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Property Paradox: Falling Property Values May Signal Bull Market for REITs

By Brad Case

Business reports are full of bad news on commercial property values: Lehman Brothers and others writing down the values of portfolios recently acquired in leveraged buyouts, Macklowe Properties and others selling properties at reduced prices to reduce leverage, and transaction-based indexes already having turned down. Does that mean equity REIT investors can expect the value of their stocks to turn down, as well?

No. Quite the contrary. History shows that when commercial property values have begun to fall, REITs have been poised for the start of a long bull market.

The last period of declining commercial property values, according to the widely followed NCREIF Property Index (www.ncreif.org), started in the fourth quarter of 1990. In fact, that downturn lasted more than two years, with property returns finally bottoming at the end of 1992. And the road back up was slow: property returns didn't recover their 1990 peak until the second quarter of 1995, just short of five years from the start of the downturn.

Meanwhile, what was happening to equity REIT returns? They had suffered a downturn, too, from their peak in August 1989 until they troughed just 14 months later, in October 1990. And then—just as underlying property values were starting their long descent, according to NCREIF—equity REITs embarked on a bull market lasting more than seven years during which total returns averaged more than 20 percent per year.

From October 1990 through December 1992, while returns on institutional-grade properties were losing more than five percent, equity REIT returns were gaining 26.4 percent. During the almost-five years until property values finally recovered in June 1995, while the total return on underlying properties averaged just three basis points per year, the total return on equity REITs averaged more than 18 percent per year.

Today's REIT investors have seen a similar pattern: after peaking in January 2007, equity REIT returns declined for 13 months until reaching their trough in February 2008. In the six months since then, REIT returns have increased nearly seven percent, at an annualized rate of more than 14 percent.

The time for shorting REITs, it seems, has passed.

What explains this tendency of REIT downturns to precede property value downturns—and, in fact, to end about the time that property values start descending? There are at least four reasons.

First, stock market investors don't wait for news about what did happen: they trade based on their expectations about what is about to happen. Savvy investors could see that highly leveraged private equity real estate funds seemed to be paying too much for commercial properties, and built a correction into their REIT valuations long before the deals started to reflect it.

Second, property owners resist selling if it would mean taking a lower price—that is, converting a paper loss into a realized loss. That means that transactions tend to dry up, leaving a paucity of evidence that property values are declining. Third, property value declines don't show up in transaction-based indexes until deals are closed—but that may be months after sellers and buyers have agreed on reduced transaction prices. Fourth, and perhaps most importantly, declines don't show up in appraisal-based indexes such as the NCREIF Property Index until appraisers—having seen lower property values in past transactions—build the declines into their new appraisals. That's a long and difficult process, resulting in what are called appraisal lag and appraisal smoothing.

In fact, it's not just during downturns that equity REITs lag property values. The correlation between equity REIT returns and the NCREIF Property Index is very low, largely because of the twin problems of appraisal smoothing and appraisal lag. If the FTSE NAREIT Equity REIT Index were smoothed similarly, and then lagged by four to eight quarters, then the correlation jumps to around 50 percent. That means that, no matter what is currently happening to property values according to the NCREIF Property Index, investors can expect that a similar movement already happened to equity REIT returns some one to two years earlier.

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