Starlight™ Capital
FOCUSED INVESTING

The Case for Global Real Estate

Publicly traded real estate can be found in two basic forms owner / operators and developers. The major difference between the two is the manner in which they generate their earnings. Owner / operators generate the majority of their earnings from rental income derived from tenants occupying the real estate they own. This revenue and cash flow stream is usually driven by multi-year leases providing a high level of visibility and predictability. In contrast, developers generate the majority of their earnings from the sale of the real estate they have developed. This revenue and cash flow stream is considerably more volatile with less visibility and predictability.

Countries that have adopted the reit approach

Source: NAREIT® Date indicates adoption year of REIT rules.

The majority of global publicly-traded real estate is in the owner/operator model with most structured as Real Estate Investment Trusts ("REITs"). Globally there are 35+ countries that have passed REIT-like legislation, with the period since 1994 recognized as the "modern REIT era", from which better data is available.

In most countries in order to qualify as a REIT, a company must first meet two tests. First, the majority of the firm's assets must be real estate (definitions and thresholds vary by country). Second, the firm must distribute most if not all of their earnings each year to investors.

In some countries meeting the distribution test allows the REIT to avoid corporate income tax and distributions are paid out of pre-tax income.

Tax illustration

	Corporation	REIT
Revenue	100.0	100.0
Expenses	70.0	70.0
Pretax income	30.0	30.0
Tax	8.4	–
Net income	21.6	30.0
Distributions	11.9	30.0
Tax	4.6	7.5
	39.3%	24.6%
Net cash distribution	**7.2**	**22.5**

Source: For illustrative purposes only

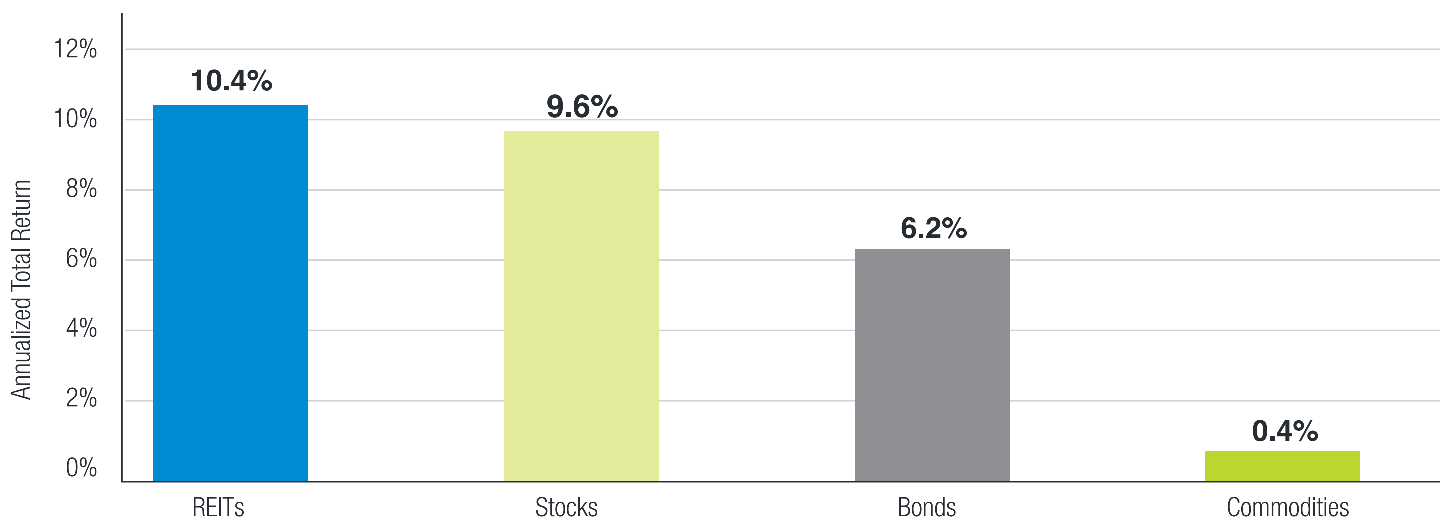
In addition, some REIT distributions have material amounts of “return of capital” which is generally exempt from taxation at the time of receipt by the investor. This results in even greater after-tax yields to REIT investors versus other competing investments.

After-tax yield comparison

	High yield bonds (%)	Common equity (%)	Preferred equity (%)	REITs (%)
Yield	5.88	2.82	3.87	5.62
Tax rate	53.53	39.34	39.34	24.64
A-T yield	2.73	1.71	2.35	4.24
Inflation	1.50	1.50	1.50	1.50
A-T real yield	1.23	0.21	0.85	2.74

Source: Bloomberg, TaxTips, Company Reports
Notes: High yield bonds represented by the Horizons Active High Yield Bond ETF, common equity represented by the S&P/TSX Composite Index, preferred equity represented by BMO Laddered Preferred Share Index ETF, REITs represented by the S&P/TSX Capped REIT Index. As at May 9, 2018.

REITs outperform other major asset classes



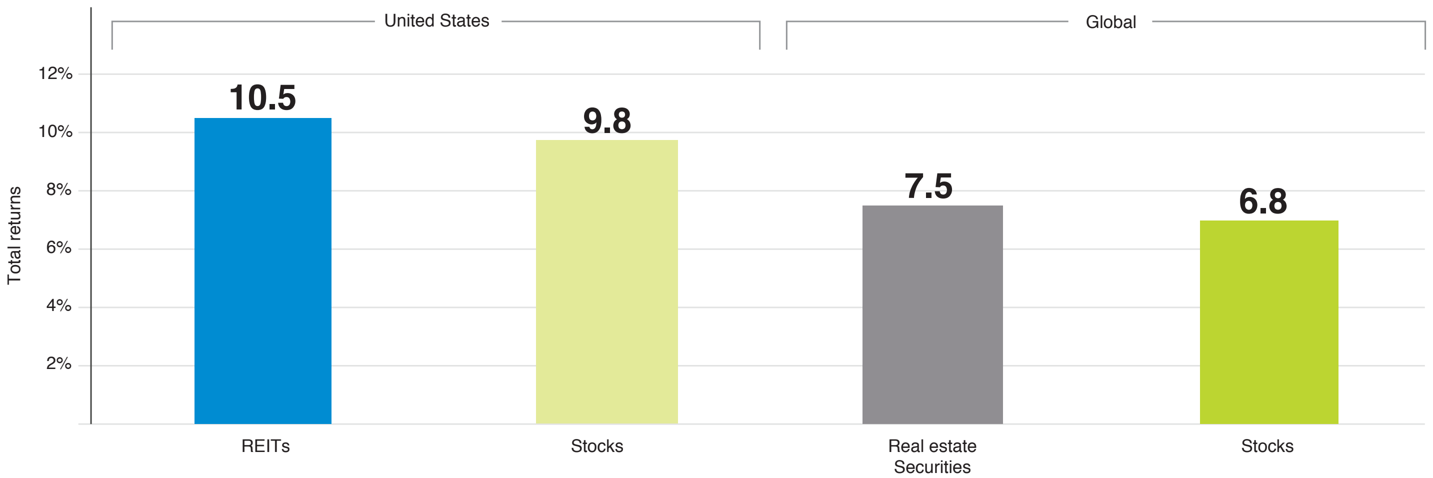
Source: Bloomberg Financial L.P. and Starlight Capital. Data from May 29, 1992 to May 31, 2018. REITs, Stocks, Bonds, and Commodities are represented by the Dow Jones U.S. Select REIT Index, the S&P 500®, Bloomberg Barclays US Corporate Total Return Value Unhedged USD Index, and the S&P GSCI, respectively. Past performance is no guarantee of future results. Chart is provided for illustrative purposes and reflects hypothetical historical performance.

The outperformance of REITs over this time period is often linked to declining interest rates. However, it’s important to note that global equities outperformed global bonds during this time period. Global equities were also levered to falling interest rates and certainly to rising economic output. The outperformance of REITs during this time period is a function of their structure and the unique attributes of REITs.

REIT cash flows are leveraged to rising economic activity in several ways. As economic activity picks up, the demand for real estate increases as firms hire more employees and expand their facilities. This increase in occupancy and demand usually results in rising rents for REITs, particularly those with desirable real estate (locations, quality, etc.). Many REITs structure their leases to participate in rising inflation by way of periodic rent increases tied to inflation. As economic output rises, and inflation rises, REIT rents have the potential to escalate as well. Finally, as the demand for real estate increases, prime locations and properties receive a disproportionate amount of demand for incremental space. If the supply of real estate is constrained in some manner (islands, downtown, zoning) the cash flow growth of quality assets located in these supply-constrained areas can be very robust.

Because of the structure of REITs (mandatory high payout ratios), the total returns from REITs have a significant income component. Historically the total returns from REITs have been evenly split between capital appreciation and distributions. However, the distribution yield from REITs has historically been almost twice the dividend yield from common equity.

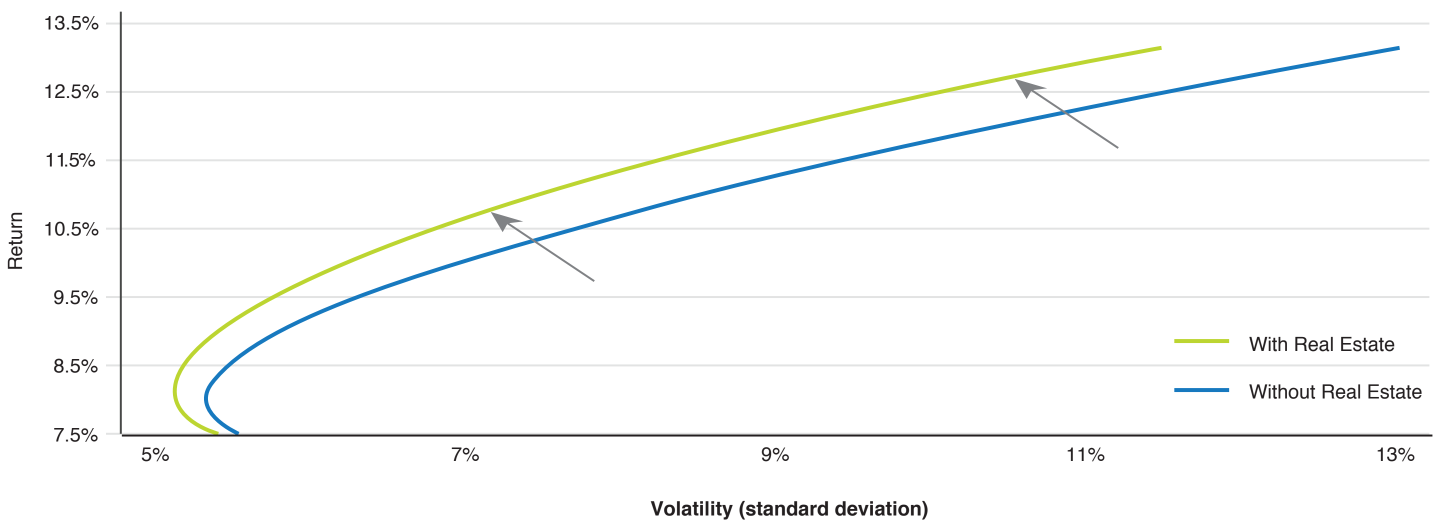
Contribution of Reinvested Dividends to Total Return
December 29, 1989 - July 31, 2018



Source: Bloomberg and Morningstar. Data from December 29, 1989 to July 31, 2018. Data quoted represents past performance, which is no guarantee of future results. The (rate of return or mathematical table) shown is used only to illustrate the effects of the compound growth rate and is not intended to reflect future values of a Starlight Capital investment fund (mutual fund, alternative investment fund or non-redeemable investment fund). The contribution of reinvested dividends is the difference between the total return and price return published by the index provider.

As a result, the total returns from REITs are generally less volatile and more predictable than those of common equities. Adding them to a diversified portfolio usually results in more returns per unit of risk incurred, improving total portfolio risk-adjusted returns.

Efficient frontier with and without real estate

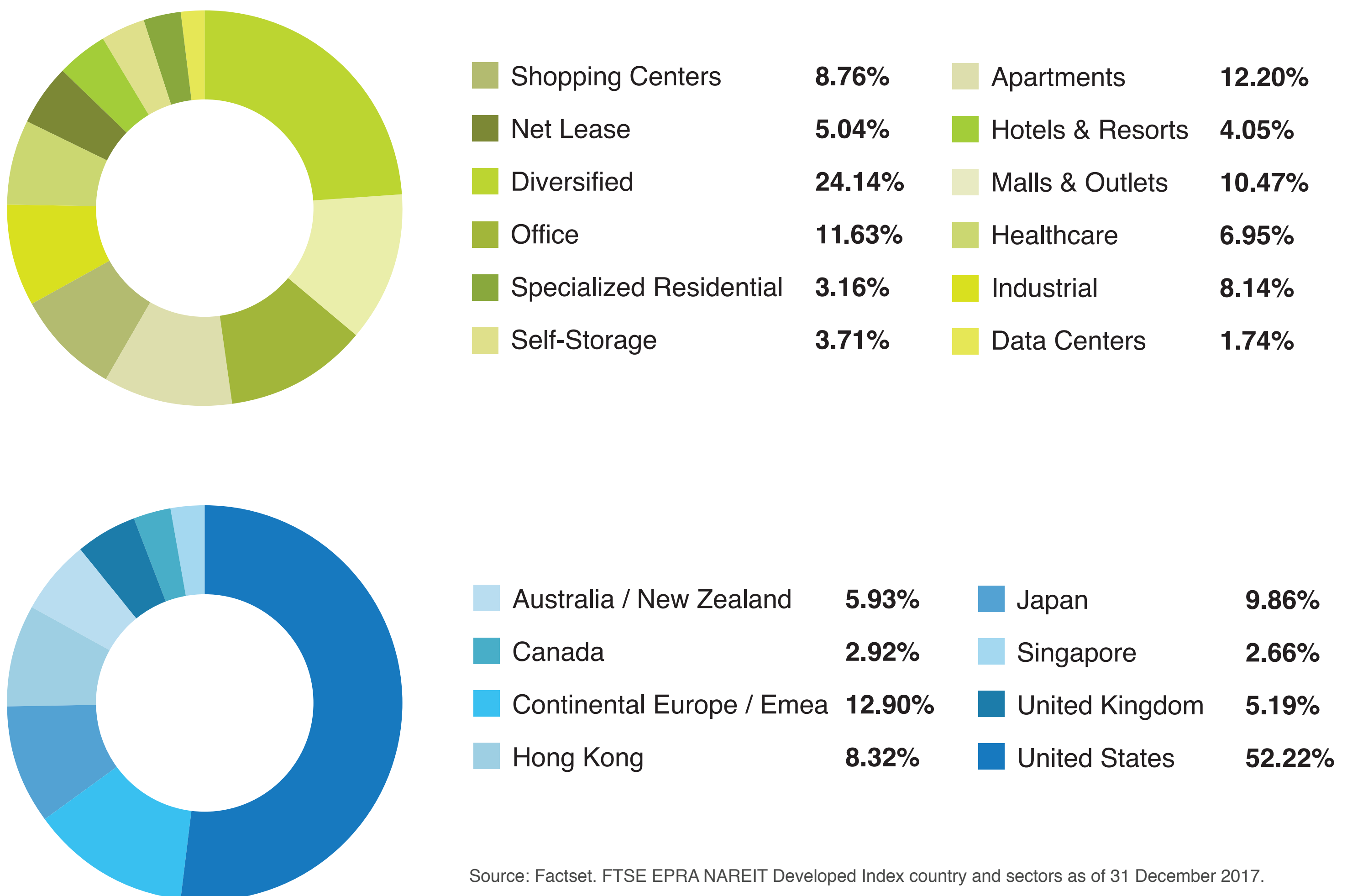


Source: The Prescott Group, LLC. For illustrative purposes only.

Recently the Global Industry Classification System ("GICS") has been expanded to include Real Estate as a standalone sector with a 2.7% weight in the S&P 500. In making this decision, MSCI and S&P Dow Jones noted the increased specialization of the Real Estate sector (13 sub-industries and two industry groups) and the low correlation of Real Estate returns with the rest of the Financials sector. We feel this change to the GICS will drive increased allocations to real estate from generalist and passive money managers. These allocations will likely be more strategic and long term in nature since these managers will have to have an opinion on real estate through the cycle.

Many investors have done well investing in the S&P/TSX Capped REIT Index over the last several years. However, it's important to note that Canadian REITs represent a very small fraction of the publicly-traded real estate available to investors. While the US still dominates at just over 52% of the FTSE EPRA NAREIT Developed Index (our benchmark), there is representation from over 20 different countries. At just 2.9% (19 total names), Canadian REITs are the seventh largest geographical allocation in this benchmark. By limiting themselves to Canadian REITs, investors are foregoing opportunities to own investment grade commercial real estate in world class cities such as New York, London, Paris, Singapore and Hong Kong. These are markets where supply is generally limited, and demand is usually robust, yielding rising real estate values and strong risk-adjusted returns. In addition, several global REIT sectors don't exist in Canada (towers, datacenters, self-storage, student housing) and are only available to global REIT investors.

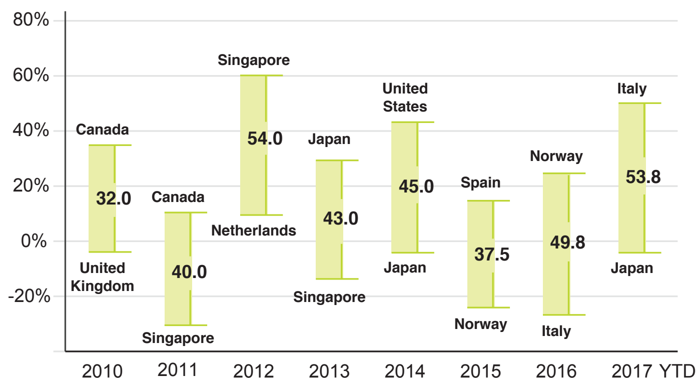
FTSE EPRA NAREIT developed index country and sectors

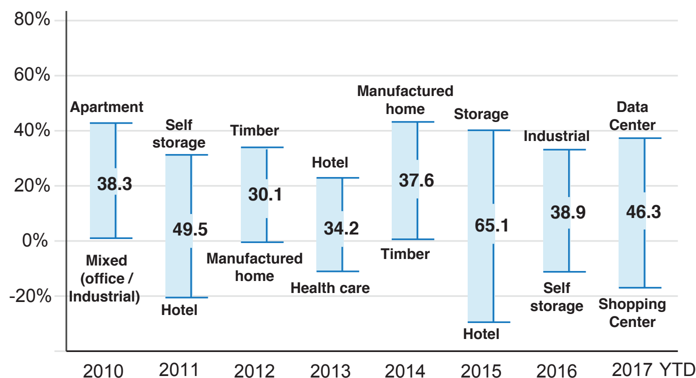


Source: Factset. FTSE EPRA NAREIT Developed Index country and sectors as of 31 December 2017.

Global REIT returns show strong evidence of mean reversion. As the chart below shows, often sectors or countries that were the poorest performers the year before, quickly rebound to be the top performers the next year. Allocating capital to undervalued real estate sectors and/or countries generally results in strong returns the following year. This characteristic of global REIT investing rewards a disciplined investment strategy predicated on valuation and patience.

Annual global real estate returns dispersion





Source: Morningstar, Cohen & Steers.
Data quoted represents past performance, which is no guarantee of future results. The information presented above does not reflect the performance of any fund or account managed or serviced by Cohen & Steers, and there is no guarantee that investors will experience the type of performance reflected above. Property sector returns based on FTSE NAREIT Equity REIT Index. Country returns based on FTSE EPRA/NAREIT Developed Real Estate Index. As at August 31, 2017.

Starlight Capital approach

At Starlight Capital, our goal is to add value by concentrating our investments into high quality REITs with several 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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