Return Premium to REIT Leverage

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Abstract

In our discussions with REIT analysts over the past several years, we have been struck by the adjustments they make to REIT valuations to take into account liquidity and balance sheet strength. We in this paper view these adjustments as consistent with the pecking order hypothesis of Myers (1977, 1984), and Myers and Majluf (1984). Our argument is that real estate markets are not 100 percent perfect 100 percent of the time. Consequently, there are times when REITs might well want to invest more in real estate, and times when REITs will want to invest less. Furthermore, during these time periods there are times when REITs will want to be highly liquid, and times when they will want to be highly leveraged. The notion is as follows. REITs in bad states will generally want to be highly leveraged, because this will constrain management to pay out cash flow, and as a consequence, will prevent management from destroying value. Analysis of REIT stock returns suggests the following. Highly liquid REITs trade at higher NAV premiums (and higher realized returns) than highly leveraged REITs when times are good. In bad times, however, highly leveraged REITs trade at higher NAV premiums (and higher realized returns). This evidence supports the work of Myers (1977, 1984), and Myers and Majluf (1984).

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