The investment potential in real estate

Mayank Markanday, Head of the Diversified Real Assets team

Home ownership is high on the agenda for many people but soaring mortgage rates and historically high property prices in much of the country mean that getting a foot on the ladder has rarely been as tough.

Yet for investors, an alternative potentially worth considering as part of a diversified portfolio is to invest in property through a real estate investment trust (REIT).

A REIT is a property investment company that effectively acts as a property rental business. Investors who put money into a REIT are therefore indirectly investing in property, albeit in a more liquid way than investing directly in property.

The benefits of investing in property through a REIT typically include long-term rental income streams which can often be inflation-linked to some degree.

The stability of the cash flow profile can be seen as a defensive source of income and returns and can provide diversification versus other traditional investments such as equities and bonds in the long run.

Furthermore, there is no corporation tax charged on either rental income or any gains made on sales of properties held within a REIT.

What has been the performance of REITs?

However, the last 12 months or so have shown that total returns from property, in particular listed property, can be volatile in share price terms – despite strong fundamental performance and in many cases growing dividends.

Higher yields on risk-free assets have led to investors requiring a higher return or income hurdle for holding ‘risky’ assets such as property. The re-setting of yields subsequently caused the prices to fall due to the long-term nature of income streams. While rental growth helped to offset some of the yield increases, we have still seen double digit declines in the valuation of property portfolios as represented by the Net Asset Valuations (NAVs).

As measured by the MSCI UK Property Index, which measures the total returns from directly held property, we saw returns of -10.1% (-14.2% from capital, 4.7% from income) in the sector, while in the year to date (2023), there has been some stabilisation in property yields, with total returns just above 1%, and a small decline in capital values (-1.1%) being offset by income at 2.4%. ***(source: NUMIS, MSCI).***

Despite the stabilisation in yields, the listed markets have continued to drive discounts wider to their NAVs and post meaningful negative returns as a result. The market is currently pricing in further yield widening due to higher interest rates – however we believe the magnitude of the discounts may be overdone, especially for certain REITs and sectors that have demonstrated strong rental growth with lowly levered balance sheets. An investor with a long-term mindset that can withstand short term noise stands to benefit from attractive returns.

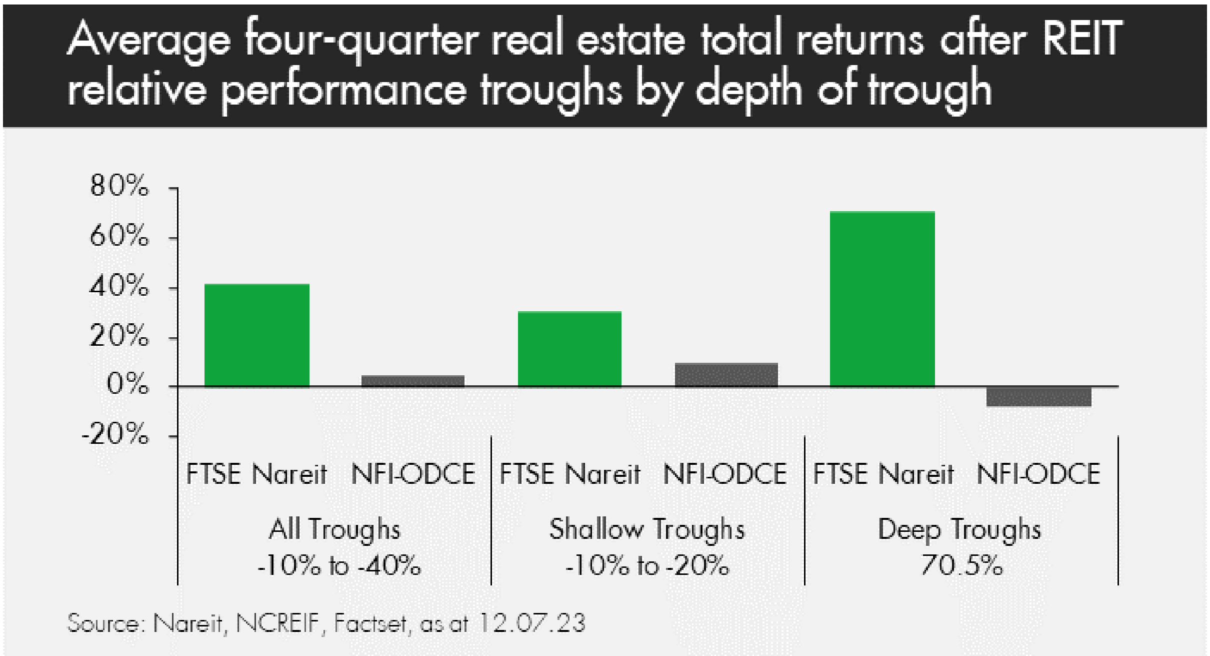
Somewhat counterintuitively, it is the more secure and defensive income REITs (e.g healthcare REITs) that have seen the biggest downgrades. This is because the starting yield levels were much lower than more risky REIT sectors such as retail, which have already seen yields widen during the Covid pandemic. Meanwhile the UK listed property sector trades at a discount of -38.8% (***source: NUMIS, 11 July 23****)*

What is the future for returns?

Falling interest rate expectations are the obvious catalyst for a strong re-rating in the sector, but we believe even if interest rates were to stabilise at current levels, the discounts will encourage buyers back into the market, especially in REITs with strong balance sheets and long-term structural growth. We have seen this through the lens of mergers and acquisitions (M&A) activity, where deep discounts have enticed M&A activity led by private market participants – for example, Blackstone's cash offer for Industrial REITs (14th April) and CK Holdings cash offer for Civitas (9th May). We may see more from well capitalised players if discounts persist at these levels, which will be positive for the REITs sector as a whole.

Using history as our guide we also note, periods of high persistent discounts are often followed by very attractive prospective returns from the higher starting yields and the unwinding of the discounts.

The chart below shows the average total 12 month returns from REITs relative to the performance of unlisted property funds which typically trade close to their NAVs. Consequently, times when REITs underperform unlisted funds – or in other words are trading at large discounts to NAVs – are typically followed by strong returns.



Debt

A key fundamental concern is leverage in the sector as represented via Loan to Value (LTVs) and the risk of re-financing in a higher interest rate environment. REITs in general have seen a reduction in their LTVs from c40% in 2012 to c30% for UK REITs in 2022; and from close to 50% in 2012 to c40% in 2022 for European REITs.

Furthermore, many REITs have also taken advantage of the low interest rate environment prior to 2022 to lengthen the maturity of their debt and fix interest at low levels. Average interest rates were c3% in UK and 1.4% in EU as of the end of 2022, compared to 4.9% in UK and 3.8% in the EU ten years earlier. ***(source Stifel, Bloomberg)***. The average maturity of debt remains fairly long on average, at around six years for UK REITs and about five years for EU REITs.

Risks and opportunity

Owning property via listed vehicles implies a trade-off of a preference for liquidity over short-term volatility and higher correlations, especially in extreme market environments. In the long-term private and listed markets for real estate deliver similar returns. However, in the current market context, we believe the forward- looking return opportunity is much greater in listed than private markets due to the deep discounts available in REITs. Within listed property, our focus remains on specialist areas with structural growth and defensive characteristics such as healthcare, logistics and digital. Stock selection remains key in this environment as emphasising companies with low LTVs, visibility of dividend cover and growth along with an astute management team will generate the highest returns.

Furthermore, we believe investors should consider a broader remit of real assets beyond property. ‘Real’ in this context can include tangible assets such as land, buildings, toll roads and energy generators (solar and wind farms), which derive value from their availability and usability. Combining disparate sources of returns from a broader range of real assets can help cushion the volatility of standalone property exposure, as well as potentially offering enhanced returns.

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For a comprehensive list of common financial words and terms, see our glossary at: https://www.liontrust.co.uk/glossary

Key Risks

Past performance is not a guide to future performance. The value of an investment and the income generated from it can fall as well as rise and is not guaranteed. You may get back less than you originally invested.

The nature of the Fund's holdings mean they may be more difficult to value objectively so may be incorrectly priced, and may at times be harder to sell. This could lead to reduced liquidity in the Fund. The fund invests in non-mainstream (alternative) assets indirectly through other collective investment schemes. During periods of stressed market conditions non-mainstream (alternative) assets may be difficult to sell at a fair price, which may cause prices to fluctuate more sharply.