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11-2019

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Citation

Singapore Management University. Surviving the property market in a low-interest and low-yield environment. (2019).

Available at: https://ink.library.smu.edu.sg/pers/517

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Surviving the property market in a low-interest and low-yield environment

29 Nov 2019

REITs should note current conditions that echo those leading up to the 2008 Global Financial Crisis and clean up their balance sheets

When the full force of the Global Financial Crisis (GFC) hit near the end of 2007, property prices in the U.S. had already been falling following the peaks of 2006. Capitalisation rates, which measured the returns or yield on property investments, had been falling leading up to the GFC as sky-high prices diluted whatever operating income the income property generated.

In the recent Mapletree Annual Lecture titled "*Recent trends in real estate markets and some implications for REIT investors*," **Todd Sinai**, Professor of Real Estate and Business Economics and Public Policy at the Wharton School cited the lessons three NYSE-listed REITs – Avalon Bay (AVB), United Dominion (UDR), and Aimco (AIV) – illustrated.

Avalon Bay, which Sinai described as the "good" REIT in the comparison, had the lowest debt-to-value ratio at 47 percent heading into the GFC. Even though its share price took a 60 percent hit in the immediate aftermath of the GFC, it recovered strongly and is trading at an all-time high of over US$200 as of November 2019.

United Dominion had a debt-to-value ratio of 80 percent and its stock price plunged even more than Avalon Bay's, shedding nearly 70 percent and not rebounding as robustly. To clean up its balance sheet it "sold assets to try and reduce their leverage and convert equity debt, [which is] not great for business to do that at that point," Sinai explained. Although its stock price fell below US$10 at its trough, it climbed back to pre-GFC levels after a six-year recovery period and is currently trading at an all-time high near US$50.

Aimco, short for Apartment Investment and Management Co., currently trades at around US$53, some US$10 short of its pre-GFC high. Its stock went into freefall in September 2008, losing 85 percent in six months, and has not yet recovered. The reason? It had a massive 90 percent debt-to-value ratio.

"Your access to capital after a downturn depends on how strong your balance sheet was going into it," Sinai notes. "If you were a REIT after a downturn…and your real estate values have fallen, you end up being in a capital raising box. If your debt is too high, equity investors don't want to invest. Your share price falls, and therefore your leverage appears to be higher, and then equity investors really don't want to invest and your share price falls some more."

CURRENT SITUATION

While observing that REITS did not need a conservative balance sheet to do well during the boom year period of 2010 to 2018, Sinai points out a less-than-sustainable source of market growth during the period.

"That rising tide of values [between 2010 and 2018] came not necessarily from increases in cashflow, but from just prices going up for the same cashflow," Sinai elaborates. "Because the yields that the market required were going down means that you did not have to be right about your investment to make money.

"You did not need to a conservative balance sheet between 2010 and 2018 because the rising tide was lifting all boats. You didn't need to worry about a downturn; you do now."

There are more signs of trouble for the property sector. In August this year, the yield curve for U.S. Treasury notes inverted – a signal of the market expecting a downturn. Perhaps more ominously, this also happened in December 2005, some 18 months before the opening salvo of the GFC. Combined with plummeting capitalisation rate and sky-high property prices, these factors point to troubled waters ahead, warns Sinai.

“The last time that we had a massive decline in cap rate and so big an increase in real estate multiples was in the period leading up to global financial crisis,” he says.

REINVENTING THE MALL

Despite the doom and gloom, Sinai believes there are bright spots for the evolving commercial real estate and retail spheres. With cities becoming increasingly crowded and housing becomes smaller – and more expensive – to accommodate the exploding urban population, social events will move away from the home to external spaces.

“They're not going to be entertaining in their living rooms. That is how retail will evolve in the world that we're coming into in the urban world – it becomes the common space of the generation,” Sinai says, articulating the need for malls to cater to lifestyle demands. Additionally, the tendency to have everyday items such as paper towels and toothpaste delivered instead of buying them at a shop requires warehouses to be close to people. He elaborates that “this is where land is most expensive and it is where the interesting innovation and growth is going to be”.

“So there will be a shakeout in the industry – the U.S. has 24 square feet of retail per person, Canada has 16, Japan has two; America has a lot of retail space that we do not need,” he details. “The future mall will be different. It will be very high-powered for the ones that remain. And the trick for being a retail landlord is making sure the mall survives the shake out.

“The rest of the retail real estate is good real estate, good locations. At the end of the day, no one likes to sit in their living room or their bedroom and shop by themselves. People are social.”

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