

Real Estate Investors are Mispricing Risk: Yet One More Reason Why This is a Good Time to Buy Real Estate

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Real estate markets are mispricing risk, systematically undervaluing real estate. Investors who buy now will profit when this mispricing unwinds.

Basic finance theory states that the way in which you finance a venture does not affect its value¹. As debt is added to the financing structure of an asset, risk is divided between debt and equity, but the overall riskiness of the asset remains unchanged.

If we imagine using an asset's cash flow to fill up a bucket of money from bottom to top, in any particular period of time it will always be more likely that the bottom of the bucket will be filled than the top. Lenders wager that a property will produce enough cash flow to fill the bottom of the bucket to pay for debt service—a relatively safe bet. Equity investors bet that there will be money left in the bucket after debt payments have been “drained” from the bottom. The risk that the entire bucket will fill up remains the same regardless of who receives the money; yet, there are two important properties in the relationship between the risk carried by debt and equity holders:

1. The risk that the entire bucket will be filled can be calculated by adding the small risk incurred by the lender to the large risk incurred by the equity investor. Since debt and equity investors demand a return—or yield—on their investment that is commensurate with their level of risk, it follows that the weighted average of the debt and equity yields should approximate the total property yield.
2. The risks to the debt and equity holders are interdependent. The more cash that needs to be drained to make debt payments, the less likely it is that there will be enough cash left over to satisfy equity holders. Imagine draining two dollars from the bottom of the bucket instead of one. When the debt is small, changing its size has only a small effect on the riskiness of the equity cash flow. Now, imagine that the entire equity payment is made up of only the last two dollars in the bucket. Increasing the debt by one dollar in that scenario means that unless the entire bucket is filled, equity holders will receive nothing. That is to say that when the debt is large, small changes in its size have a large effect on the riskiness of the equity payments.

The argument above indicates that knowing the equity yield required by an investor is meaningless unless one knows the amount of debt involved in the investment. However, what we find in practice is that many real estate equity investors demand a fairly constant yield regardless of the amount of leverage on an asset. One typical strategy is for an investor to determine her required return based on the asset class she invests in. The investor then proceeds to find as much financing as possible in as favorable terms as possible. The larger the loan, the more the equity yield gets boosted (given the same expected cash flows). As long as that yield exceeds the required minimum, the investment is made.

The strategy just described has been one of the reasons why prices have plummeted during the credit crunch. During the boom years of 2004 through 2007, senior debt was available that routinely reached loan-to-value (LTV) ratios around 75%. After including mezzanine and/or other junior debt, total indebtedness commonly reached 90% or more. During those years, hotel investors typically looked for equity yields (also known as leveraged discount rates, or cash-on-cash returns) between 19% and 20%. Total property yields (also known as

Summary

Real estate markets are mispricing risk, systematically undervaluing real estate. Investors who buy now will profit when this mispricing unwinds. Historical data and examples are presented to support this statement.

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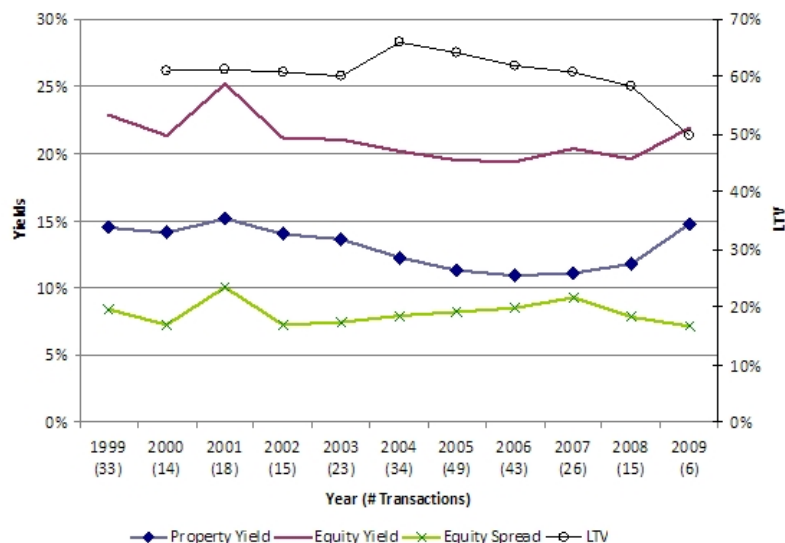
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free and clear discount rates, or unleveraged discount rates) hovered around 11%. Since the third quarter of 2008, debt has become much scarcer. Senior debt now is typically constrained by a 50% LTV (calculated off already much lower values), and junior debt is practically non-existent. Meanwhile, many equity investors are still looking for yields in the “low twenties.” As the following table illustrates, equity yields actually increased in 2009, despite a steep drop in debt financing. As reduced cash flows are forced to pay higher returns, property values have crashed.

Figure 1 Historical Relationship Between Equity Yields and Total Property Yields



Source: HVS (Property and Equity Yields, and Equity Spread); and ACLI (LTVs)

HVS closely tracks transactions of hotels that sell close to the date when they are appraised by the firm. Over the past decade, there were 261 such sales. In these cases, we were able to determine the appropriate equity yield rate by inserting our cash flow projection into a valuation model and adjusting the appraised value to reflect the actual sales price by modifying the return assumptions. The previous chart shows how equity and property yields have trended over the last 10 years. The equity spread represents the difference between the equity yield and the total property yield. The LTV data shown comes from the American Council of Life Insurers (ACLI), and it represents the LTV of new commercial mortgage loans originated by member companies. The trend shown is helpful in understanding the general availability of leverage. However, it understates the extent of the credit crunch for two reasons. First, because the most active and most aggressive real estate lenders during the recent real estate boom were CMBS originators (especially between 2004 and 2007), which are not included in the trendline shown. Second, because it excludes the prevalence of junior debt shops that routinely “topped up” leverage to the 90%+ LTV level during the boom.

What we **should** expect to see on the chart above is the following:

- Property yields that fluctuate as the supply and demand for like assets change; otherwise, relatively stable total property yields, unless there is a fundamental reason why hotels as an asset class suddenly become more or less risky.
- Equity yields that move in the same direction as LTVs. Particularly, when LTVs are high, small changes in LTVs should result in comparatively large changes in equity yields.
- Equity spreads that move in the same direction as LTVs. That is to say that as debt disappears from an asset’s capital structure, the equity spread should approach zero, and the equity yield should converge toward the total property yield.

What we **do** see on the chart is the following:

- Relatively stable total property yields, except for an upward spike in 2001. Our investor feedback suggests that by late 2000 market players figured there was little upside to cash flow growth and adjusted their yields

