The Benefits of Leverage:

A Real Estate Perspective

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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.

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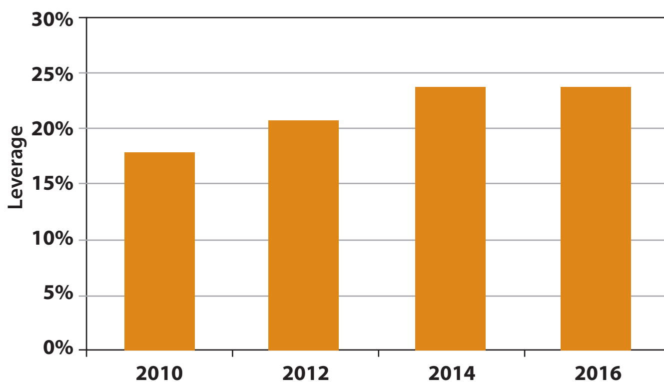
This article discusses why prudently managed leverage, particularly as it relates to real estate, allows investors to put existing resources and investment opportunities to good use, rather than earning lower returns by avoiding the use of leverage.

Lower Return Challenge

In response to lower expected returns, while being mindful of return volatility, institutional investors have enthusiastically embraced alternative investments, such as real estate, infrastructure, private equity, and hedge funds to enhance returns. In the current environment,

Figure 1

PUBLIC PENSION PLANS TURN TO LEVERAGE TO OFFSET LOWER INTEREST RATES



Source: Moody's Investors Services.

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 expires

Source: Connor, Clark & Lunn Financial Group.

alternatives represent, on average, 32 per cent[1] of total corporate and public sector pension assets.

Alternative strategies often come as a packaged deal of illiquidity and leverage. Investors can be 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 per cent to 24 per cent since 2010 (See *Figure 1*).

The level of leverage for individual strategies or asset classes may be much higher. For example, OMERS' latest annual report[3] suggests real estate investments were approximately 50 per cent leveraged.

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, manage, and, where possible, mitigate it.

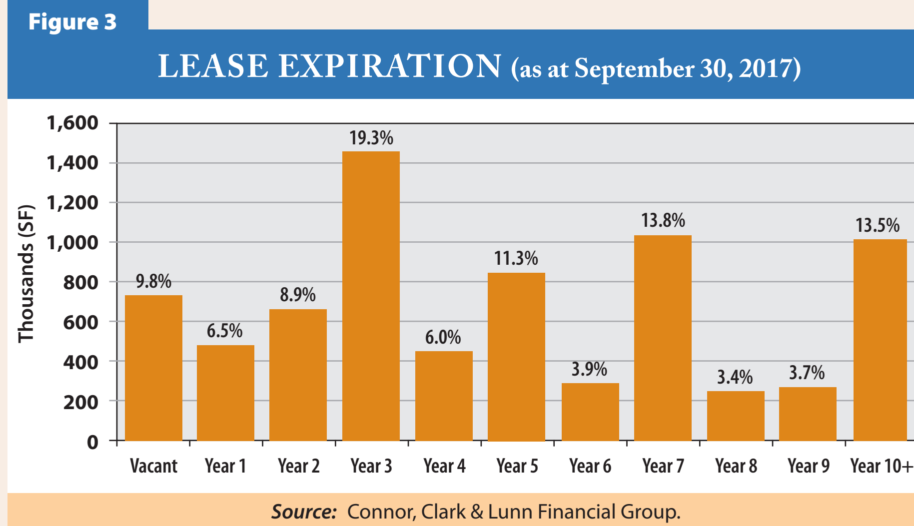
For real estate, while the primary sources of risk are investment related, other sources include:

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

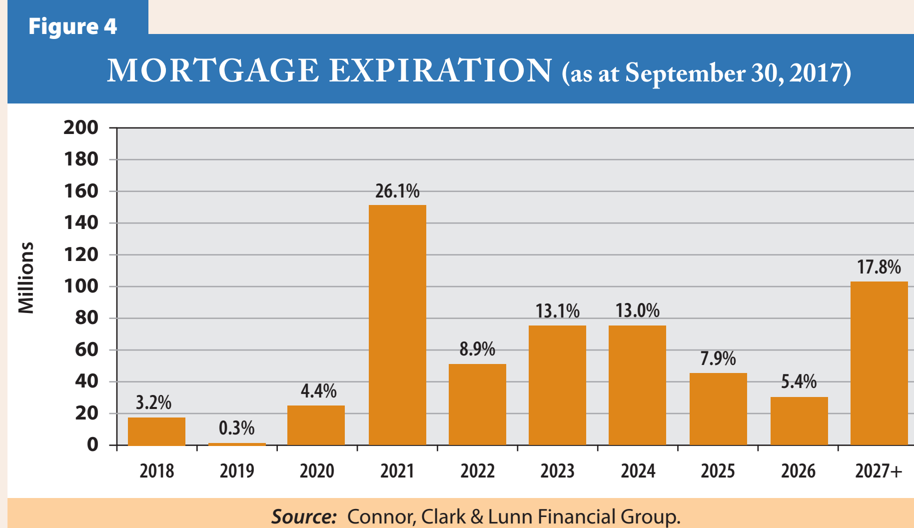
The components of investment risk include the underlying investment strategy (core, core plus, value add, opportunistic), the fund structure (open versus closed-end, direct versus listed), and diversification (property type, geographic, lease expiry, tenant).

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*.

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 number of investments compared to having no leverage, thereby enhancing portfolio diversification and, ultimately, achieving higher returns.



Source: Connor, Clark & Lunn Financial Group.



Source: Connor, Clark & Lunn Financial Group.

The amount of leverage varies depending on the strategy. Typically, 'core' funds have 10 per cent to 30 per cent leverage, while 'core plus' funds are approximately 50 per cent leveraged and opportunistic funds may have in excess of 60 per cent 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. Investor

Figure 5

CANADIAN REAL ESTATE POOLED PERFORMANCE

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

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

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.

Higher Rates

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 to placing longer-term as opposed to shorter-term debt financing. For example, the Connor Clark & Lunn Financial Group real estate specialist manager, Crestpoint Real Estate Investments Ltd., has a weighted average term to maturity of 6.2 years with a weighted average fixed interest rate of 3.8 per cent and a debt service coverage ratio of 2.1 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.

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 6.5 years.

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 +/- 6.2 years.

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 four-year period ended 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.

Take Advantage 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. **BPM**

1. Greenwich Associates, Canadian Institutional Investors 2017
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 HOOPP
3. 2016 Annual Report
4. At September 30, 2017

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