How REITs Generate Growth

Starlight Capital
FOCUSED INVESTING

Over the last 30 years, REITs have become the global standard for owning publicly traded, investment-grade real estate. They offer investors a reliable source of income, transparency, liquidity, diversification and inflation protection. However, REITs are often maligned for being low growth.

On a relative basis, this is true but it does not mean that publicly traded real estate is devoid of growth. REITs have several levers they can utilize to generate growth, some of which are often overlooked by investors. They are discussed here in descending order of attractiveness based on the magnitude of the impact on the portfolio and the capital required to generate this growth.

Asset and property management

Collectively, these are the scale and scope advantages that accrue to a skilled operator with a large and clustered portfolio of assets. Skilled property management (who operate individual properties) and asset management (who optimize the portfolio) should yield revenue gains and expense savings that allow for cash flow per unit growth, independent of market factors.

These benefits tend to accrue to most of the portfolio and perpetuate into the future. For instance, newer, more efficient appliances purchased at a larger discount, unsecured debt issuances in the capital markets and lower property taxes from assessment appeals should all result in higher rents and/or lower expenses. Rolled out across an entire portfolio, this should result in meaningful value creation through the business cycle.

Contractual rent increases

These represent return on past negotiations and result in current period revenue gains based on past period expenditures (leasing costs and tenant inducements). A quality real estate portfolio should see annual contractual rent increases across most (if not all) of the portfolio leases that don't expire that year. Indexing these rent increases to inflation creates a natural inflation hedge to offset some of the impact of rising rates and capture some growth.

Positive lease renewals and occupancy gains

These levers are similar in that capital is required to retain an existing tenant or acquire a new tenant. Positive lease renewals result in increased revenue from the existing asset. Depending on the capital outlay required, this is generally cheaper and preferable to finding a new tenant. Occupancy gains involve securing a new tenant for an existing and unoccupied space. The capital required is generally higher but partially offset by the impact of taking vacant space off the market and tightening up current supply and demand fundamentals.

Accretive acquisitions and developments

Both of these activities grow cash flow per unit by adding new assets to the portfolio. Acquisitions are of existing assets and so more operating information is available to make an accurate assessment of the value of the asset. However, developments are usually more lucrative from a return standpoint but they also carry greater risks (e.g., over budget, delays, economic downturn). Both of these options entail significant current capital outlays for at-risk future cash flows.

Starlight Capital approach

At Starlight Capital, our goal is to add value by concentrating our investments into high-quality REITs with several of these value creation levers at their disposal. REITs with more growth potential should outperform through the cycle but their value is especially important when economic activity accelerates, and inflation expectations and spot rates rise. Purchased when they offer us sufficient return for the risk incurred these investments should yield us strong risk-adjusted returns over the long term.

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