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Investment Perspectives 57

Real estate and COVID-19: the story so far

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QUAYglobal INVESTORS

A Bennelong boutique

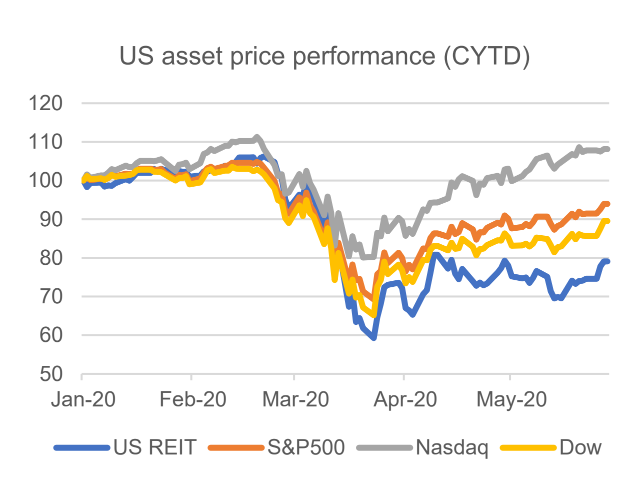
Key points

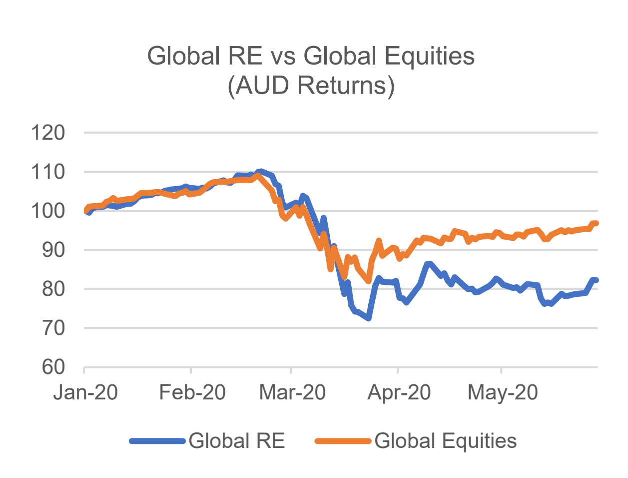
- Listed real estate, both globally and in the US, has significantly lagged the broader equity market during the recent rally.
- Unlike during the global financial crisis (GFC), many real estate companies are in better financial shape (lower leverage and greater access to liquidity), even without central bank support.
- This weak performance is understandable if the market is expecting a deep and protracted recession – although this appears to be at odds with the recent risk-on rally for equities.
- Recent results from our investees have been encouraging, with most companies and sectors in good operational and financial shape prior to the COVID-19 crisis and collecting well over 90% of rents due in April, with even better collection rates thus far in May.
- Significantly lower interest rates for longer will support earnings in the short term via lower debt costs, while the potential collapse in new supply will improve the fundamentals long term.

Real estate missing out on the recent recovery

Sell in May and go away? Well, not quite.

For equity investors, the rally that began 23 March continued through May. Incredibly, despite a one in 100-year pandemic, calendar year-to-date (at 1 June 2020) the Nasdaq is now up +8%, global equities (in AUD) only down -4%, and the S&P500 down -7%. By contrast, US REITs and listed global real estate are both down ~20%.





Source: Bloomberg, Quay Global Equities

Despite the tsunami of dire economic indicators (jobless claims, GDP estimates, industrial production), one can make an argument that the recent bounce in equities is based on the massive fiscal response from most governments. Indeed, last month we made the case using the Kalecki-Levi profit framework.

So why has real estate lagged?

One argument is that real estate is exposed to sectors that may be challenged in a post COVID-19 world. Retail and office (not a small part of the market) are good examples. However, like the broader equity market, the real estate universe includes many sectors that are unlikely to be impacted solely by the virus, such as industrial property, single family homes, apartments, data storage and self-storage, etc.

Of course, if the world is headed for a deep and protracted recession, the performance of the real estate indices is justifiable. But the broader equity market is telling a different story. Either the recovery is extremely quick, or investors are willing to look past the downturn all together.

Either way, there seem to be inconsistencies. In Australia, retailers such as JB Hi-Fi are down just -7% and Premier Investments -14%, while Scentre Group (a senior creditor to both the aforementioned businesses) is down around -40%.

Of course, it's early days, and the equity market may well be wrong – the world could be headed for a significant and prolonged economic downturn and markets may need to re-adjust. Time will tell.

However, we think a better explanation is a strong recency bias against real estate.

A missed opportunity?

During the GFC, real estate was one of the worst performing asset classes and justifiably so. Part of the reason was that the financial crisis began as a real estate crisis (US housing), before morphing into a credit crisis. Real estate relies on credit, and back in 2008 many real estate companies were significantly levered (50-60% loan-to-value ratios (LVRs) were not uncommon). Further, since it was almost 80 years since the last major financial crisis, little value was placed on access to liquidity. So when the crisis hit and liquidity was needed, the cupboard was bare; and for many, the only alternative was equity at painfully depressed prices.

Big losses were locked in, and many investors today still remember those costs.

Our observation is the current climate is different.

While we cannot speak to the entire REIT universe, balance sheets across Quay's coverage list (including investees) are in much better shape than those prior to the GFC. We estimate the average LVR across our portfolio at 26% measured by debt to enterprise value, or 5.4x measured by net debt/EBITDA. Additionally, all of our companies have significant access to liquidity. And even if they were to fall short, central banks have taken the highly unusual step of buying investment (and sub investment) grade credit, providing a credit backstop for all industries – including real estate.

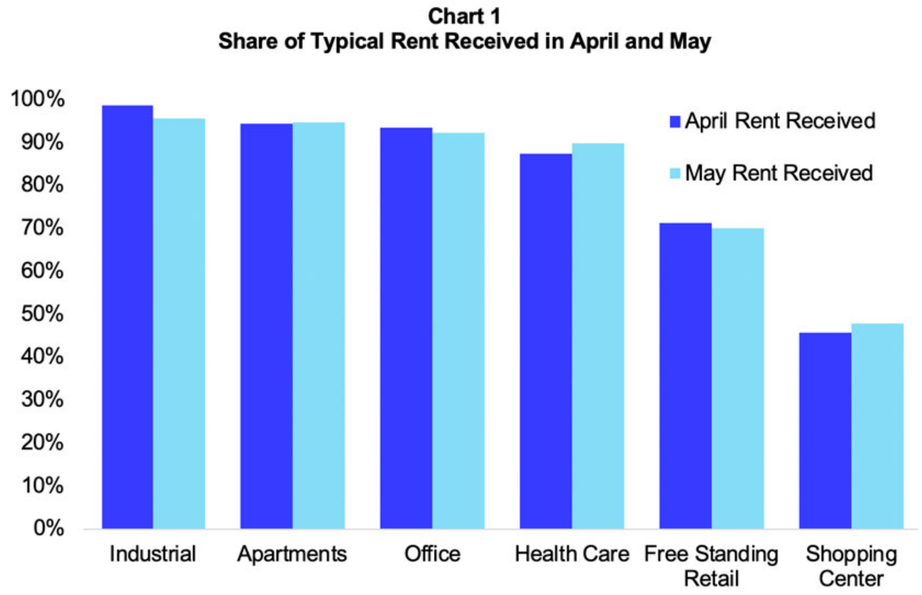
By way of example, one of our investees, Camden Property Trust, issued 10-year notes at an all-in rate of 2.9% in the middle of April. There was over $8bn of investor demand for the $750m issue. Credit markets have *improved* since. In our opinion, access to liquidity and credit is generally not a problem.

Therefore, it's more about the economy. Which means it is hard not to conclude that either the equity market is wrong, or there is a significant opportunity in global real estate.

Rents are (mostly) being paid, the cost of debt is falling, and the medium-term supply outlook has improved

One of the initial concerns stemming from stay-at-home orders was the inability (or unwillingness) of tenants to pay rent. Lack of rent would squeeze the cashflows of real estate owners, which (under a worst-case scenario) would lead to potential breaches of fixed-charge cover ratios within lending agreements.

The swift response of governments around the world with payments supporting wages and small businesses has ensured rents continue to flow. Indeed, outside of retail, most US REITs have reported mid-90% cash rent collection (with May collections generally better than April for apartments, healthcare and malls). Most of the rents not yet paid are on deferral agreements. Only slightly worse cash rent numbers were reported from Europe/UK.



Source: NAREIT

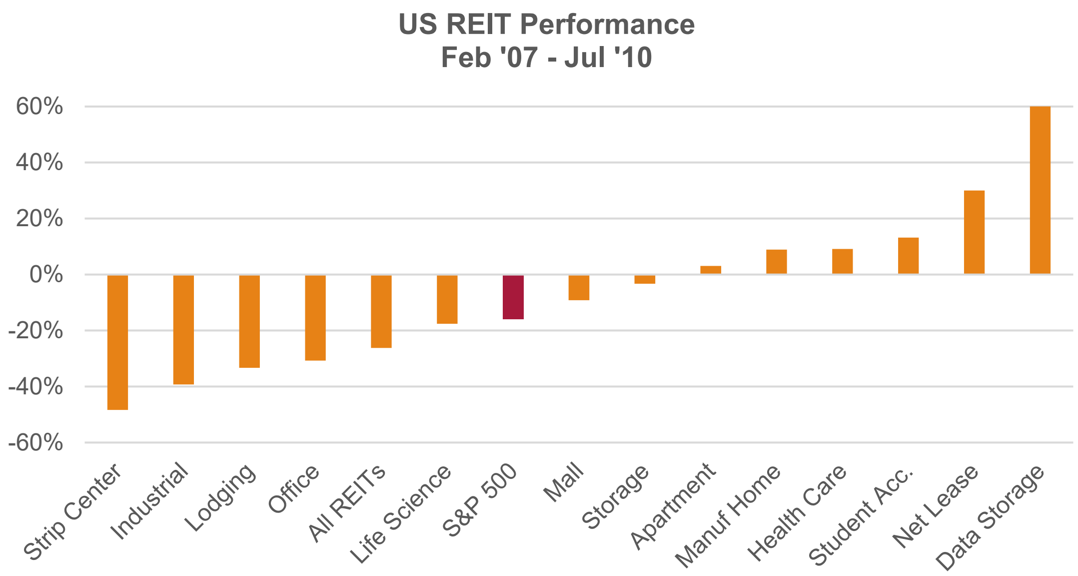
While the current environment is challenging, there are other elements that support REIT pricing in the medium term.

1. It is almost certain interest rates will remain lower for much longer, which means many REITs will generate interest rate savings on future refinancing over time.
2. New supply (one of the biggest threats to real estate pricing) is likely to abate, leading to much tighter rental conditions over the next few years. Given most listed real estate asset values are now below the cost to build, less future supply should come as no surprise.

Extreme volatility creating pricing inconsistencies within real estate

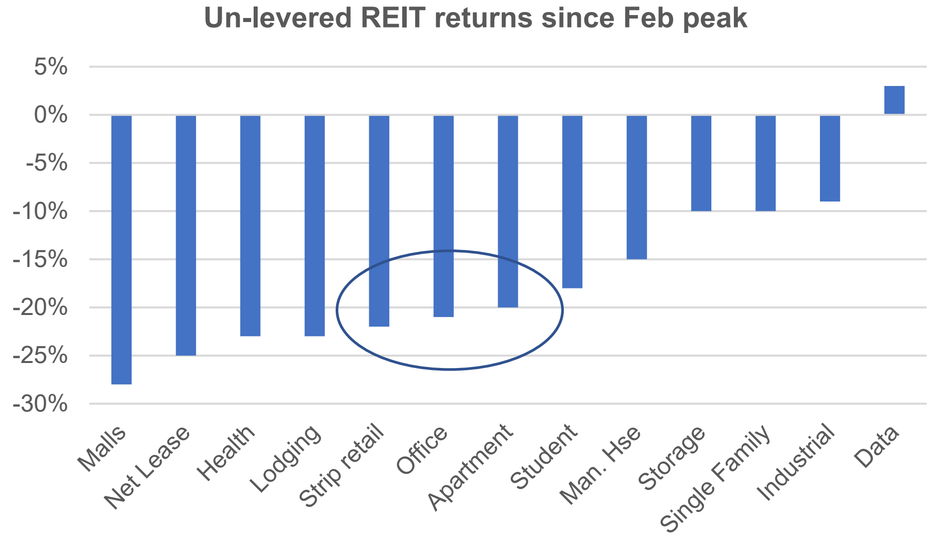
While there seems to be a disconnect between equity market euphoria and real estate depression, within the sector there appear to be anomalies.

Last year, in our article What happens if there is a recession, we highlighted sectors within real estate that historically outperformed or underperformed during economic downturns. The chart is re-created below.



Source: Green Street Advisors, Quay Global Investors

However, the performance of these sectors to date have not matched the last downturn. Traditionally defensive sectors not directly affected by COVID-19, such as manufactured homes and apartments, are performing just as poorly or worse (when adjusted for leverage) than the more economically sensitive sectors of office and industrial. Given the high rate of rent collection to date, we see no reason why this should be the case.



Source: Green Street Advisors, Quay Global Investors

Again, similar to the relationship between equities and real estate, it seems even within the real estate sector investors cannot make up their mind whether we are having a recession or a recovery.

The opportunity is to buy the sectors where there is a prolonged recession implied in the market price – this offers investors a skewed bet. If the worst-case economic scenario plays out, this should mostly be reflected in the price – if not, significant upside is potentially available.

Where to from here for the market is subject to much debate. While there seems to be a degree of enthusiasm reflected in equity market indices, listed real estate has been a significant underperformer. Across most of our investees, we are seeing solid rent collection with robust balance sheets and good access to credit. Despite this, in some instances many years of share price gains have been erased and we believe this represents opportunity.

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