. In fact, new construction as a percentage of existing stock is at record lows for the major property types in the U.S. (Exhibit 7). Supply forecasts across the major property types over the next three years are well below historical averages. This has important positive implications for a recovery in real estate values – as demand returns, landlords will be in a position to improve their negotiating power and the market equilibrium will favor owners and not renters. REITs will also benefit from constrained supply along with the rest of the real estate market. To some extent, the premium valuation also reflects the view that constrained supply in the coming cycle will be a distinct advantage to landlords and REITs.

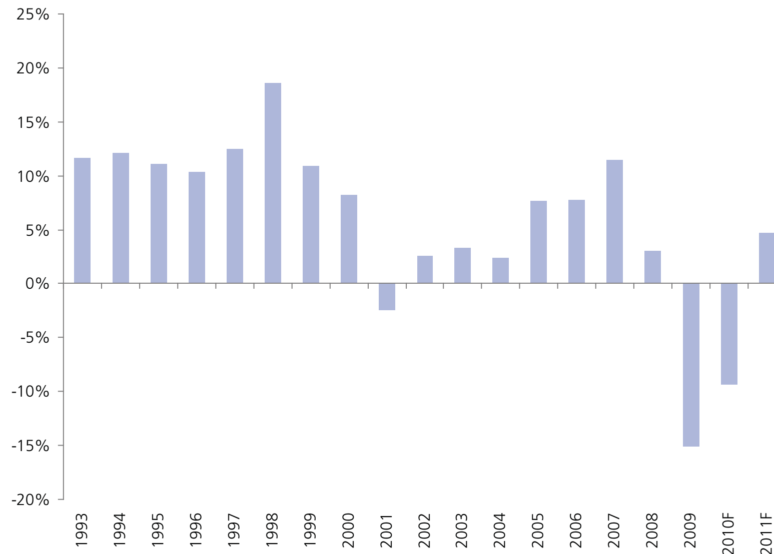
Exhibit 7: Construction Forecast as Percent of Current Stock, 2010-2012



Sources: ING Clarion Research & Investment Strategy, CBRE-EA, REIS, Smith Travel Research.

Tighter supply forecasts and a growing economy have also encouraged investors to take a more positive view towards the potential for higher earnings growth for REITs. Expectations are for earnings growth to turn positive in 2011 after the impact of dilutive equity raises ends in 2010. As Exhibit 8 shows, REIT earnings recovered strongly in the aftermath of the recession and collapse in real estate values in the 1990s. With REITs recapitalized and signs of stabilization in the underlying real estate market, forward looking investors may be discounting improvements in earnings growth thus pushing valuations to premiums relative to NAVs. Although the forecast for earnings growth is still modest for 2011, if the economy grows faster than currently projected, earnings growth momentum is likely to move higher.

Exhibit 8: Historic and Projected REIT Earnings



Sources: Green Street Advisors, NAREIT, ING Clarion Real Estate Securities as of 4/30/2010.

Conclusion

We began this paper asking if investors should worry if REITs trade at premium to underlying NAV. A history of REIT stock prices since the 1990s reveals that valuations relative to private asset values have varied over different periods of time and that a premium or discount has been largely a function of cyclical factors. Although there are structural reasons why REITs may provide a premium to NAVs, the forward looking nature of the equity market lets investors apply a filter to REIT prices that can lead to either a discount or a premium.

Although history rarely ever repeats itself, we note that the current environment has some similarities to conditions in the 1990s, a period when REITs were valued at premiums to NAV. Then, as now, investors factored in an improving economic environment, access to more and cheaper capital sources and improving earnings growth, which have encouraged them to view and hence value REITs favorably. Increasing signs that the cyclical factors are aligning in favor of commercial real estate suggests that premium valuations for REITs during the up-cycle should not be a cause of alarm to investors at this juncture.

Author

ING Clarion Real Estate Securities

Indraneel Karlekar, Ph.D.
Senior Vice President
Head of Global Research and Strategy

Endnotes

1. *NAV refers to an estimate of the value of underlying private commercial real estate. Private commercial real estate is always valued at an independent appraiser's view of NAV, which is defined as equity value of the property less total liabilities as defined by Generally Accepted Accounting Principles (GAAP).*
2. *NAV is only one albeit important metric with which global real estate securities are valued and will vary over time.*
3. *TBI Data and NCREIF: The TBI is based on data received by MIT on a quarterly basis from the National Council of Real Estate Investment Fiduciaries. NCREIF is a not-for-profit industry association dedicated to improving knowledge about institutional real estate investment performance. The NCREIF Property Index (NPI) is produced quarterly by NCREIF and is available on the NCREIF website.*

Important Information

The views expressed in this paper represent the opinion of ING Clarion Real Estate Securities which are subject to change and are not intended as a forecast or guarantee of future results. This material is for academic and informational purposes only. It does not constitute investment advice and is not intended as an endorsement of any specific investment. Stated information is derived from proprietary and non-proprietary sources which have not been independently verified for accuracy or completeness. While ING CRES believes the information to be accurate and reliable, we do not claim or have responsibility for its completeness, accuracy, or reliability. Statements of future expectations, estimates, projections, and other forward-looking statements are based on available information and management's view as of the time of these statements. Accordingly, such statements are inherently speculative as they are based on assumptions which may involve known and unknown risks and uncertainties. The analysis in this paper is based on historical data and was constructed with the benefit of hindsight. We make no representation that any account has, will, or is likely to achieve similar results. The returns in the analysis are derived from the returns of one or more indexes. Investors cannot invest directly in an index. Past performance is not indicative of future results.

Investing in real estate securities involves risks including the potential loss of principal. Real estate equities are subject to risks similar to those associated with the direct ownership of real estate. Portfolios concentrated in real estate securities may experience price volatility and other risks associated with non-diversification. While equities may offer the potential for greater long-term growth than most debt securities, they generally have higher volatility.

PA06252010