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Long-Term Wealth Creation in REITs: Yielders vs Growers

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In the realm of real estate investment, the pursuit of consistent and growing income streams is a fundamental objective for many investors. REITs emerged as a popular avenue for investors seeking reliable dividends, and the strategy of chasing dividend yield has gained significant traction. The appeal mainly lies in the promise of high and regular payouts, surpassing those offered by more traditional investments. However, it is essential to tread cautiously, as the pursuit of dividend yield in REITs carries its own set of risks and challenges and proves to be a poor indicator of overall total returns. We will expand further on this in the article.

In its simplest form, REITs were first designed as flow-through vehicles that grant investors access to income-generating real estate. Investors could access high-quality assets without needing large capital reserves. They could benefit from higher liquidity in their investments, qualified and experienced management and diversification benefits that direct property investment struggles to offer.

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The leases that underpin the portfolio lock in tenants for extended periods with fixed or indexed-linked escalators, giving REITs their bond-equity characteristics. This creates a foundation of stable and predictable cash flows mandated by law to be distributed as dividends to investors. It is a key attraction for investors looking to structure their portfolio around passive income. However, it can sometimes lead to a misconception that higher-yielding REITs offer a ’bigger bang for your buck’.

We believe that if your primary objective is to generate strong total risk-adjusted returns on your investment, then REITs that adopt sustainable practices to grow their earnings or dividends over the long-term is a more rewarding strategy.

Higher yielding REITs are likely to be associated with some form of business- or sector-specific risk that leads the market to believe that what the REIT has to offer in the short-term could unlikely be there in the longer-term. Increased probability of financial distress, structural sector trends driving away demand, or poor capital allocation to maintenance or accretive acquisitions are a few reasons that can lead to a decline in profitability or cash flow.

This risk of lower cash flow in the future will need to be compensated by higher returns in the shorter term. Due to the widespread understanding that these REITs are unlikely to generate attractive growth over the long-term, the market reprices them leading to a higher dividend yield.

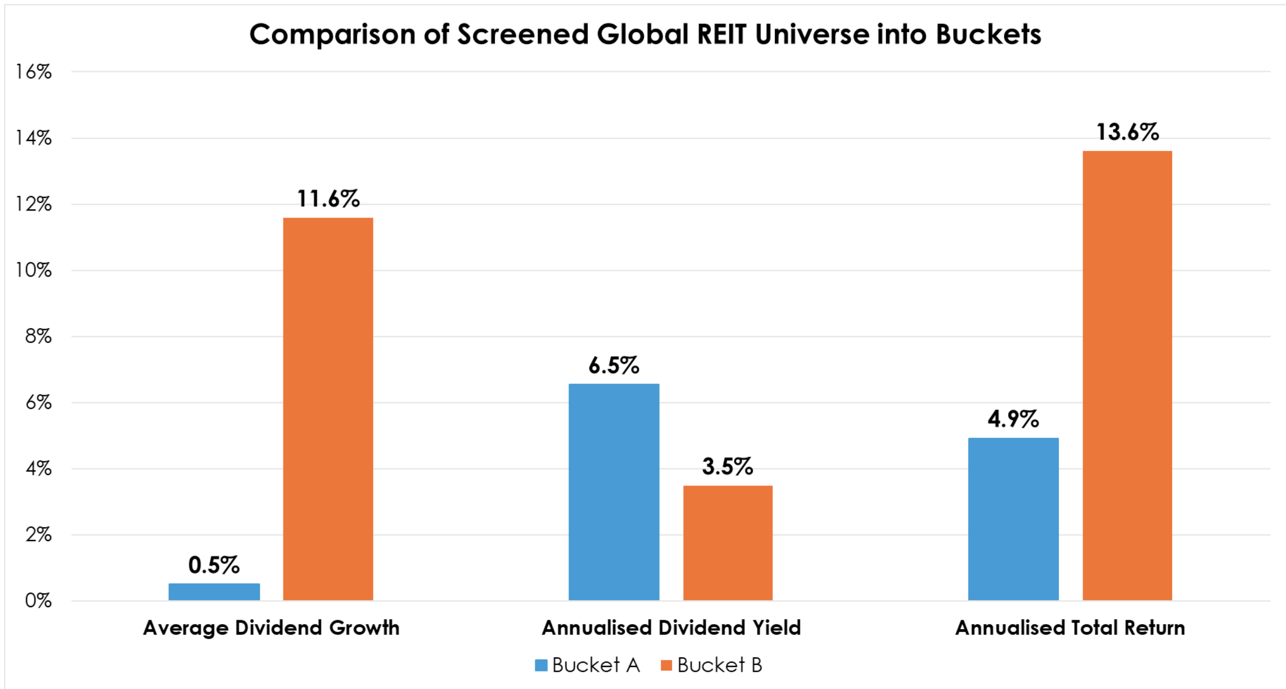
A high dividend yield may give the impression that a REIT is relatively cheap/undervalued, particularly if it trades at a higher level than it has done historically or in relation to its peers however, it often represents increased risk within the company or sector.

To substantiate our argument, an exercise was undertaken that involved screening the entire global REIT universe by some simple selection criteria and historical data consisting of *dividend growth*, *dividend yield* and *total return*. A 10 year-period was chosen to help illustrate the long-term impacts that dividend growth and dividend yield have on total return. The criteria required that all counters 1) be classified as a REIT, 2) have a current market cap greater than USD1bn and 3) have paid a full dividend in 2023.

The process returned 159 REITs. The top 30 REITs with the highest average dividend yield over the period were placed into Bucket A (Dividend Yielders). The top 30 REITs with the highest annualised dividend growth were placed into Bucket B (Dividend Growers).

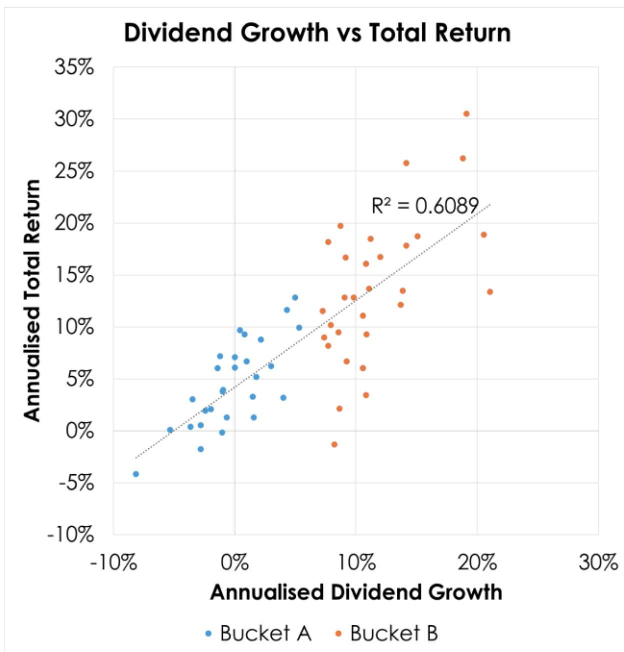
All metrics were calculated in the relevant local currencies to avoid the impact of currency fluctuations over the period and illustrate the relationships between dividend growth, dividend yield and total return within their geographies.

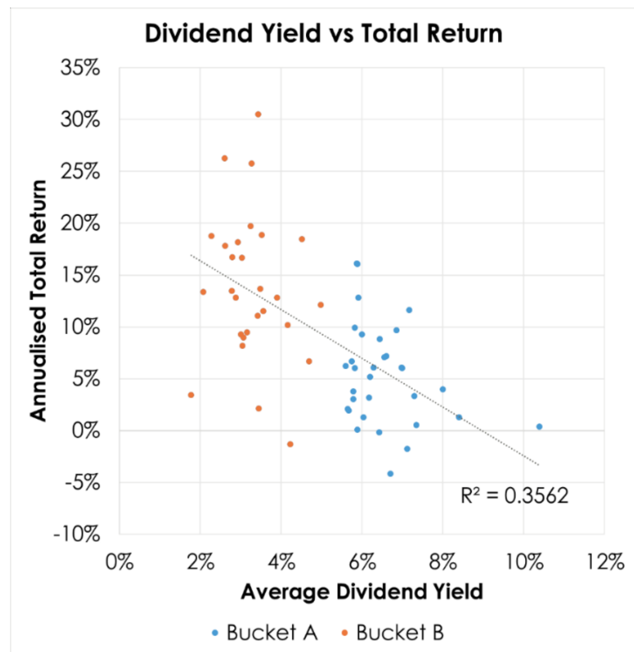
From examining the chart below one can see that the average total return from counters in Bucket B offers a more attractive total return over the last 10 years than counters in Bucket A by a large margin despite having a substantially lower dividend yield. This aligns with our narrative that high sustainable dividend growth may be accompanied by less risky, lower yielding investments but are expected to deliver better total returns to investors.



Source: Refinitiv, Reitway Global

A clear pattern is displayed when breaking down these buckets into their constituents and the data sets are combined to measure their total return against both dividend growth and dividend yield. The REITs selected based on dividend yield returned relatively underwhelming dividend growth and is aligned with the higher risk in lower future growth mentioned earlier. Similarly, the REITs that were selected based on dividend growth (Bucket B) typically had far lower dividend yields, as the market was willing to sacrifice a higher initial yield for long-term growth on investment.





Source: Refinitiv, Reitway Global

While these patterns can be observed, both variables' explanatory power on total return differ. Dividend growth proves to be a stronger explanatory variable of total return in REITs, while dividend yield is rather weak. In the pursuit of delivering higher total returns, placing focus on REITs that have a high propensity for dividend growth has a greater chance of excess returns in the long-term than a strategy pivoting around high-yielding, “cheap” REITs.

This exercise may adopt some form of hindsight bias as strong long-term dividend growth cannot be viewed currently and is challenging to predict with laser-point accuracy. In contrast, the dividend yield for any stock can be interpreted at present. However, when analysing a stock with a high dividend yield, a similar forecasting process needs to be adopted to determine whether the REIT is truly undervalued. The risk-profile needs to be understood to identify whether the market has overreacted, and whether the REIT still can sustainably grow its future cashflows and see a positive repricing.

The choice then becomes one of selecting reasonably priced REITs with a high propensity to grow their future cash flows or selecting cheaply priced REITs with have a lower likelihood of facing a decline in cash flow. Depending on which side of the spectrum you sit on, the latter carries a greater risk of losses than the former and, as illustrated, does not deliver the long-term returns that many investors are looking for.

A trade-off of immediate income gains for long-term total return is difficult yet necessary. Placing focus on REITs with bolstered balance sheets, a track record of accretive capital allocation, sustainable maintenance capex funding, aligned management compensation and favourable pricing power creates **a recipe for sustainable cash flow generation.**

Conclusion

Warren Buffet said it best: “It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price”.

Investing, indeed, is a marathon rather than a sprint. Opting for the allure of a "wonderful price" for a mediocre or risky company might seem tempting in the short term. Still, the real reward lies in identifying and investing in outstanding companies, even if they come at a fair valuation. The quality of the company, its management, and its long-term growth potential ultimately drives sustained success in the investment game.

While the prospect of selecting low-yielding, seemingly "low-risk" REITs may appear less exciting, *especially in a market driven by higher-yield temptations*, it transforms into a rewarding strategy when grounded in businesses that prioritise sustainable practices for growing their cash flows**.** The seemingly "boring" game of investing in such companies becomes a cornerstone of stability and resilience, aligning with the principles of prudent, long-term wealth creation.

Glacier Research would like to thank James Tucker for contributing to this week's *Funds on Friday.*

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James graduated his studies at the University of Cape Town where he qualified with an honours degree in B.Sc. Property Studies (with distinction) where shortly after he enrolled and graduated with a B.Com. Financial Analysis and Portfolio Management (with distinction) in order to combine his interest in real estate with finance.

During his final year studies, he gained property valuation experience working with for De Leeuw Valuers conducting assisted property valuations and reports.

He went on to become a REIT analyst at Metope Investment Managers for two years where he covered the South African listed real estate universe.

In pursuing his interest in finance, James aims to become a CFA charterholder and recently passed the CFA level II exam in the top 10% of participants.