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REITs Should Hold Up In 2005: Merrill Lynch

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The real estate investment trust (REIT) market has posted a 29.5% year to date return, reports Merrill Lynch. That's even more impressive when you consider the S & P 500's 9.2% return.

It also makes 2004 the fifth year in a row that REITs have outperformed the markets—but investors are increasingly asking themselves if this performance will continue into 2005.

A forecast report prepared by Merrill Lynch analyst Steve Sakwa projects that REIT returns will stay on the plus side in 2005 though they may moderate somewhat.

"We think the key issue facing the REIT sector in 2005 is whether the strong capital flows, driven by low interest rate environment and lackluster stock market returns, will continue to chase yield oriented investments both in the private and public markets," says Sakwa.

Merrill Lynch's forecast assumes that the S & P will yield single-digit returns in 2005 amid an interest rate environment that should remain "benign".

They project that the REIT sector could post a total return of 5% to 10% over the next 12 months. What should investors watch out for? Employment growth, says Sakwa, as it remains a key issue for both the apartment and office REITs.

"Without a pickup in the level of monthly employment gains, it will become difficult for REITs in both of these sectors to post meaningful FFO/share growth during 2005," says Sakwa.

Economy.com projects employment growth in 2005 at roughly 1.8%. For 2004, they project employment growth to be slightly lower than that at 1.7%. The office employment numbers are even more encouraging: Economy.com forecasts that the number of office-using jobs should increase by 3.1% during 2005 (only 2.4% growth in office employment is expected for 2004).

For the retail sector, one major concern next year is potential fallout from Sears/Kmart merger. The central issue hinges on how many Sears stores will be shuttered. Sakwa believes that this issue will be a larger concern for mall REITs rather than shopping center REITs.

"We believe the company could announce the closure of up to 200 Sears locations which could happen as early as fall 2005," says Sakwa.

While these closures would have little bearing on Merrill's 2005 FFO estimates, Sakwa believes that investors would view these store closings as a negative for all mall REITs.

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