Looking beyond dividend yield when investing in REITs

Investors should perform a holistic assessment of a Reit’s overall return, and exercise prudence in diversifying across asset classes.

Real estate investment trusts (Reits) are characterised by their low volatility and stable returns. Their ability to generate relatively consistent dividends through economic cycles has made them a preferred asset class amid economic uncertainty. However, is dividend yield the only factor to consider when deciding on which Reit to invest in? What are the other factors that determine the quality of a Reit?

Income support provided by the Reit sponsor
Income support is an arrangement where the Reit sponsor assists in topping up for any difference between the desired rental income and the actual rental income derived for a stipulated period of time. Income support cushions the yield of the Reit by providing short-term boost to support yield. It is most commonly applied when a Reit has an asset that is currently in its initial post-completion phase and is in the process of securing new tenants to reach its potential, or when the asset is undergoing asset enhancement works. It is not meant as a long-term solution, and there is always a risk that the Reit may not be able to achieve the expected rental income when this income support is withdrawn in the future, resulting in a sudden decline in dividend yield.

While the intention of income support is to provide stability for short-term returns, it could possibly be employed as a financial engineering tool to inflate short-term yields. Investors can assess the reasons and extent of income support provided as disclosed in the prospectus prior to investing.

In 2015, the Monetary Authority of Singapore (MAS) contemplated on the effectiveness of relying solely on disclosure to impose market discipline, and whether additional regulatory measures should be employed when necessary. Following the consultation period, MAS eventually decided against additional regulatory measures. Probable reasons could be the challenge of effectively implementing this regulation due to low comparability across individual real estate assets to determine the true asset yield, and difficulty in assessing the intent of income support.

The benefits of providing financial support have been assessed to outweigh the costs of negative rental reversion when income support ends. Therefore, investors should perform due diligence to understand the extent and period of the income support, and exercise professional judgement when assessing the true yield of a Reit.

Assessing the potential for inorganic growth
1. Extent of leverage: Leverage – defined as the debt-to-asset ratio – provides an indication of the Reit’s ability to perform yield accretive acquisitions. As the cost of debt is usually cheaper than the cost of equity, a low ratio indicates that the Reit has the capacity to undertake additional borrowings at a lower cost of capital, which is likely to result in yield accretive acquisitions.

2. Potential pipeline from a sponsor: Besides understanding the financial ability of a Reit to under-take acquisitions, it is important to assess the Reit’s potential pipeline. A strong sponsor can give a Reit access to high quality assets through a robust pipeline of asset injections into the Reit. While asset quality tends to have an inverse relationship with dividend yield, having a strong pipeline enhances shareholders’ returns through effective asset recycling and the Reit’s ability to have a first right of refusal to buy those assets.

Diversifying properties into the Reit offers benefits to both parties – it allows the sponsor to offload capital-intensive assets, effectively maintaining a lighter balance sheet, and get to retain management control of the property and earn recurring management income as Reit manager. It also offers growth opportunities to the Reit.

Understanding the impact of asset tenures and loan types on yield
1. Loan types and volatility of interest expenses: The type of loan determines the volatility of interest expense. Interest rates of a short-term variable loan is usually lower than a long-term fixed rate loan (assuming a non-recessionary environment). However, a short-term variable loan is also more susceptible to rising interest rates when the loan is refinanced. Investors should understand the risk profile of the Reit’s capital structure when assessing the sustainability of existing interest rates.

2. Asset tenures and its impact on yield: With all other factors being equal, the dividend yield of a leasehold property should be higher than a freehold property. Investors should expect higher dividend yield for a Reit consisting of properties with shorter remaining lease term, as higher yield takes into consideration the effects of lease decay.

Extent of diversification across geographies and asset classes
1. Geographical diversification: Increasingly, Singapore Reits (S-REIT’s) have been expanding overseas in the pursuit of diversification and higher yield. A paper published by KPMG titled “Singapore – A Global Hub for REIT Listings” in July 2019 reported that 80 per cent of S-REITs have some, or all, of their properties outside Singapore.

With higher prevalence of S-REITs owning overseas assets, investors should take into account the effects of geographical diversification in optimising a portfolio’s risk-reward profile. Different jurisdictions carry different levels of risks. Higher returns may be a result of higher risks associated with the specific country which the Reit operates in.

2. Diversification across asset classes: After assessing the abovementioned points, an investor should consider the proportion of Reits allocated to their overall portfolio to optimise their risk-reward profile.

As evident, there are numerous factors including the presence of income support, potential for inorganic growth, asset and loan tenures and the extent of portfolio diversification, which go beyond dividend yield. While there are opportunities for investors to gain competitive returns through Reits in this volatile economic environment, investors should perform a holistic assessment of the Reit’s overall return and exercise prudence in diversifying across asset classes.

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