How do Office REITs Perform in time of Market Volatility?

Introduction

I was recently asked a very reasonable question regarding the office REIT fund which I run which is, "How do you think the fund will perform if the US enters a recession?" The answer to this question is not nearly as straight forward as I would like it to be but it is worth examining the logic that underlies what I think is the best answer.

Earnings Changes for the S&P 500 and REITs during a Recession

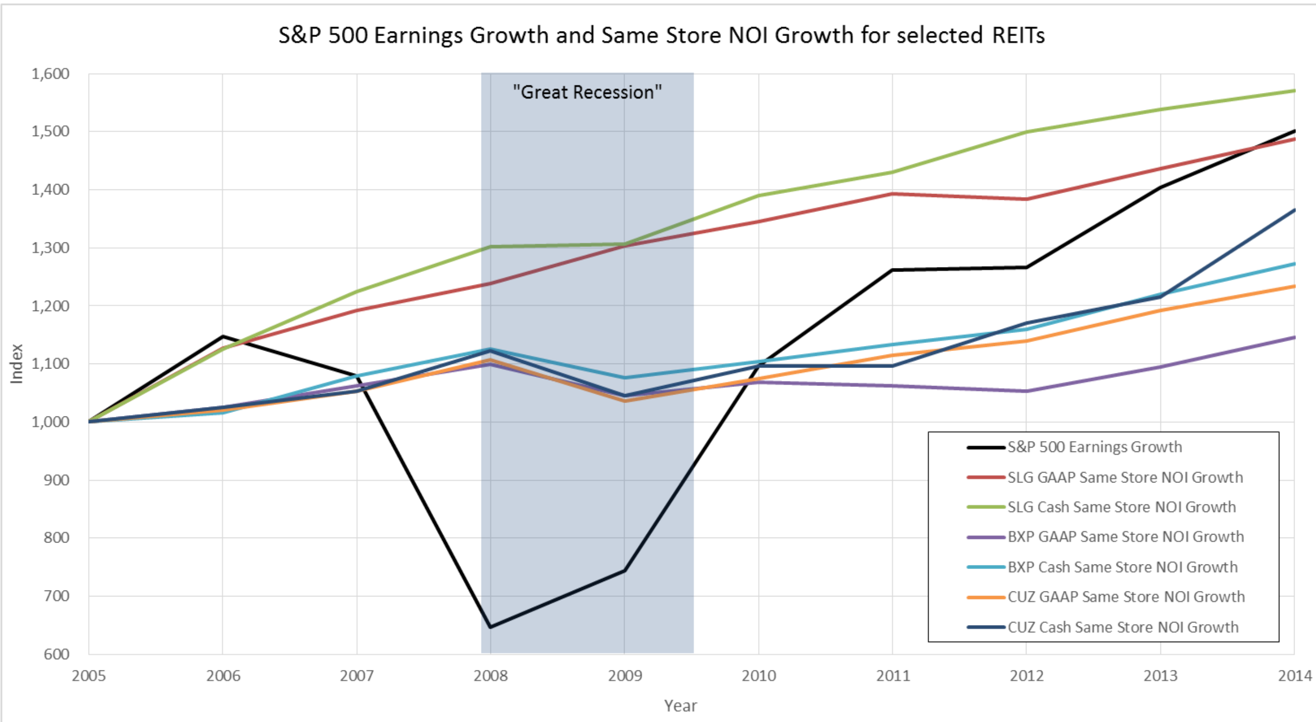
To provide a complete answer to this question, one needs to examine the changes that happen to the earnings of S&P 500 companies and to office REITs during a recession. S&P 500 companies are generally in the business of selling products and these products sell for a premium over their cost which is their sales margin and this margin is what creates earnings for these companies. In a recession, sales generally decline but what really effects earnings is the drop in the sales margin as companies have to reduce prices to sell product into a market with weakening demand which eats away at their margin and in turn their profits. I am far from an expert in margins but investment management firms such as GMO and Hussman Funds have written extensively on sales margin and why it is so important in valuation.

Office REITs and office buildings in general do not share similar economics to companies that sell "things" for several reasons. The first is because office buildings involve an initial purchase of an asset and then there is very little marginal cost to accommodate additional tenants. The second is because leases are for terms of multiple years and in practice have yearly escalations. It is quite common to have less than 10% of leases up for renewal in any one year. Certainly companies that sell "things" can have long term sales contracts but it is uncommon to have 90% of a company's revenue contractually locked in from year to year.

To simplify this comparison, I will show the NOI growth in properties owned by several REITs during the "Great Recession" of 2007-09. REITs report same store statistics including NOI growth using GAAP and often cash. By chaining together numerous years of same store NOI growth, one can compare the growth to the growth of earnings for the S&P 500. I chose to use property level NOI growth as I find that people often get confused with effects of leverage and the point is easier to make using property level NOI growth. Equity returns are the leveraged effects of property level NOI along with several other factors including capital expenditures, acquisitions and dispositions, development and non-property level general and administrative expenses. By looking at the performance of properties owned by REITs, one can get very good idea of the major driver of value for REITs' equity.

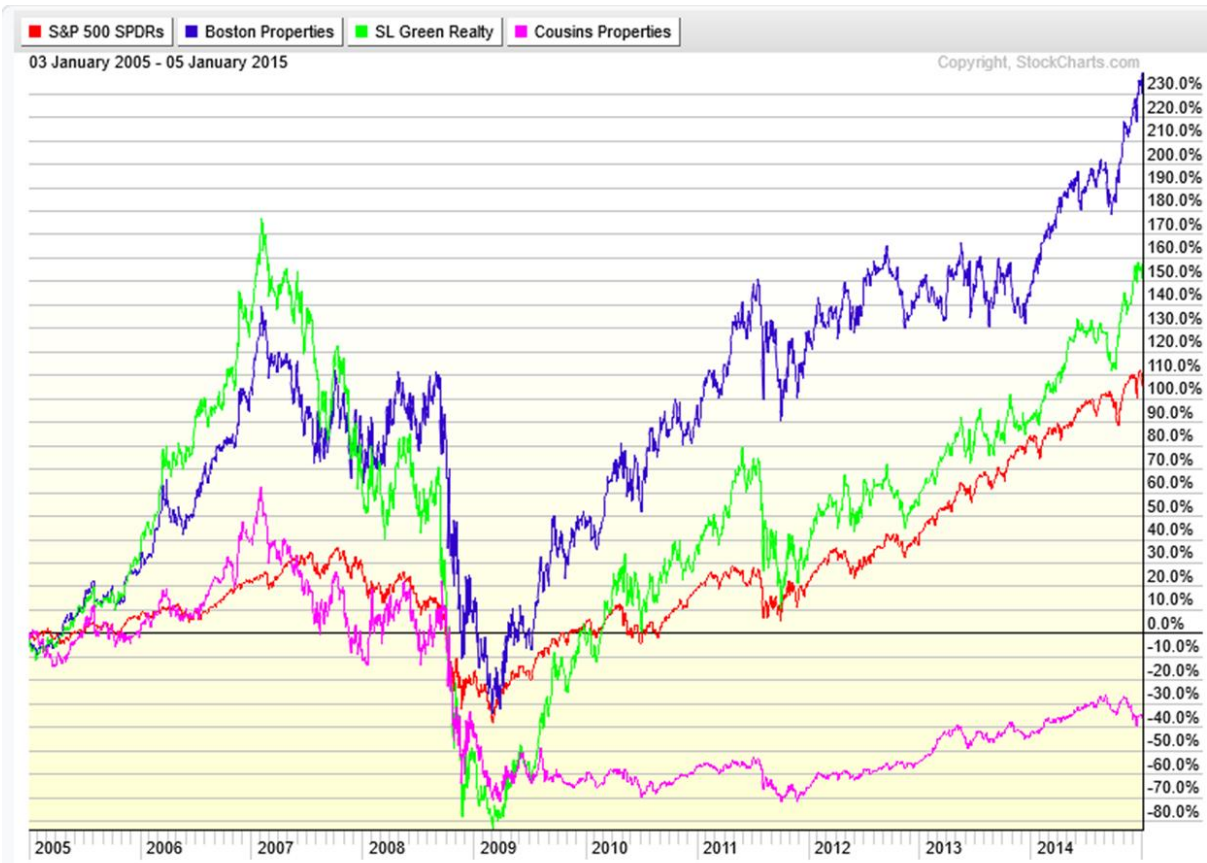
Property Level NOI Growth Compared to S&P Earnings Growth

The chart below depicts the earnings growth of the S&P 500 between 2005 and 2014 compared to the NOI growth of properties owned by each of the REITs depicted. What the chart shows is that even during recessions, NOI growth for office properties is minimally affected by a recession compared to the earnings of the S&P 500 as office properties have long term leases with contractual rental escalations compared to the earnings of the S&P 500 which are largely affected by significant swings in profit margin.



Equity Returns the Great Recession

Depicted below is the total return of the S&P 500 SPDR ETF, BXP, SLG and CUZ prior to, during, and subsequent to the Great Recession. What we see is that REITs' equity is much more volatile than the S&P 500 which is a bit surprising considering how stable office REITs' properties operating income is during a recession compared to the earnings of the S&P 500.



REIT Valuations Prior to the Great Recession

With the prior information as background, the question should be asked if earnings for the properties that REITs own are so stable compared to the earnings of S&P 500 companies, why were their equity values so much more volatile in the Great Recession. Moreover, why did office REIT equity values drop more dramatically than the S&P 500 when their earnings were so stable?

With perfect hindsight, we can see that at the start of 2007 SLG, BXP, and CUZ were all tremendously overvalued as only BXP has managed to have a positive total return in the subsequent 8 years. To compare the valuation of REITs today to REITS at the beginning of 2007, I like to use the spread between the implied cap rate of REITs and 10 year US Treasuries. The implied cap rate looks through the REIT's capital structure and sees how the market is valuing the income return generated by a REIT. In this comparison, the implied cap rate is using GAAP revenue instead of cash but this allows for an "apples to apples" comparison to the GAAP implied cap rate today.

My measurement of the market implied GAAP capitalization rates of SLG, BXP, and CUZ as of the beginning of 2007 is 4.6%, 4.7% and 5.1%. Two out of three of these cap rates are right at the yield on the 10 year US Treasury at the beginning of 2007 of 4.68% with the implied cap rate of CUZ being slightly higher. Compare these implied cap rates to the stock price at the close of Sept. 9, 2015 where I calculate the GAAP implied cap rate of SLG, BXP and CUZ as 5.34%, 5.41% and 7.96% respectively compared to the yield of the 10 year treasury of 2.18%. This means the spread between the 10 year US Treasury and the implied cap rate for SLG and BXP is over 3% and is 5.78% for CUZ which is dramatically higher than at the beginning of 2007. This difference in spreads can be illustrated best by calculating the difference in stock prices today of each of these REITs if their spreads were the same as in 2007.

REIT Prices today Compared to 2007

SLG's stock was $101.86 at the close on September 9, 2015 which equated to a GAAP implied cap rate of 5.34%. If its GAAP implied cap rate were at the current yield of the 10 year treasury of 2.18%, similarly to the beginning of 2007, it would be $395.25 or 288% higher than it currently is.

BXP's stock was $153.47 at the close on September 9, 2015 which equated to a GAAP implied cap rate of 5.41%. If its GAAP implied cap rate were at the current yield of the 10 year treasury of 2.18%, similarly to the beginning of 2007, it would be $686.07 or 347% higher than it currently is.

CUZ's stock was $9.04 at the close on September 9, 2015 which equated to a GAAP implied cap rate of 7.96%. If its GAAP implied cap rate were at a 42 bp spread to the current yield of the 10 year treasury or 2.60%, similarly to the beginning of 2007, it would be $36.67 or 306% higher than it currently is.

These nosebleed valuations in the beginning of 2007 are what led to the drawdown of SLG of 95%, BXP of 70% and CUZ of 80%. Because REIT valuations today are nowhere remotely close to the valuations of 2007, it is extremely unlikely there will be a similar drawdown if the economy enters a recession.

Looking Forward

The data from the Great Recession makes it quite clear that that the NOI growth of office properties is much less affected by a recession than the earnings growth of S&P 500 companies. Nevertheless REITs suffered tremendous drawdowns in the Great Recession but that was largely a function of the nosebleed valuation levels at the outset of the Great Recession as opposed to negative NOI growth at the property level. With valuations significantly lower than they were in 2007, the risk of a significant drawdown in REIT valuations as seen in the Great Recession is considered to be very remote.

If the US enters a recession, it is anticipated that earnings for the S&P 500 will likely significantly decrease owing to an erosion in margin similarly to what happened during the Great Recession and therefore put downward pressure on the S&P 500 Index. REIT Property level NOI will likely be much less affected by a recession owing to the nature of long term office leases and built in rent escalations similarly to what happened during the Great Recession. The combination of office REITs' much more stable earnings during a recession and much lower valuations compared to prior to the Great Recession, make me believe that office REITs will be an excellent investment in the case of a recession.

Mr. Bollinger is the founder and CEO of Magnolia Realty Advisors. Prior to founding Magnolia, he was an analyst at KBS Realty Advisors in Atlanta, GA for 5 years where he worked on a 2 person asset management team overseeing a $500M portfolio of commercial real estate. Prior to KBS, Mr. Bollinger worked in the CMBS industry in New York City as a consultant for 3 years supporting clients such as Merrill Lynch and Bear Stearns. He earned an MBA from Vanderbilt University and a BS in Industrial Engineering from Virginia Tech.