After a Selloff, Public REITs Set to Perform

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Notes from the Global Value Desk

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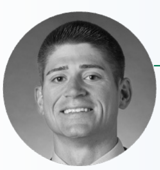

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Key Takeaways

- A bruising selloff in 2022 cast a pall over public REITs, but they now trade at attractive valuations.
- History shows us that public REITs have outperformed in the aftermath of monetary tightening.
- Supply and demand imbalances serve as a tailwind for REITs, particularly for data centers and select residential real estate markets such as single-family rentals.

A Tough 2022

When the markets closed on Dec. 31, 2021 — a few hours before corks would fly from champagne bottles to usher in the new year — shares of IYR, a public real estate investment trust index, traded at $116.

That share price represented the index's peak over five years, seemingly presaging a strong 2022 for public REITs.

That did not end up happening. Instead, the Federal Reserve and other central banks spent the year increasing interest rates dramatically — poison for real estate investors when done so quickly— to beat rising inflation. Public REITs tumbled the rest of the year.

It appeared that 2023 would shape up as more of the same. Interest rates kept going up. Inflation stuck around. Big office defaults happened. Major regional banks failed. Lending standards tightened.

But a peek behind headlines about the travails of commercial real estate might help investors come to understand why we remain optimistic for listed REITs for the rest of 2023 and 2024.

They may also notice how one of the most puzzling riddles in the real estate investment scene — the disconnect in values for private real estate versus listed REITs — bolsters our confidence in publicly traded REITs.

The Interest Rate Cycle

Fed chair Jerome Powell and the Federal Open Markets Committee (FOMC) members have been careful not to tip their hands in public statements and press interviews about what they may do on interest rates, insisting that data will drive their decision.

The FOMC announced on Sept. 20 that it would hold rates steady at 5.25-5.5%. Looking further out, Fed Fund Futures are not projecting any further hikes for the balance of 2023 with the next possible cut happening in late-2024.

We tend to agree that the Fed is at or near the end of its tightening cycle. True, inflation remains higher than the Fed's 2% target, but it has cooled down faster than many expected it would by this time of the year. We also don't think the Fed will jump into a rate-cutting cycle any time soon, absent some unforeseen financial calamity that would require such an approach.

While higher interest rates generally don't benefit real estate, 30 years of market research reveals something interesting: Whenever rates stop increasing, REITs spent the next 12 months outperforming broad equities. Our research shows the average return for REITs during these 12-month periods more than doubled that of the S&P 500 over the last three decades.

REIT Performance During and After Rising Yields

Dates		Yield			REIT Returns		S&P 500	
Start	End	Starting Yield	Ending Yield	Change in Yield (bps)	Rising Rate Period	Following 12 Months	Rising Rate Period	Following 12 Months
11/1/1993	10/31/1994	5.56	7.81	225	-5.98	12.22	3.87	14.71
2/1/1996	5/31/1996	5.63	6.85	122	3.74	29.31	6.07	29.41
10/1/1998	1/31/2000	4.33	6.68	235	-5.37	27.26	28.32	-0.90
11/1/2001	2/28/2002	4.24	4.88	64	10.37	0.34	4.96	-22.68
7/1/2003	7/31/2003	3.56	4.49	93	5.35	21.00	1.76	13.17
4/1/2004	4/30/2004	3.91	4.53	62	-14.58	34.62	-1.57	6.34
6/1/2005	6/30/2006	3.91	5.14	123	22.91	12.57	8.08	20.59
1/1/2009	5/31/2009	2.06	3.46	140	-8.81	55.98	2.96	20.99
10/1/2010	1/31/2011	2.52	3.38	85	11.86	10.61	13.38	4.22
5/1/2013	12/31/2013	1.63	2.97	134	-10.52	28.03	17.43	13.69
1/30/2015	6/30/2015	1.65	2.36	71	-5.44	23.62	1.23	3.99
7/1/2016	10/31/2018	1.47	3.15	168	1.39	25.32	13.84	14.33
8/1/2020	12/31/2022	0.54	3.88	334	4.70	-	8.51	-

Notes

Average return after rising rates:

REITs: 21.1%

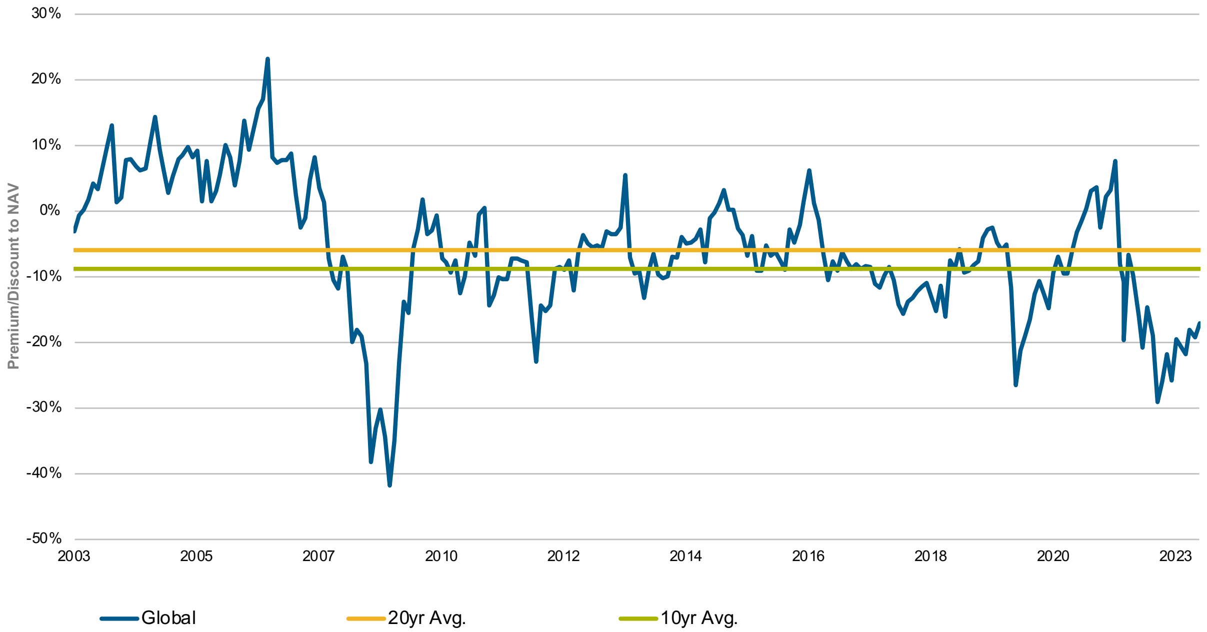
S&P 500: 10.4%

Data as of 12/31/2022. Source: FactSet. REIT Returns are FTSE-NAREIT All Equity REIT index total returns. Yield refers to 10-year U.S. Treasury Yield. **Past performance is no guarantee of future results.**

We think this history may repeat itself. For one thing, listed REITs have largely priced in lower asset values and potentially a recession that may or may not happen. Earlier in the year, a recession seemed likely. Now, thanks to a still-strong labor market and consumer resilience, economists are second-guessing that assumption. And while we think REITs, which trade on exchanges daily, have priced in the recession, private real estate has been slow to meaningfully mark down its assets. As private real estate values are reset appropriately, publicly listed real estate companies with materially better balance sheets should be able to take advantage of strong investment opportunities as we have seen in prior cycles.

Either way, REITs currently trade at attractive valuations, meaning now might be a good time to consider them.

Global Real Estate – Premium/Discount to NAV



Data from 6/30/2003-6/30/2023. Source: UBS. Data based on UBS Global Real Estate Universe.

Valuations and Fundamentals

Valuations are the second reason we are keen on listed REITs. Public REITs trade at the most attractive valuations we have seen since the Great Financial Crisis. And, unlike the financial crisis, the underlying fundamentals of real estate are generally much stronger.

The financial press has zeroed in on office as a struggling sector in commercial real estate. There's a case to be made for weakness in office, due largely to work-from-home trends, in certain markets. Even assuming wider problems with office, the sector only makes up 7.56% of the FTSE NAREIT Index.

Other sectors with larger weights in the index benefit from persuasive tailwinds.

Take data centers, for example. Supply chain issues, lack of power availability and cost inflation caused by the pandemic meant that fewer new data centers came online. Vacancy rates for existing data centers dropped as a result. Now data centers enjoy strong pricing power, due not only to the limited supply of space but also the significant demand coming from the excitement over artificial intelligence.

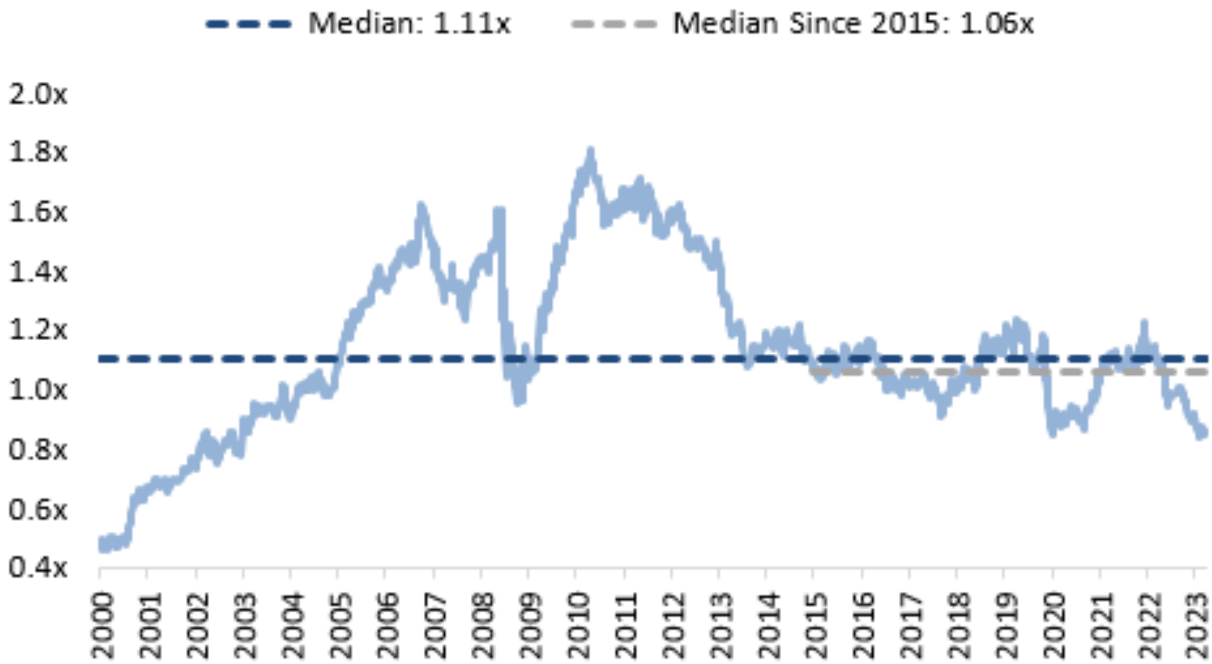
Select residential real estate fundamentals also remain strong from an investment perspective.

Residential Real Estate

Within residential real estate, we favor single-family rental REITs in the United States for several reasons. Rising mortgage rates have forced many U.S. households into renting, given low purchase affordability today as well as the costs of renting a home compared to buying reaching its widest gap in several decades. For example, as interest rates have gone up, the average monthly mortgage rates for prospective homebuyers has increased 70%, according to data from the National Association of Realtors.

Single-family rental assets — think suburban stick-built homes across the U.S. — provide growing households a value alternative with more living space at much more affordable cost than many urban and suburban multi-family communities with much smaller units. Lastly, supply is much more muted relative to demand in the single-family market relative to demand resulting in strong pricing power for single-family rental landlords.

S&P 500 REITs Relative Multiple



Data as of 6/30/2023. Source: FactSet.

The Credit Cycle

Every few months, the Fed asks loan officers at some 80 large U.S. banks about changes in their lending standards. The Senior Loan Officer Opinion Survey (SLOOS) over the last year has shown less enthusiasm by banks to loan to commercial real estate as concerns about the long-term health of the economy came into question. The July SLOOS report indicated that banks tightened their lending standards on all categories of commercial real estate loans for the last four quarters.

That's generally bad news for developers, who either can't get a loan or, confronted with having to pay more to borrow, decide to stop building. But for REITs, tighter lending can be a good thing as it causes a mismatch of supply and demand. New commercial real estate development starts have fallen dramatically and now sit below long-term averages as a percentage of total stock. We expect this to fall further as bank lending remains tight for commercial real estate. The consequence, leaving all else equal, will be better pricing power for current landlords.

Investment return and principal value of security investments will fluctuate. The value at the time of redemption may be more or less than the original cost. Past performance is no guarantee of future results.

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