THE BENEFITS OF LEVERAGE: A REAL ESTATE PERSPECTIVE

One of the greatest advantages of investing in real estate is the ability to use leverage. In simple terms, leverage provides investors with the opportunity to achieve enhanced returns compared to when leverage is not used.

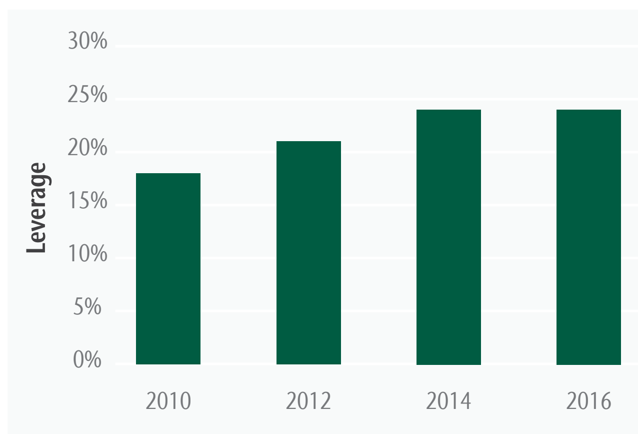
This article discusses why prudently managed leverage, particularly as it relates to real estate, allows investors to put existing resources and investment opportunities to good use, rather than earning lower returns by avoiding the use of leverage.

Meeting a Lower Return Challenge

In response to lower expected returns, institutional investors have enthusiastically embraced alternative investments, such as real estate, infrastructure, private equity and hedge funds to enhance returns. For example, in the current environment, alternatives represent, on average, 31%[1] of total public sector pension assets.

Alternative strategies often come as a packaged deal of illiquidity and leverage. Investors can be particularly cautious about the use of leverage, despite the benefits. However, a recent study of Canada's public pension plans[2] noted that leverage provides an important tool to help offset lower interest rates with the aggregate overall portfolio leverage of the largest six funds having increased from 18% to 24% since 2010 (Figure 1).

Figure 1 – Public Pension Plans Turn to Leverage to Offset Lower Interest Rates



Source: Moody's Investors Services

The level of leverage for individual strategies or asset classes may be much higher.

The ability to use leverage makes real estate an attractive investment. If not for leverage, most of us would not be able to afford the homes in which we live. For institutional investors, the prudent use of leverage provides a strategic tool to gain broader exposure to different types and a greater number of investments compared to having no leverage, thereby enhancing portfolio diversification and ultimately achieving higher returns.

[1] Greenwich Associates, Canadian Institutional Investors 2018

[2] Moody's Investor Services: Canada – Public Pensions Managers, 2 October 2017. Pension plans included in the sample were CPPIB, PSIB, CDPQ, OTTP, OMERS and HOOP.

Risk Management

Regardless of the asset class, all investment strategies have an element of risk. It cannot be avoided, therefore the key is ensuring there are processes in place to identify, measure, and manage it, and where possible, mitigate it.

For real estate, while the primary sources of risk are investment related, other sources include:

- **Execution:** the depth of team experience, effectiveness of the due diligence process; and
- **Operational:** formality and consistency of the approval process, effectiveness of policies and procedures and oversight of third parties.

The components of investment risk include the underlying investment strategy (core, core plus, value add, opportunistic), the fund structure (open vs. closed-end, direct vs. listed) and diversification (property type, geographic, lease expiry, and tenant).

The use of leverage is a somewhat unique aspect of real estate that potentially introduces another source of risk into the investment equation. There are a variety of tools to help minimize the impact of leverage. The major risks and associated mitigation approaches are summarized in Figure 2.

Figure 2 – Leverage Risk Mitigation

SOURCE OF RISK	RISK MITIGATION
Amount of Leverage	Set range at portfolio level
Interest Rate	Fixed rate debt vs. floating rate Long-term vs. short-term financing
Debt and Valuation	Non-recourse debt Marked-to-market valuation
Lease Expiry and Mortgage Maturity	Extend and synchronize lease and mortgage expiries

Source: Connor, Clark & Lunn Financial Group

The amount of leverage varies depending on the strategy. Typically, "core" funds have 10% – 30% leverage, while "core plus" funds are approximately 50% leveraged and opportunistic funds may have in excess of 60% leverage. Regardless, all funds can present returns both including and excluding the impact of leverage. Non-leveraged returns allow for the real estate manager's portfolio management skill to be assessed on a like-for-like basis, while total returns identify the contribution from leverage.

There is a tendency to equate leverage with greater risk. However, the majority of risk can be mitigated by managing leverage at both the portfolio and individual asset level. At the portfolio level, there is typically a stated range within which the manager will operate.

The actual level of leverage reflects the economic environment, specifically the relationship or differential between overall yields and property capitalization (cap) rates. The cap rate relates to the ratio of a property's net operating income (NOI) to market value. Investors' concerns tend to focus on the arithmetic showing that rising interest rates result in increasing cap rates and, all else being equal, declining property values.

However, if the driver of increasing interest rates is inflation, the higher rates can lead to increases in rental payments over time. The result will be a growth in the NOI, which can offset the negative impact of increasing cap rates on property values.

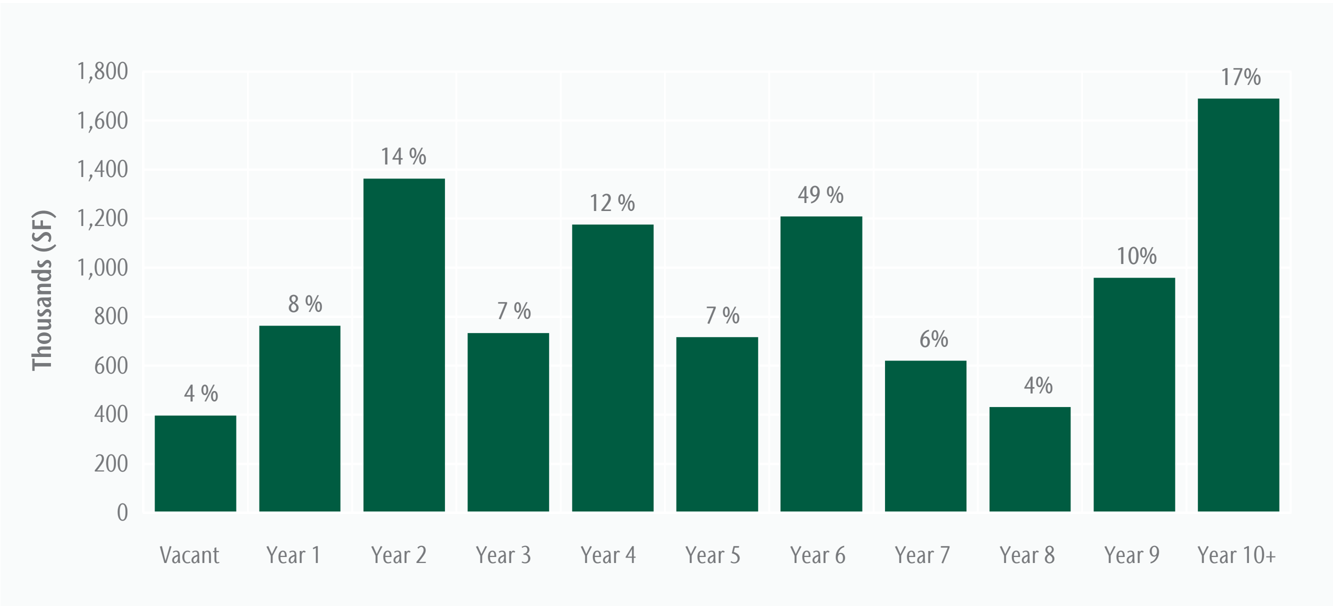
Another risk mitigation practice is arranging fixed rate rather than floating rate debt and putting in place longer-term as opposed to shorter-term debt financing. For example, Connor Clark & Lunn Financial Group's commercial real estate investment manager, Crestpoint Real Estate Investments Ltd., has a weighted average term to maturity of 5.4 years with a weighted average fixed interest rate of 3.7% and a debt service coverage ratio of 2.0 times[4].

Other risk management practices include limiting recourse to individual real estate assets and valuing mortgage debt on a marked-to-market basis, which helps to capture the impact of the differential between market interest rates and contractual interest rates.

[4] At December 31, 2018

The risk management function also typically marries macro and micro variables, such as tenant and industry concentration, physical issues (building age and capex requirements), and the most critical variable, lease expiry. Ensuring a portfolio is constructed to avoid any significant lease expiry exposure to any given year is another form of risk management. Figure 3 provides an illustration for how Crestpoint extends its lease expirations. The weighted average lease term was 5.3 years.

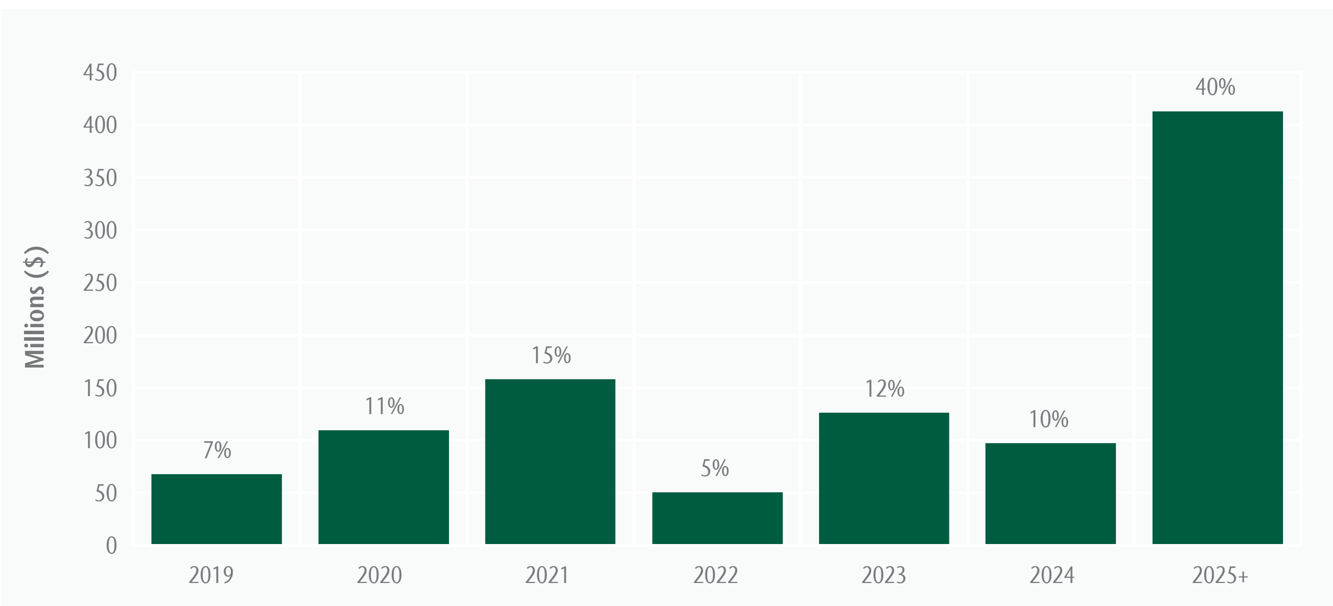
Figure 3 – Lease Expiration (as at December 31, 2018)



Source: Connor, Clark & Lunn Financial Group

Similarly, extending the weighted average maturity of the mortgages mitigates interest rate risk and mortgage renewal exposure, by matching mortgage terms with lease terms where possible. Figure 4 shows the mortgage expiration for the Crestpoint portfolio, which on average stood at +/-5.4 years.

Figure 4 – Mortgage Expiration (as at December 31, 2018)



Source: Connor, Clark & Lunn Financial Group

While leverage increases the refinancing dollar risk, the balance of a particular loan is typically partially paid down (amortized) during its term prior to the need to be refinanced. It will therefore generally represent a smaller component of the portfolio compared to the initial financing which ultimately results in a lower loan to value ratio, all other things being equal.

Past Experience

The global financial crisis of 2008/2009 saw liquidity dry up in most markets. While this was also a challenging time for real estate managers to obtain refinancing, one leading Canadian lender indicated that it was able to meet real estate investor's needs during these difficult times.

What matters to most investors is how well a fund performs in difficult environments. Analysis of the performance of Canadian real estate open-ended pooled funds during the crisis reveals relative performance was driven by the quality of the real estate portfolio and not the use of leverage.

The returns for the three major real estate pooled funds operating during the financial crisis are summarized in Figure 5. Returns are shown for the 4-year period ending December 31, 2011 and the individual calendar years, thereby capturing performance before, during and following the financial crisis. The analysis supports the notion that prudent use of leverage provides a strategic tool to enhance both portfolio diversification and returns, as the managers who incorporated leverage performed much stronger than the manager that had a policy of no leverage.

Figure 5 – Canadian Real Estate Pooled Performance

					Periods Ended December 31, 2011			
	2008 (%)	2009 (%)	2010 (%)	2011 (%)	1 Year (% pa)	2 Year (% pa)	3 Year (% pa)	4 Year (% pa)
Fund A: Uses Leverage	-0.5	1.6	4.8	16.6	16.6	10.6	7.5	5.4
Fund B: Uses Leverage	9.7	-1.6	8.5	13.7	13.7	11.1	6.7	7.4
Fund C: No Leverage Policy	2.9	-7.2	9.2	11.6	11.6	10.4	4.2	3.8

Source: Mercer Pooled Fund Survey, December 31, 2011.

Take Advantage of the Benefits of Leverage

There is a tendency to equate leverage with greater risk. However, the majority of risk can be mitigated, particularly as it relates to real estate. Instead, prudently-managed leverage provides a strategic advantage for real estate investors to obtain greater access to capital, improve portfolio diversification and ultimately to enhance returns in a yield challenged environment.

Connor, Clark & Lunn Financial Group's Strategic Exchange is an initiative to promote dialogue, understanding and the development of solutions to the often complex investment challenges faced by institutional investors.

Under the direction of Peter Muldowney, SVP Institutional Strategy, we bring together investors and consultants in a variety of interactive, educational forums. We also produce thought pieces addressing issues that are top of mind to those involved in managing and overseeing various asset pools.

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