

## **Real Returns in Real Estate**

### *Closing in on REITs During Periods of Inflation*

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#### **Introduction**

The research team at North Star has been thoroughly analyzing the small-cap Real Estate sector. As we outline in this paper, we believe the small-cap Real Estate sector offers attractive potential total returns relative to other small-cap sectors during periods of above-trend inflation. Our conviction in this asset class is reinforced by the compelling ratios of tangible assets – land in particular – relative to enterprise values. Such tangible assets may maintain value in the event of economic downturns, consistent with our analysis below.

The small cap Real Estate sector consists of 77% Real Estate Investment Trusts, or REITs, and 23% Real Estate Management and Development businesses. There are three categories of Real Estate Investment Trusts, or REITs: 1) public securities that trade like a stock on major exchanges but directly invest in real estate, 2) public Non-Listed REITs that are listed with the SEC but do not trade on an exchange and may be illiquid, and 3) private REITs that are exempt from SEC registration, whose shares do not trade on national exchange and are highly illiquid. In general, REITs receive special tax considerations and may offer investors high yields.<sup>1</sup> The small-cap Real Estate Management and Development universe consists of companies providing real estate services, as well as real estate technology, transaction brokering, land development, space sharing, and home flipping companies that market to individuals and businesses. As REITs make up the majority of the sector, this paper will focus on that subsector.

#### **North Star's Small-Cap Real Estate Screen**

There are approximately 120 U.S.-domiciled real estate companies that are publicly traded and have equity market capitalizations between \$100 million and \$2.5 billion. Within this group, only 11 companies fit North Star's screening parameters for attractively valued micro-cap stocks, and 17 companies populate when screening for attractively valued small-cap dividend paying stocks (as of 09/30/2022). The quantitative screen North Star uses for its micro-cap value strategy is market capitalizations below \$1 billion and price-to-earnings ratios less than 12. North Star's small-cap dividend strategy screens for companies with market capitalizations below \$2.5 billion, price-to-earnings ratios less than 20, and dividend yields above 3%. In general, real estate dividend yields tend to be higher than yields in other sectors largely because Real Estate Investment Trusts (REITs) must pay out a high percentage of their profits in order to maintain their legal status as REITs.

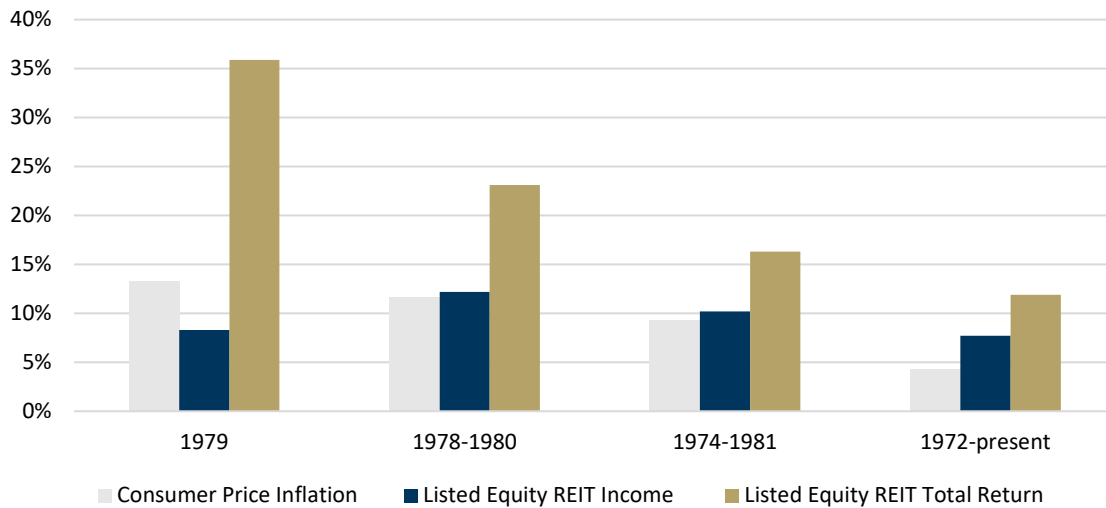
Small-cap REIT companies make up approximately 77% of the publicly traded small cap real estate universe with 92 equities populating when searching for real estate companies that have market capitalizations between \$100 million and \$2.5 billion (as of 9/30/2022). As the subsector name suggests, these are REIT (Real Estate Investment Trust) businesses that own and operate real estate in a trust manner that require 90% of taxable income to be distributed to shareholders. Small-cap REITs operate across property types including offices, retail space, hotels, healthcare facilities, industrial warehouses and distribution centers, and residential real estate. Within this group, value-oriented opportunities tend to be relatively abundant as REITs typically have stable cash flows that come from tangible properties, though ongoing trends have proven disruptive to several subsectors.

**Real Estate Stocks May Exhibit Attractive Returns During Above-Trend Inflationary Periods**

While the widely followed inflation statistic Consumer Price Index (CPI) trended at an annual average of 2.1% from 2000 through 2020, CPI accelerated to 7.0% in 2021 and was 8.3% in the month of September 2022.<sup>ii</sup> Therefore, it is imperative to consider investment opportunities with regard to investment performance potential in similar times of higher-than-trend inflation.

One compelling statistic occurred in the period of 1974 through 1981 where Listed Equity REIT total return exceeded inflation by more than 5% (see below). U.S. inflation averaged 10.7% during those years; this average was much higher than the preceding 10-year period when inflation averaged just 6.9% and was higher than the succeeding 10 years that averaged 3.3%.<sup>iii</sup> It is also worth noting when inflation averaged 11.3% in 1979 – one of the highest annual readings in the past 50 years – Listed Equity REITs provided returns more than 20% beyond inflation. This data suggests that Listed Equity REITs may perform in excess of inflation rates when such rates outpace longer-term trends.

**Listed Equity REIT Income and Total Returns Compared to Inflation**



Source: National Association of Real Estate Investment Trusts

### Certain Valuation Measures Suggest Relative Downside Protection

In an inflationary environment, some believe it is beneficial for companies to have assets that may protect against decreased purchasing power. As shown above, REITs have historically been an asset class that provides such protection. The success rate seen by REITs total return is influenced by several factors, one of which may be the land and properties owned by real estate companies which, as of 06/30/2022, had a PPE/enterprise value ratio of 0.71 while all other small-cap sectors excluding energy and utilities have a value less than 0.33. In the event of an economic downturn or inflationary period, these tangible assets may retain more residual value than intangible assets.

Small-Cap Sector Index	Tangible Book Value / Enterprise Value Ratio	Property Plant & Equipment / Enterprise Value Ratio
REITs	0.47	0.71
Technology	0.12	0.08
Health Care	0.96	0.11
Communications	0.02	0.25
Consumer Discretionary	0.11	0.23
Consumer Staples	0.05	0.18
Basic Materials	0.30	0.32
Industrials	0.13	0.21
Energy	0.36	0.59
Utilities	0.16	0.63

Source: FactSet

### REITs with Shorter Lease Durations May Outperform in an Inflationary Environment

Lease durations vary across REITs based primarily on the type of property under management and the tenant. These durations can be greater than ten years on the long end with large businesses as tenants, or less than a week on the short end, such as with individuals booking a hotel stay.<sup>iv</sup> Typically, shorter lease durations can generate higher volatility of revenue and earnings due to heightened exposure to the cyclical nature of the economy. However, REITs with shorter lease durations, by design, are more adaptable to unexpected and persistent periods of inflation compared to long-duration leases. Shorter lease durations allow for pricing increases in a timely manner. In contrast, longer leases may cause REITs to absorb margin compression due to inflation until the lease comes up for renegotiation. Therefore, small-cap REITs with business models that emphasize short-term leases may be more successful during inflationary periods than those with long-term leases.

Recent historical return data shows that the hotel and lodging sub-sector has been the best-performing small-cap REIT sub-sector in the year since a non-transitory period of inflation began getting priced into the financial markets<sup>v</sup>, as it is the only REIT sub-sector to outperform the Russell 2000 by over ten percentage points in that period. Hotel and lodging REITs are required to have a third party operate their properties, but typically collect rents as a portion of the revenue generated by leased locations. This lease structure enables hotel and lodging REITs to immediately offset inflationary costs as hotels can change room and food prices daily, thus passing on the costs to the customer and potentially maintaining profit margins.

REIT Type	Typical Lease Duration	Triple-Net	1-Year Stock Price Return	1-Year Total Return
Hotel & Lodging	1-7 days	No	-7.01%	-6.21%
Residential	1 year	No	-17.16%	-14.72%
Office	5-7 years	No	-21.90%	-17.21%
Retail	5-10+ years	Yes	-15.21%	-11.12%
Industrial	5-10+ years	Yes	-28.14%	-25.29%
Health Care	10-15+ years	Yes	-17.29%	-11.53%
Russell 2000 Index	-	-	-19.60%	-18.48%

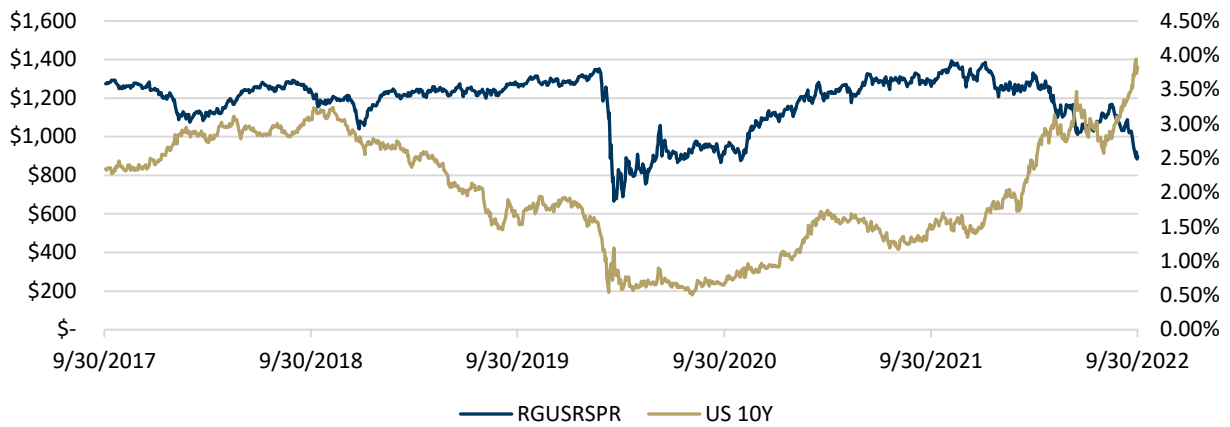
Source: Bloomberg

Conversely, while REIT sub-sectors with long lease durations or “triple net” leases could be expected to underperform during inflationary periods, they could be more likely to outperform in periods of stable or low inflation. Longer-term return data of the Industrial and Health Care sectors REITs were two of the three REIT sub-sectors with positive total returns over a five-year period where low inflation was persistent (January 2017- March 2021<sup>v</sup>). Additionally, investors should not ignore the counterparty risks for REITs, particularly with companies that utilize long-duration leases and have a concentrated customer base. Failures from tenants to meet lease liabilities may undermine the stability characterized by a long-term agreement. The health care sub-sector has provided some examples of this risk in recent years with REITs such as **Medical Properties Trust (MPW)** experiencing payment issues from their largest occupants.<sup>vi</sup>

**Medium Term Influence of Interest Rates**

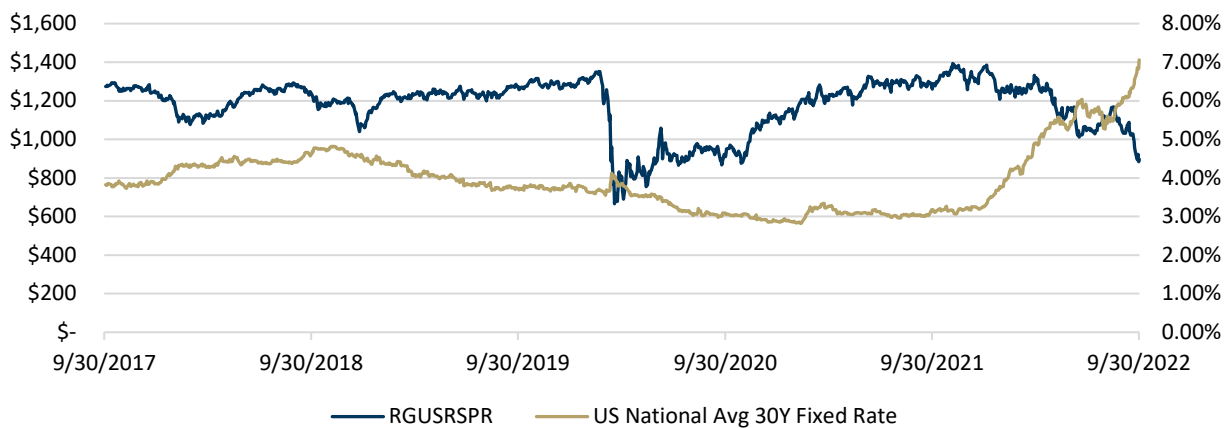
Whereas this paper has demonstrated REITs generally perform well during periods of above average interest rates, rising interest rates in the medium term can be prove to be a headwind. As shown below, excluding the Covid-intense period from early 2020 through late 2021, the performance of Russell 2000 Real Estate Sector Index has been inversely correlated with the benchmark 10-Year U.S. Treasury Rate. The 10-year U.S. Treasury Rate in turn is directly correlated to the U.S. Home Mortgage 30-Year Fixed National Average rate; when this important mortgage interest rate rises, borrowing costs rise and when this rate declines, borrowing costs fall. As such, borrowers can afford higher-priced real estate properties at lower interest rates, driving real estate values higher. On the other hand, under higher prevailing interest rates, real estate values decline because borrower cost of funds rise.

**Russell 2000 Real Estate Sector Index (RGUSRSPR) vs  
US 10Y Treasury Rate**



Source: Bloomberg

**Russell 2000 Real Estate Sector Index (RGUSRSPR) vs  
Bankrate.com US Home Mortgage 30Y Fixed National Average**



Source: Bloomberg

### **Related Home Builder Case Study**

Whereas REITs own and operate properties, we also believe that homebuilder stocks – or the companies who construct these properties – make up a fascinating and dynamic subindustry. Texas-based **Green Brick Partners Inc (GRBK)** buys land and develops communities in the Southern and Southeastern regions of the U.S. An interesting development over the last decade is that most homebuilders have transitioned to an asset light model.<sup>vii</sup> In this business model, the home builders do not purchase land prior to development and therefore may have less downside protection provided by the scarce resource of land. GRBK, on the other hand, owns its land and lots. This strategy, combined with a pristine debt-to-capital ratio of 0.27 (as of 09/30/2022)<sup>v</sup>, makes Green Brick stand out from its peers. Once its homes are built, Green Brick has a team of sophisticated real estate experts who have deep ties to, and an intricate knowledge of, their core markets.

### **An Attractive, Niche Small-Cap REIT**

As mentioned earlier in the paper, we typically consider significant customer concentration to be a red flag. **Postal Realty Trust (PSTL)**, on the other hand, has a unique advantage as its primary customer is the United States Postal Service (USPS). A few months ago, Postal reform was passed by US Congress<sup>viii</sup>, and more investment has been made available to strategically grow mail volume for assets such as the ones PSTL owns. Overall, rent is not a significant line item for the USPS<sup>ix</sup> and increasing distribution infrastructure is a principal goal in the Postmaster General's 10-Year plan<sup>x</sup>; as such, PSTL shares could benefit from managing and financing of the planned USPS distribution infrastructure expansion. With a 6.0% dividend yield<sup>v</sup> as of 09/30/2022, we believe PSTL is an intriguing member of the REIT space and well-positioned for the future.

### **Summary**

The small-cap Real Estate universe merits thorough investment analysis particularly in times of elevated inflation. For income-oriented investors, Equity REITs with short duration leases have historically been resilient during periods of inflation and rising interest rates. Additionally, due to the nature of the underlying assets, companies with higher PP&E to enterprise value ratios may provide downside protection in uncertain economic environments. Given the recent turbulence in the global economy, we believe this may be a timely sector.

*The stocks mentioned above may be holdings in the North Star Mutual Funds. For more information, please visit [www.nsinvestfunds.com](http://www.nsinvestfunds.com).*

**Contact Information**

Please contact us at [info@nsinvest.com](mailto:info@nsinvest.com) if you would like to discuss the North Star funds, strategies, and investment research.

**Investors should carefully consider the investment objectives, risks, charges, and expenses of the North Star Funds. This and other important information about each of the Funds are contained in the prospectus, which can be obtained at [www.nsinvestfunds.com](http://www.nsinvestfunds.com) or by calling (855) 580-0900. The prospectus should be read carefully before investing. The North Star Funds are distributed by Northern Lights Distributors, LLC member FINRA/SIPC. Northern Lights Distributors, LLC and North Star Investment Management are not affiliated. 7223-NLD-12022022**

**Important Risk Information**

Mutual funds have investment risks including loss of principal. There is no guarantee either fund will meet its objective. No-load mutual funds are sold without sales charge; however, they have ongoing expenses, such as management fees. There is no guarantee that any investment strategy will achieve its objectives, generate profits or avoid losses.

**About North Star Investment Management**

North Star is an employee-owned boutique asset management firm. The North Star Funds, managed by North Star Investment Management Corporation, are part of the North Star Family of Financial Services. North Star is a Chicago-based investment management firm serving individual investors since 2003. The North Star Funds actively invest in undervalued and often overlooked small and micro capitalization companies where our macroeconomic and primary research and analysis indicate a catalyst for growth. We believe in the businesses we own—we have “high conviction” in the securities we select, and typically only hold 40 to 50 names in each portfolio.

*Portfolio Selection – High Conviction, Low Turnover, Risk Management*

- Each fund has a concentrated portfolio of 40 to 50 high conviction names with low turnover averaging 11%
- For risk management, each position is limited to approximately 3.0% of a portfolio
- We overweight the best stocks, but no more than 5% in any one position
- For both SMAs and funds we will nibble and bunt our way into positions by buying a little at a time
- We talk to company management in addition to doing our own primary research
- We have a bullpen of potential stocks to add to our portfolios
- Sell discipline results from a dramatic change in firm strategy, or failure to perform according to business goals.

## Appendix

**Real Estate Investment Trust (REIT):** A REIT is a company dedicated to owning, and in most cases, operating income-producing real estate, such as apartments, shopping centers, offices, and warehouses. Some REITs also engage in financing real estate.

**Russell 2000 Index:** The Russell 2000® Index measures the performance of the small-cap segment of the US equity universe. The Russell 2000® Index is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership.

**Dividend Yield:** The dividend yield is a financial ratio showing the return an investor would earn from an investment based solely on its dividend payments. It is expressed as a percentage and is calculated as (dividend/stock price).

**Triple Net Lease:** In a triple-net lease, in addition to the monthly rent, the tenant pays all costs associated with property operations, maintenance, insurance and taxes. The landlord essentially collects monthly “coupon” payments from the tenant, similar to receiving monthly interest income from having invested in a bond. Source: *The Intelligent REIT Investor*

**Debt to Capital Ratio:** The debt-to-capital ratio is a measurement of a company’s financial leverage, calculated by dividing interest-bearing debt, both short- and long-term liabilities, by total capital, which is all interest bearing debt plus shareholders equity, which may include items such as common stock, preferred stock, and minority interest.

**Consumer Price Index (CPI):** The Consumer Price Index, or CPI, evaluates expenditures of domestic and internationally imported consumer-related services such as food and beverage, housing, apparel, transportation, medical care, recreation, education, communication, and other personal goods.

**Producer Price Index (PPI):** The Producer Price Index (PPI) looks at prices that producers pay and measures changes in the sale prices for the entire domestic market of raw goods and services.

**Property, Plant, and Equipment (PP&E):** PP&E are long-term assets vital to business operations and the long-term financial health of a company. Examples include equipment, machinery, buildings, and vehicles.

### *Definitions provided by Bloomberg LP*

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<sup>i</sup> Investopedia

<sup>ii</sup> Bloomberg Data

<sup>iii</sup> <https://www.usinflationcalculator.com/inflation/historical-inflation-rates/>

<sup>iv</sup> Krewson-Kelly, Stephanie, and R. Brad Thomas. “4,5,7.” *The Intelligent REIT Investor: How to Build Wealth with Real Estate Investment Trusts*, John Wiley Et Sons, Inc, Hoboken, NJ, 2016.

<sup>v</sup> Bloomberg

<sup>vi</sup> Dorsey, Edwin. “More Problems at Medical Properties Trust (MPW).” *The Bear Cave*, 6 Oct. 2022, <https://thebearcave.substack.com/p/more-problems-at-medical-properties>.

<sup>vii</sup> Mackintosh, Drew. “Builders Go ‘Land Light’ in an Effort to Improve Returns.” *Builder*, 16 Mar. 2021, [https://www.builderonline.com/land/builders-go-land-light-in-an-effort-to-improve-returns\\_o](https://www.builderonline.com/land/builders-go-land-light-in-an-effort-to-improve-returns_o).

<sup>viii</sup> “H.R.3076 - 117th Congress (2021-2022): Postal Service Reform Act of 2022.” *Congress.gov*, Library of Congress, 6 April 2022, <https://www.congress.gov/bill/117th-congress/house-bill/3076>.

<sup>ix</sup> [https://www.uspsoig.gov/sites/default/files/document-library-files/2022/FY2023\\_CongressionalBudgetJustification.pdf](https://www.uspsoig.gov/sites/default/files/document-library-files/2022/FY2023_CongressionalBudgetJustification.pdf)

<sup>x</sup> Katz, Eric. “This Is Where USPS Is Building out Its First Mega-Centers This Year.” *Government Executive*, Government Executive, 5 July 2022, <https://www.govexec.com/management/2022/07/see-where-usps-building-out-its-first-mega-centers-year/368961/>.