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SPECIAL REPORT | JUNE 27, 2023

Real Estate Divergence:

Two Ways to Profit From a $1.5 Trillion Reset

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Two Ways to Profit from a $1.5 Trillion Reset

The COVID-19 pandemic may not be in the headlines anymore, but it hasn't gone away...

In fact, financial markets are just now grappling with the ramifications of pandemic policies. When the government spends trillions of dollars so that tens of millions of people can stay home... the ripple effect of that decision spreads far and wide.

During the lockdown era, bored consumers looked for ways to spend their stimulus money. They bought lots of stuff... just as global supply chains were breaking. And that led to record inflation, which hit 40-year highs last June.

Out-of-control inflation meant the Federal Reserve, and central banks everywhere, had to raise interest rates to arrest price growth. And as we're about to show you, those actions have created diverging outcomes for two important parts of the real estate sector – and an opportunity to make money from what's unfolding.

In this report, we'll recommend two trades that play both sides of this real estate trend.

We'll go short (that is, we'll aim to benefit from a decline in asset prices) in one sector where we see wealth destruction, and we'll go long in another where we see wealth creation.

Rebekah Neumann believed that she could spot "bad energy" from across the room.

If she detected it in you... she'd fire you.

The mystical, hippie yoga guru – who served as "chief brand and impact officer" at her husband Adam's infamous office space rental startup, WeWork – had lots of bright ideas about how to "elevate the world's consciousness," one of the couple's stated goals (as explained in WeWork's IPO prospectus).

Rebekah insisted that all her personal technology be white, down to the nuts and bolts – she once had staff disassemble her desk phone, paint its interior mechanics white, and reassemble it. She launched an expensive (and short-lived) private school for the children of WeWork employees, offering “a cosmic education.” She refused to eat meat, claiming that it transferred “sad” emotions from the dead animals. And she said that she sensed “toxic energy” like a human radon detector – that was how one very puzzled WeWork staff mechanic lost his job.

But Rebekah looked downright sane compared to her husband, WeWork CEO Adam Neumann.

Up until WeWork’s spectacular fall from grace in 2019, Adam likely spent more time in weed dispensaries than in boardrooms...

He installed an industrial-strength “smoke eater” in WeWork headquarters in order to clear out weed fumes, and he insisted that the private company jet remain stocked with Don Julio whiskey (even for morning flights). On one occasion, he smoked so much pot on the company plane that the crew had to wear oxygen masks. (Around the same time, he said that he wanted to “live forever” and become “president of the world.”) And after one employee filed a sexual harassment lawsuit over drunken groping, he limited his staff to only *four* beers per workday.

More alarming for investors, Adam treated WeWork as his own personal cash cow... using a variety of accounting schemes to funnel upwards of a billion dollars of company money back into his own account, even as WeWork’s financials tanked and it careened toward bankruptcy. (His shenanigans included trademarking the company’s name and licensing it back to WeWork and buying office space that he then leased back to the company for a profit.)

Eventually, though, reality caught up with shady Adam and spacy Rebekah.

When WeWork’s IPO prospectus was released in August 2019, it revealed alarming financial details. The IPO was postponed as a result (more on that in just a moment), and the company’s biggest investor, SoftBank, paid the Neumanns $1.7 billion to step down from company leadership. (Today they’re nursing their wounds in the ritzy Hamptons on Long Island and preparing to launch a new, shared-apartment startup called “Flow.”)

In August 2020, WeWork finally went public, at $10 per share. After a brief surge to $13, the share price has done nothing but drop. In the process, it has taken $47 billion worth of investor value and turned it into $445 million... a loss of 99%.

As of May 2023, its shares had traded below $1 for over a month (now it’s at under a quarter), and it faced a delisting warning from the NYSE.

The WeWork debacle – described by *The New York Times* as "an implosion unlike any other in the history of start-ups" and dramatized in an Apple TV+ miniseries, "WeCrashed" – is an epic tale of "startup energy" gone wrong.

It also played a role in an even bigger crash… the painful death of the office real estate industry. And that's where we'll find our first profit opportunity.

Empty Offices, Pumped-Up Prices

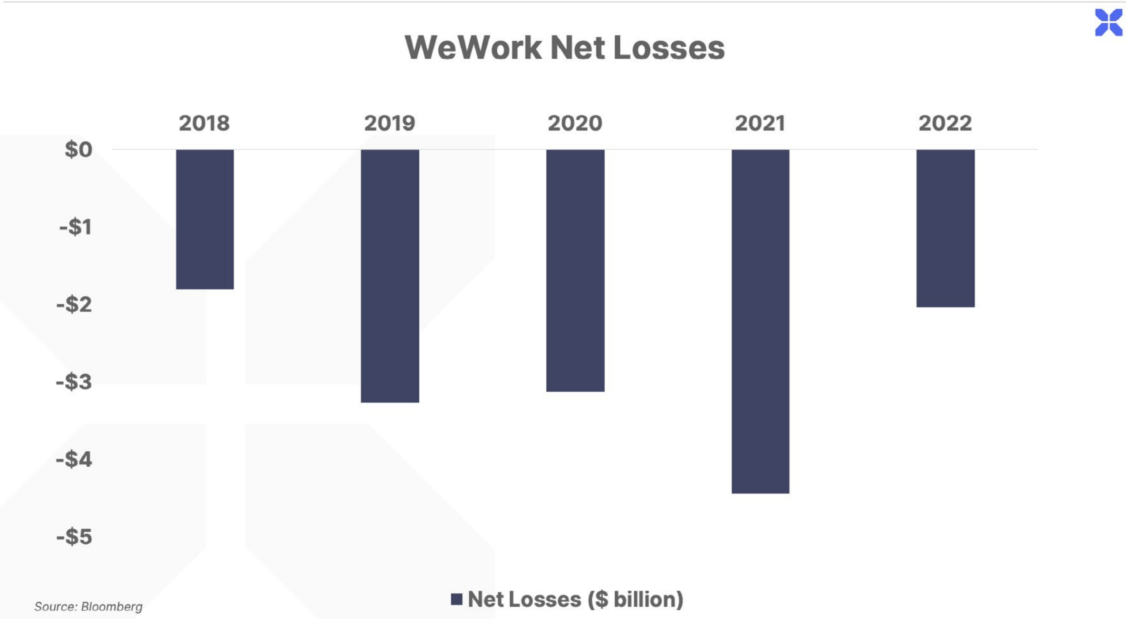
WeWork's concept was simple. It rented office space from building owners, added upgrades like coffee shops and gyms, and then sublet the space out to short-term tenants who wanted a temporary office. The company launched in 2011, with a $15 million investment. Within four years, it had 350 customers and offices all over the U.S. and internationally. *Forbes* magazine dubbed the company "the fastest growing lessee of office space in America."

Along the way, WeWork raised more funds at ever-higher valuations. In late 2014, it received $570 million from a who's-who of big-time investors, at a valuation of around $4.6 billion. Two years, and a few fund-raising rounds later, its valuation had risen to $17 billion.

WeWork went on an acquisition spree to fuel its growth, sending eager investors into a cash frenzy. By mid-2019, WeWork had collected $9 billion from investors, and Neumann was looking to cash out on the company's $47 billion private market valuation through an IPO.

But when the company released its deal prospectus, investors – including SoftBank, WeWork's primary bankroller – realized that something was profoundly wrong with the company's business model.

WeWork had $47 billion in future leasing obligations – but just $4 billion in signed leases by customers. On top of that, the company had posted a $900 million net loss through the first six months of 2019, after losses the previous year had more than doubled, to $1.9 billion.



As SoftBank realized when it paid Adam Neumann to go away shortly thereafter, WeWork's business model was unsustainable.

The company was locked into long-term contracts with office building owners, sometimes for as long as 15 years (and it paid to fix up assets it didn't own). Its customers signed short-term, day-to-day leases.

That math – a real estate maturity mismatch – can work for a while. But if those short-term tenants don't renew (if, say, the economy falters and businesses pull back on spending), the WeWork model implodes. WeWork is still on the hook for paying for space – but no one is paying WeWork to use the space.

Moreover, by signing so many contracts without having firm long-term client commitments, WeWork actually caused real estate prices to rise. Between 2010 and 2019, the value of office properties in Manhattan, for example, rose more than 120%.

WeWork's leasing contracts created office demand that was *12 times greater* than clients actually needed. That demand inflated values and contributed to a ticking time bomb in the office property space.

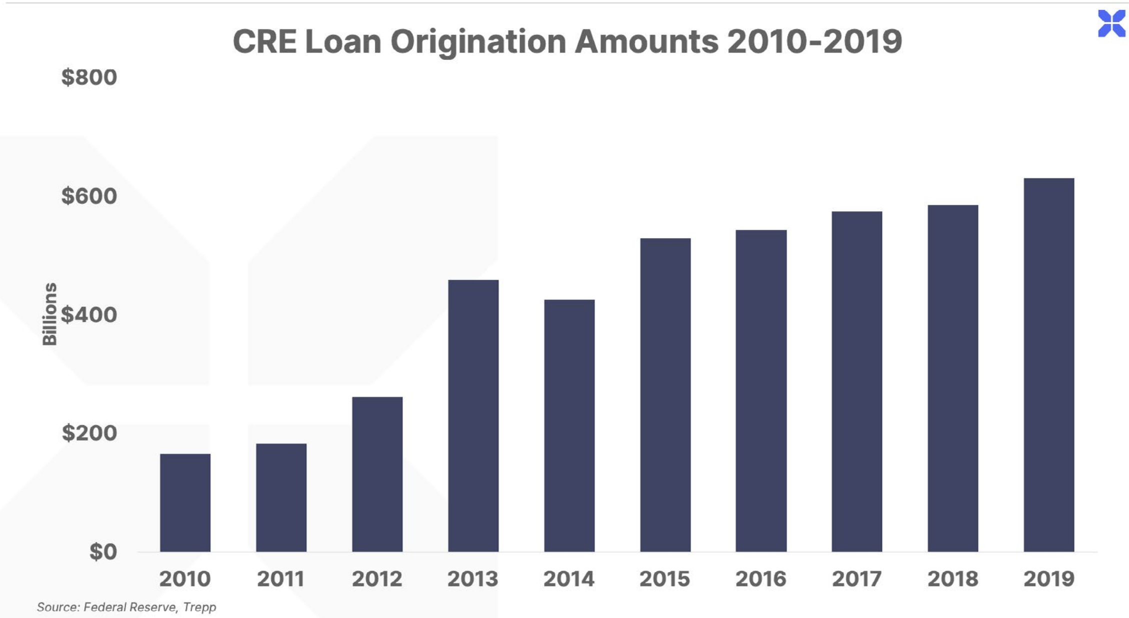
Nationwide office property values were inflating when Adam and Rebekah Neumann came on the scene – and over the next decade, things just got worse.

Covid Pricks the Nationwide Office Space Bubble

According to commercial real estate (CRE) research provider Green Street Advisors, prices of overall commercial real estate (that includes offices, malls, and warehouses) doubled on a national basis from 2010-2019. Any bank making a loan to a property owner during that period likely did so based on an elevated value.

That's partly because, for the entire decade, interest rates were at or near rock bottom. The economy was still recovering from the financial crisis of 2008-2009. The Federal Reserve didn't want to raise interest rates too soon and kill growth. Borrowing costs stayed low.

Building owners took advantage. In 2015 alone, commercial real estate companies borrowed $529 billion, according to the Federal Reserve. That was a jump of 25% compared to 2014. In 2019, the number had shot up to $630 billion. The total amount of CRE loans taken out between 2010 and 2019 was $4.35 trillion. That easily exceeded the total borrowing prior to the 2008-2009 financial crisis.

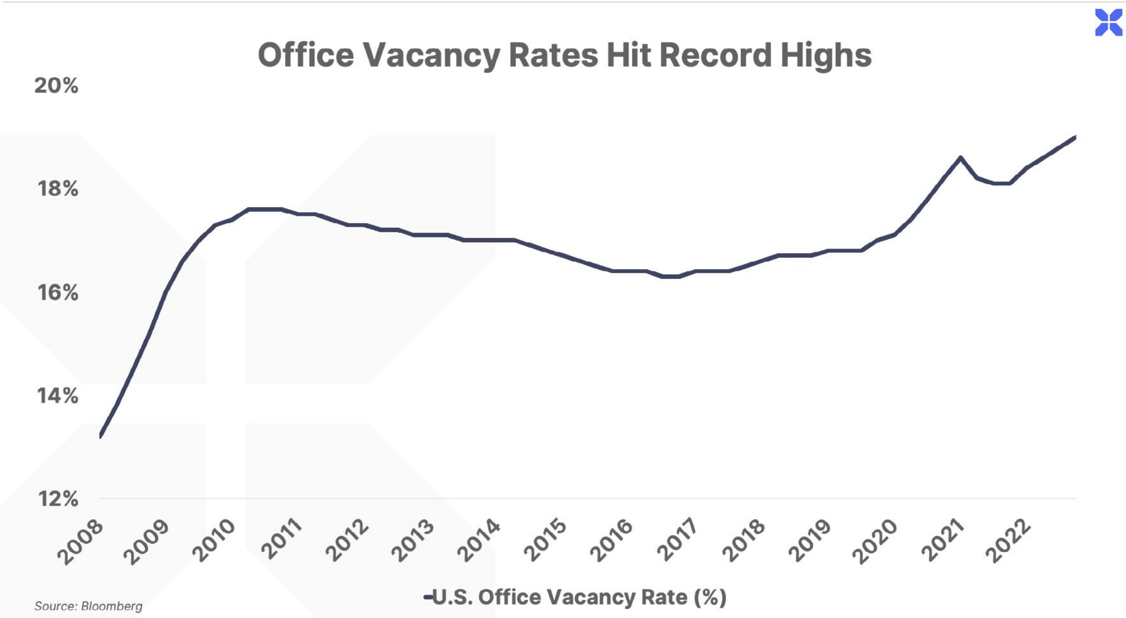


And then Covid hit.

In March 2020, workers took their computers home for two weeks to "stop the spread" – and as two weeks turned into two years (and then some), they realized that they'd rather skip the commute and stay home permanently. Employers leaned into the trend, eager to save money on office space.

Over the first few months of the pandemic, office occupancy collapsed. According to security-solution provider Kastle Systems, the number of card swipes to go into work stood at 98.9% in February 2020. In April, only 15.8% of employees were showing up. And three years later, as of June 2023, only 50% of workers are back in the office.

That's driving office vacancy rates in major metropolitan areas to record highs. According to a New York City budget analysis, the office vacancy rate is now 22.7%. That compares to the previous high of 17.4% in February 2022.



As you can see in the chart above, the national vacancy rate stands at 19%, according to real estate and investment management services firm Jones Lang LaSalle. But as high as vacancy rates are in New York, they're even worse in other major cities.

In San Francisco, vacancy rates have jumped to a record 30%, according to real estate services firm CBRE. It's gotten so bad, property owners in the city like Brookfield Properties and Park Hotels and Resorts are halting payments on loans and giving the keys to lenders. Chicago is also seeing vacancies skyrocket, hitting a new record of 22.4%, according to *Crain's Chicago Business*. That eclipsed the previous top of 21.4% set in the fourth quarter of 2022.

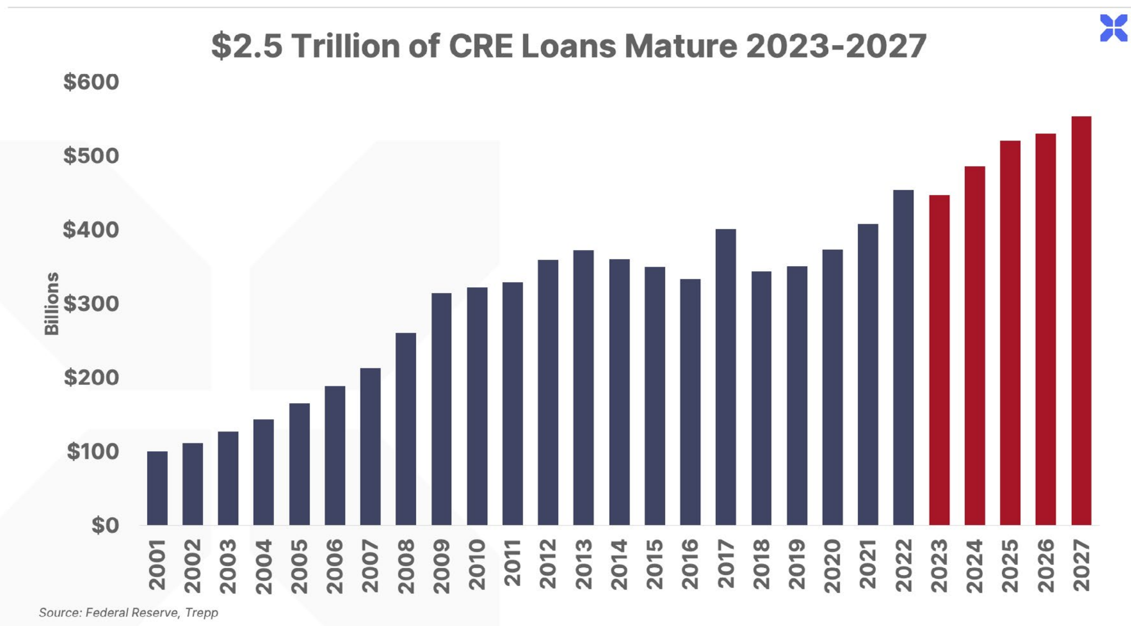
When The Bills Come Due

As we said before, the economy has mostly recovered from Covid (in large part, due to trillions of dollars of government stimulus). In the process, inflation shot to a 40-year high. So the Federal Reserve has had to raise interest rates to try and bring rising costs back under control.

Since March 2022, the U.S. central bank has increased its benchmark federal funds target from 0.25% to the current 5.25%. That compares to a range of between 0% and 2.5% between 2010 and the end of 2019.

The increase in borrowing costs shrinks profitability for companies who took out short-term loans at cheaper levels and now have to refinance at higher levels. If you borrowed money against a building at 2.5% and now you have to refi at 5.25%, your monthly payments are going to double. In other words, profitability is going to shrink, and the building owner will have less to spend on upkeep.

Take a look at the following chart of pending CRE loan maturities…



According to real estate data provider Trepp, roughly $1.5 trillion worth of loans will mature between now and the end of 2025. Through 2027, that figure shoots up to more than $2.5 trillion. Both of those sums are larger than any other three-year stretch since 2001 (which is as far back as the data goes).

There's another factor to keep in mind. With higher interest rates, banks are more cautious about lending. The graph below shows the change in loan-to-value (LTV) since 2007. LTV is the percentage of a property's appraised value that banks are willing to lend. As you can see, it has declined steadily since, meaning that property owners have to put in more of their own capital.

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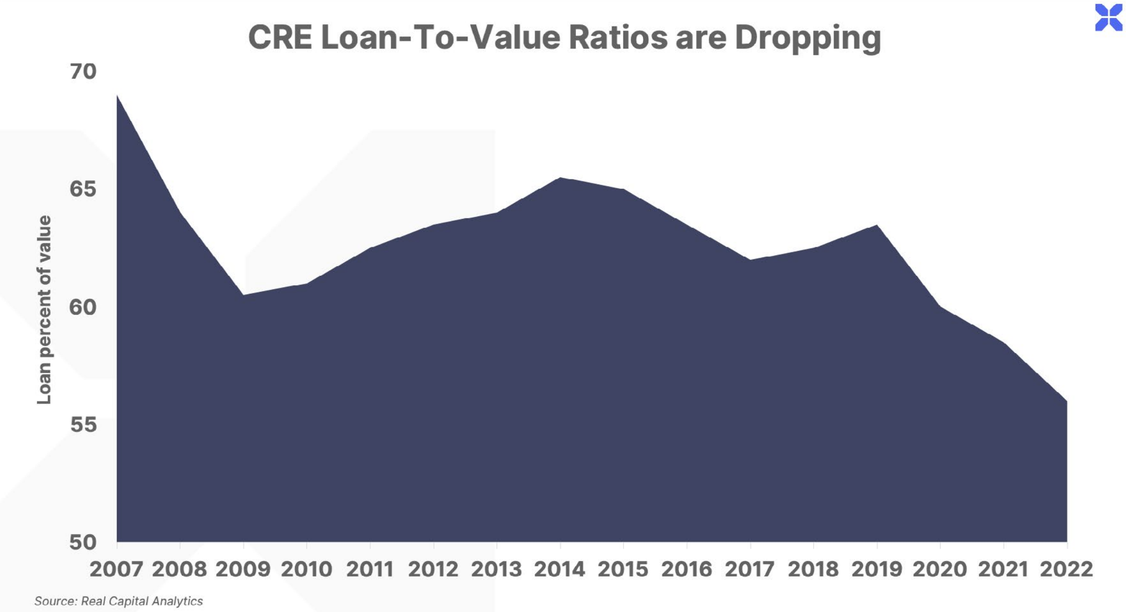


As a result, buyers and owners looking to refinance their debt are paying more – and able to borrow less… which means that they'll have less funds available to maintain properties and to service debt. That will weigh on profitability for property companies and could force them to default on loans.

According to CRE data and analytics provider Real Capital Analytics, at the end of 2022, banks' loan-to-value ratio stood at 56%. That's lower than the roughly 61% during the financial crisis. Since then, interest rates have risen. The financial system also hadn't suffered the collapse of Silicon Valley Bank, Signature Bank, or Silvergate Capital. That means that the loan-to-value percent has probably fallen further.

The problem is likely to get worse before it gets better.

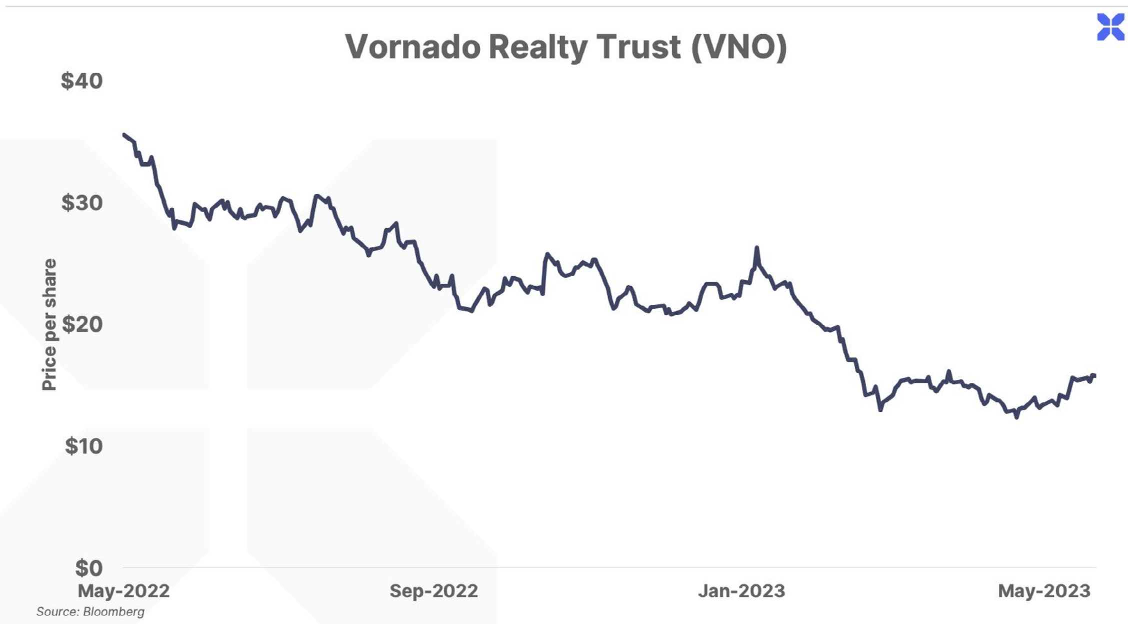
Opportunity #1: Short Office Space

We've found one company whose core markets are at the center of the storm. That's why we recommend **shorting the shares** of **Vornado Realty Trust (NYSE: VNO)**. We want to use a $15/share sell-down-to price with a 25% trailing stop.

Shorting a stock is when you sell a security you don't own. In other words, you're betting that the price will fall from your point of entry, or sale, and you'll be able to buy the stock back at a lower price. The position will close once you buy back the shares.

There's a big difference between buying and shorting a stock. When you purchase a security, your downside is the price falls to zero. That means there's a floor in the losses you can take. But when shorting a stock, there's no ceiling on how high a price can, in theory, rise. So it's important you adhere to the trailing stop (which will be *higher* than the level at which you sell short) and buy back the shares if it's triggered.

To short shares, you'll need to borrow the security from your broker, like Fidelity or Schwab. You will have to establish a margin agreement with your broker to do so. Here are the procedures for Fidelity, Interactive Brokers, and for Schwab.



VNO owns, operates, and leases commercial properties in New York (which accounts for 80% of the company's revenues), Chicago, and San Francisco. Office space real estate in all three of these cities is facing surging vacancy rates and a slow recovery. We don't think that's going to change anytime soon.

The company has roughly $5.6 billion worth of debt expiring between now and 2027. The bulk of that is $3.2 billion due in 2025. In addition, VNO has an above-average amount of floating rate debt compared to its peers. That means any increase in rates will strain profits more.

Currently, the average interest rate it pays on its debt is just over 4%. According to real estate services firm Cushman & Wakefield, the current rate on 10-year office debt is around 7%. In other words, borrowing costs would have to drop significantly for VNO to refinance loans at a rate lower than it's currently paying.

In addition, VNO is burning through cash. Since 2019, the amount of cash and equivalents on its balance sheet has dropped from $1.5 billion to $890 million. At the same time, its total debt load has risen from $7.9 billion to almost $9.2 billion. So, given the current rate outlook and environment, we would expect VNO's cash pile to fall even more.

Before long, the company will either be forced to liquidate some of its assets to try to improve its balance sheet, or it will have to accept low rental rates on its properties. Either one would be a bad outcome for shareholders.

At some point, the office market will bottom, and the opportunities to own good companies at cheap prices will materialize. But, in the meantime, we think share prices will move lower. That's why we think there's money to be made shorting VNO.

Action to Take: ***Short VNO with a $15 sell-down-to price (that is, short the shares when they're trading above that level) and a 25% trailing stop.***

Now let's look at a real-estate opportunity where we see wealth creation…

When "Stay at Home" Turns into "Buy a Home"

While the office space sector has suffered, the residential housing sector has been a big beneficiary of the Covid-19 pandemic.

When rates go up, prices usually drop because it costs more to own a home. But there's good news… those rate hikes may have slowed down one part of the housing market, but there's another where we see an opportunity to profit.

Now to be clear, the residential housing and office property spaces are both smaller parts of the broader commercial real estate (CRE) sector. But the nationwide shift to remote and hybrid work has created a headwind for office occupancy, while it has been a tailwind for home buying.

Housing supply can't keep up with demand… and at the same time, material costs are tanking. And existing homeowners aren't adding much supply to the market by selling their houses.

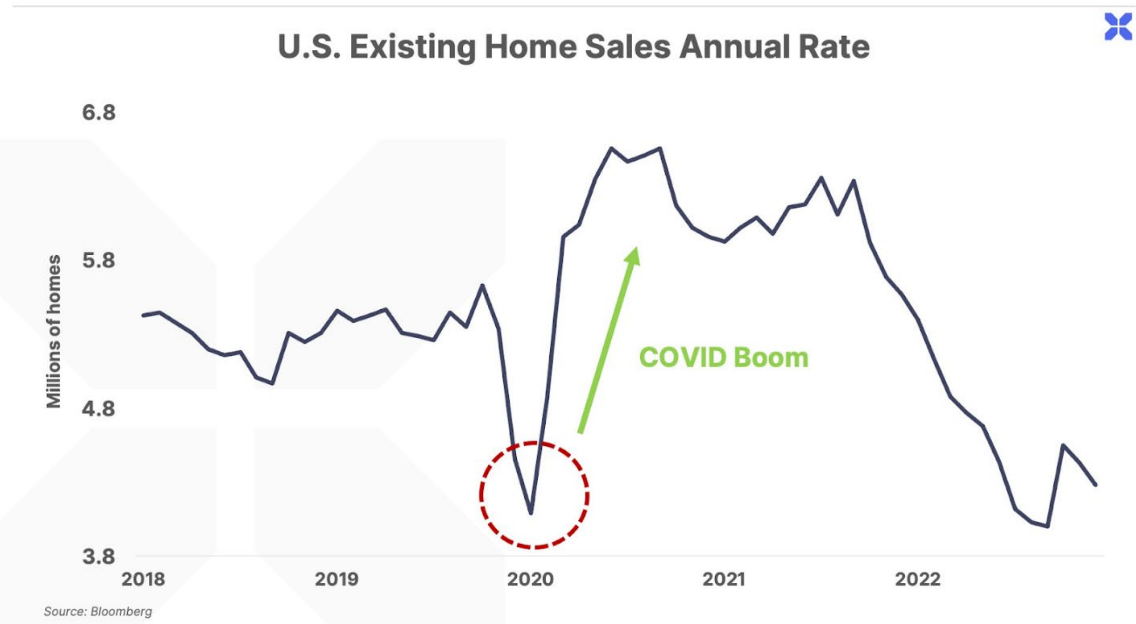
This has created an opportunity for rising margins and market share gains for newly constructed homes.

And that's good news for homebuilding stocks…

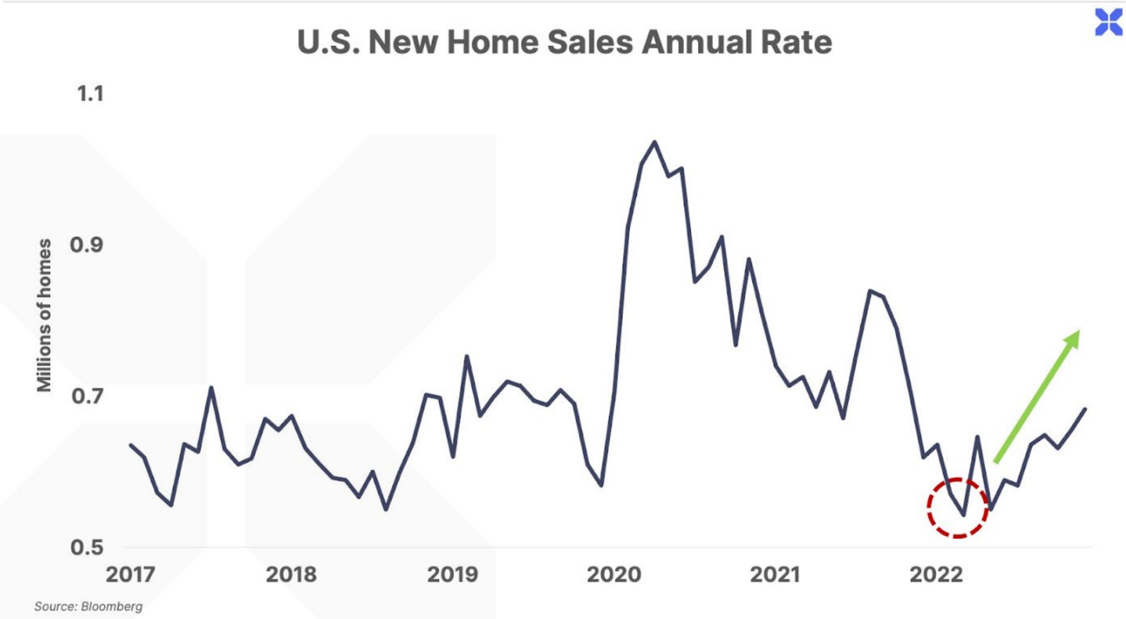
The National Association of Realtors' (NAR) existing home sales report, released monthly, sums up sales and prices for existing single-family homes in the U.S.

As shown below, existing home sales (that is, homes that *aren't* newly built by developers) took off in June 2020.

After an initial drop early in the pandemic, the purchase of previously owned homes shot up from a pre-pandemic annual pace of 5.3 million in 2019 to 6.6 million by the end of 2020. That was the highest level since the late 2005 peak of 7.25 million.



And just like existing homes, the price of new homes also rose dramatically. Pre-pandemic, the median price for a new single-family home was about $315,000. By the end of 2020, that figure stood at $365,000, or a gain of 11%.



The year-on-year price gains kept running until August 2021. That month, they were up 24%. The timing was almost identical to the May 2021 peak in existing home price gains.

That's not to say that the prices of new homes aren't falling now: In fact, prices fell 8.2% YOY in April. But let's keep it in perspective… the average price for a new single-family home is $421,000 compared to $330,000 at the end of 2019. Prices have slipped from the peak but are still high.

What drove the acceleration in prices for both existing and new homes was the same: Fed policymakers signaling that they were going to start raising interest rates again. So, homebuyers looking to take advantage of rock-bottom interest rates needed to move… fast.

The Rate-Lock Boom

Interest rates, of course, define mortgage rates – which drive monthly mortgage payments for homeowners (or for those who aspire to that title). And, they've been rising.

If you bought a $400,000 house pre-pandemic with 20% down and a 30-year mortgage rate at 3%, your monthly payment is roughly $1,700. Today, if you got the same loan at 7%, you're shelling out $2,500 every 30 days to pay it off. That's 47% more.

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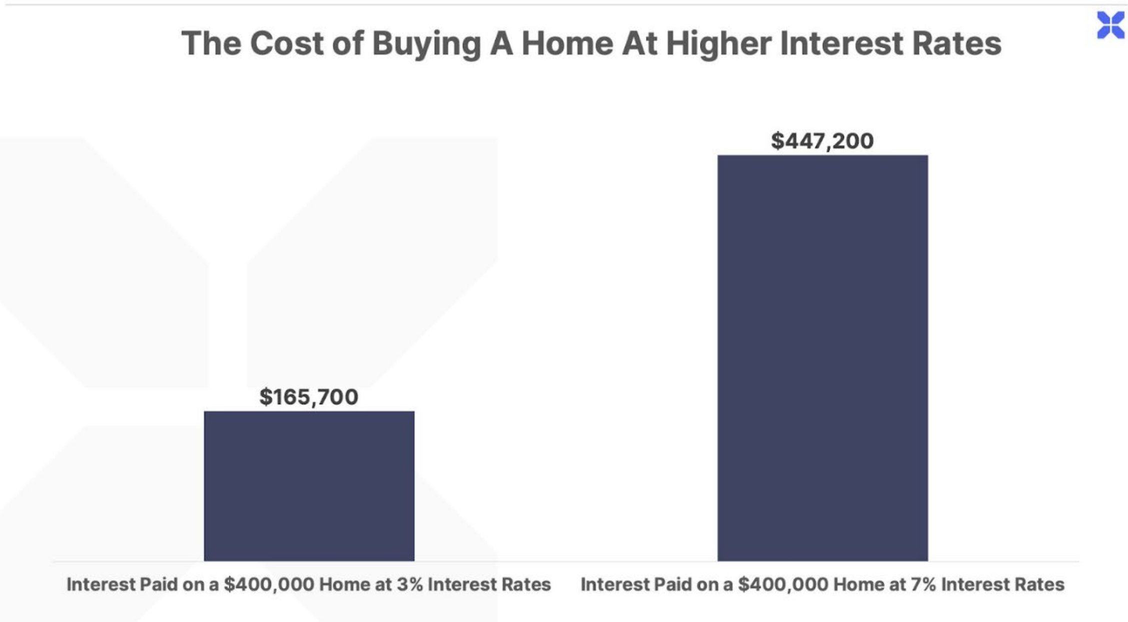
Over the lifetime of the loan, at 3% you're paying $165,700 in interest. But at 7%, you'll shell out $447,200… in addition to repaying the principal. In other words, the total cost is 170% higher.



So, it makes sense that when the Fed indicated that interest rates were about to rise, people bought houses.

According to home-search website Redfin, 85% of all U.S. homeowners have a mortgage rate of less than 5%. And according to residential property data provider Black Knight, just over 64% of all households have a mortgage rate under 4%.

The big headwind for home sales now is… who wants to trade a sub-4% or 5% mortgage in favor of a 7% interest rate? No one! Unless rates drop sharply or people are forced to leave their homes for work-related reasons or an adverse event, the supply of existing homes will remain constrained for the foreseeable future.

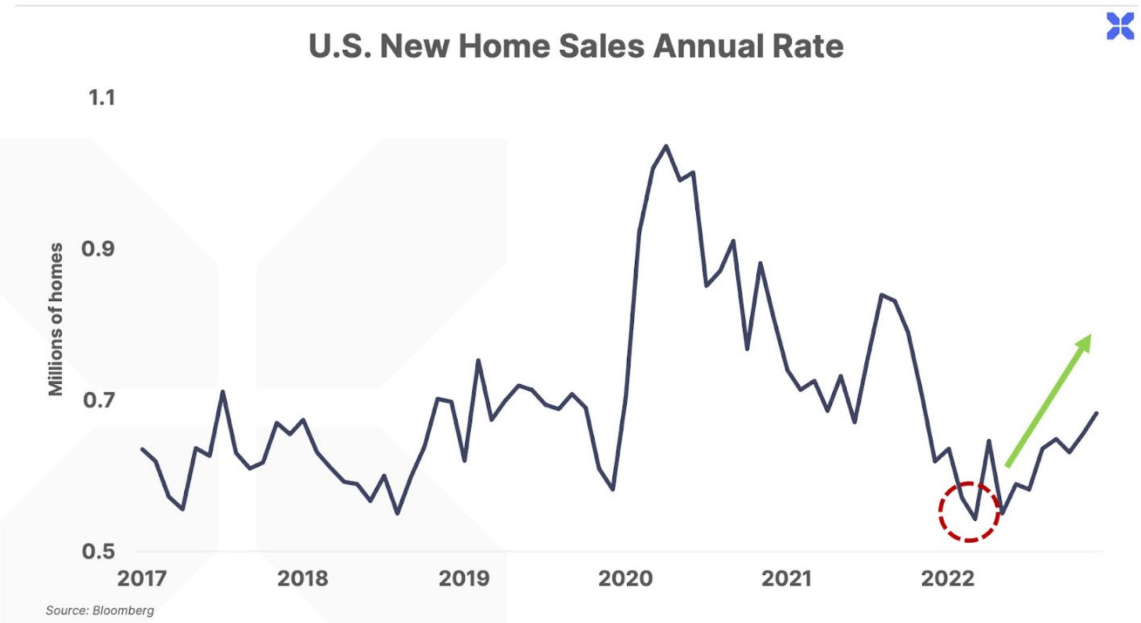
That's one major tailwind for home builders. And we see two others on the horizon…

More New Households – and Less Expensive Supplies

According to the U.S. Census Bureau, 17.4 million new households (defined as two or more people sharing a living space) were formed from the end of 2009 through the end of 2022 – for growth of 16%. That's a lot of new families that need a place to live.

But over that period, only 9.4 million new homes were built – suggesting a deficit of around 8 million homes. If we divide that by the roughly 720,000 homes built per year over the span, there's about 11 years' worth of demand. That's going to underpin new home prices for a long time.

If we look again at the pace of new home sales, we can see they're already recovering...



In July 2022, the number of new homes sold had slipped all the way back to an annualized rate of 540,000. By April 2023, that increased to 683,000. That's the strongest number since just before the Fed started raising interest rates in March 2022.

Moreover, building costs have dropped... and that means improving margins for home-building companies.

According to the National Association of Home Builders' (NAHB) most recent Cost of Constructing a Home survey, it cost roughly $392,000 to build a house in 2022. We want to focus on construction costs (labor included) because they're the bulk of the expense at 61%. They involve two main inputs... wood and metal.

According to data from the Chicago Mercantile Exchange (CME), lumber prices have plummeted from COVID housing boom levels...

In May 2022, lumber prices hovered around $920. But today, they're closer to $340. That means the single biggest housing-cost input has fallen by 63% to return to pre-pandemic levels... while house prices are still up 28% from that time.

Tin, which is mixed with other metals in nuts, bolts, nails, rebar, and I-beams, is another key input. And prices of tin are also down sharply. London Metal Exchange

(LME) figures show that tin currently costs around $25,000 per metric ton. It means spot tin prices have dropped 29% in the last year. That also compares to the post-pandemic peak of just over $50,000 and the pre-pandemic price of around $19,000.

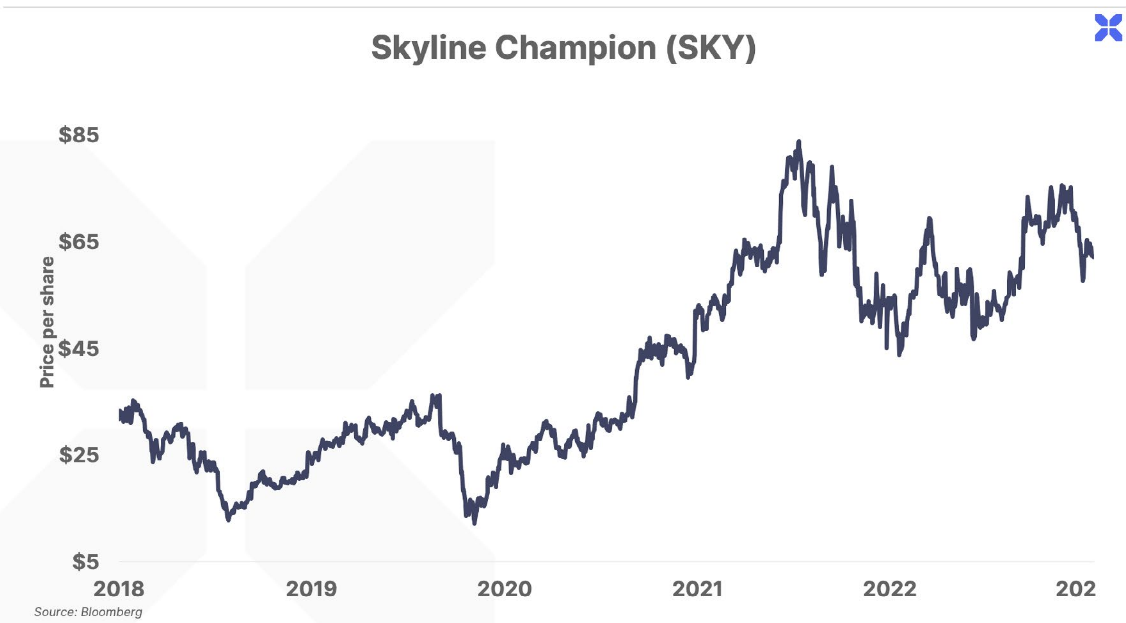
When we consider that compared to the minor 8% slide in new home prices, it means builders' margin opportunity is growing. Construction costs have fallen far more than housing prices.

Opportunity #2: Long Modular Homes

Simple demographics highlight why housing demand is strong. Meanwhile, owners of existing homes aren't interested in selling – and thus taking on more expensive mortgages when they buy elsewhere.

That means that unless there's a complete economic calamity, the housing supply/demand equation will continue to favor the builders. The dynamic will help to underpin new home prices for the foreseeable future. And falling costs will boost margins.

That's why we want to **buy shares of factory-built housing company Skyline Champion (NYSE: SKY)**. We want to use a buy-up-to price of $69 and a 20% trailing stop.



Skyline Champion was formed in 2018 with the merger of Skyline Corporation and Champion Enterprises. It's the second-largest builder of prefabricated homes (built in a factory and assembled onsite) in the U.S., with a roughly 24% market share. It has 43 manufacturing facilities spread across Canada and the U.S.

The company is focused on delivering affordable housing in all of its markets. It can build houses at a fraction of the cost of on-site home builders and in far less time. And depending on the price point, it allows buyers to customize their purchase through a number of (margin-improving) options.

Over the last few years, business has boomed. Between fiscal year 2020 and 2023, revenue has jumped from $1.4 billion to $2.6 billion, and operating margins have risen from 20.4% to 31.4%.

At the same time, the company has been retiring debt, which has dropped from $92 million in 2020 to less than $43 million today. That has allowed the company's free cash flow (the amount of money generated after capital expenditures) to rise sixfold, from $61 million to $364 million. These are signs of a healthy and profitable business.

Management recently started to streamline its manufacturing processes. It's attempting to increase automation and decrease manual construction. This has resulted in improved output and margins. That's important for community developers who are looking to quickly turn over their land.

Backlog sits at roughly $308 million, down from record levels in the quarter prior but in line with its historical average. CEO Mark Yost said levels have normalized to an average of 8 weeks due to its productivity enhancements. On its fourth-quarter conference call in May, Skyline Champion management said order activity had doubled compared to the prior two quarters, rising over 50% on a sequential basis. And it said quoting activity on potential purchases is up about 32% year to date, which should lead to even more orders.

Lastly, Skyline Champion's shares trade at a price-to-book value multiple of 2.9x compared to its historical average of 4x. So we think this is an opportunity to buy a rapidly growing business at a solid discount in a housing sector that is booming.

Action to Take: ***Buy Skyline Champion (NYSE: SKY) up to $69 and use a 20% trailing stop.***