



Capitalization Rate Valuation of REIT ETFs

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Finding the intrinsic value of an ETF is notoriously difficult. It's probably more difficult than convincing your mother-in-law not to drop in unannounced. Using the methodology of capitalization rate calculations for real property is one way to make sense out of REIT ETF valuation. In general, property value is determined by the cash flow it generates.

Real property value: $\text{Desired cap rate} = (\text{Net operating income} - \text{costs}) / \text{Value of property}$

The neat thing about ETFs is that they arbitrage away company-specific details like property expenses and debt costs. We're left with the expense ratio of the ETF as the only relevant cost to consider in a cap rate calculation. A REIT must pay 95% of its income to investors as a dividend, so aggregating the dividends from multiple REITs into an ETF arbitrages away company-specific factors like management quality. The dividend of an ETF is thus the aggregate equivalent of the rental income from a single property or the NOI from a single REIT's portfolio of properties.

REIT ETF: $\text{Desired cap rate} = \text{Dividend} / \text{Value of ETF}$

Therefore, we can estimate the intrinsic value of a REIT ETF:

Value of ETF = $\text{Dividend} / \text{Desired cap rate}$

Choosing a suitable dividend value is complicated by the amount of information a given dividend period reflects. The most recent dividend reflects the ETF portfolio's current health, but older dividends reflect longer operating histories covering several parts of a normal business cycle. Using a weighted average of three methods provides a dividend figure balanced between recent operating history and longer macroeconomic trends.

Method 1: Most Recent Quarterly (MRQ) dividend, annualized (least information content)

Method 2: Trailing Twelve Month (TTM) dividend (more information content)

Method 3: Ave. of last 5 years of dividends (most information content)

Selection of the desired cap rate and discount to intrinsic value are the prerogative of the investor. A cap rate of 10% or more gives an investor a considerable margin of safety. Capturing a high cap rate incorporates the investor's desire to purchase a real estate proxy at an affordable price, so adjusting the cap rate and desired discount allows the investor to compare tradeoffs between capturing a higher future income (cap rate) or a higher appreciation in property value (discounted entry point).

Adjusting historical dividends for inflation provides a dividend estimate in current dollars. One other consideration is how the expense ratio of the ETF (normally found in the ETF's prospectus) affects its current market valuation. Investors must calculate the amount of expense to subtract from the projected valuation.

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The spreadsheet file accompanying this report provides a working valuation template based on the methodology outlined here. The iShares Dow Jones U.S. Real Estate ETF (ticker IYR) is a useful example security since it tracks about two thirds of all publicly traded U.S. REIT companies. The screen capture below uses the accompanying template to estimate the intrinsic value of IYR.

Dividend Methods				
MRQ Annualized	2.368	Date	Dividends	Inflation Adjusted
TTM	1.973	Y1	12/22/2010	0.592
Last 5yr Ave.	2.731	Y1	9/23/2010	0.464
Inflation (LT historical ave.)		Y1	6/24/2010	0.428
	1.05	Y1	3/25/2010	0.489
Weighted Average of Divs:		Y2	12/23/2009	0.501
Desired Cap Rate	0.10	Y2	9/22/2009	0.391
Expected ETF Value:	23.55	Y2	6/24/2009	0.467
Expense ratio:	0.0047	Y2	3/25/2009	0.573
ETF Value After Expenses:	23.44	Y3	12/23/2008	0.910
Desired Discount:		Y3	9/24/2008	0.780
	0.10	Y3	6/25/2008	0.636
Desired Purchase Price:	21.09	Y3	9/25/2007	0.688
Yellow data from Yahoo Finance		Y4	3/23/2007	0.678
Gray box equations do not change		Y4	9/26/2006	0.708
Blue box data are investor's estimates		Y4	6/22/2006	0.644
		Y4	3/24/2006	0.450
		Y5	12/22/2005	0.895
		Y5	9/23/2005	0.662
		Y5	6/20/2005	0.643
		Y5	3/24/2005	0.645
				0.784

Note that the weighted average used in this spreadsheet assigns equal weights (33.3%) to the three dividend calculation methods. Investors can adjust these weights to favor the time period they believe is most relevant for analyzing the real estate market. Adjusting one's mother-in-law to a favored time period is not covered here.