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The REIT Newsletter for Advisors Spring 2019

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Nareit is the worldwide representative voice for real estate investment trusts—REITs—and publicly traded real estate companies with an interest in U.S. real estate and capital markets.

A Late-Cycle REIT Defense

In a challenging market, real estate may help investors protect the downside.

by Thomas Bohjalian, *Cohen & Steers*

It's probably been a while since a lot of investors have given REITs a second thought, with tech stocks and other high-growth sectors dominating the market's attention. In fact, REITs have spent the last several years out of favor, with a strong economy benefiting their property values and cash flows, but not so much their share prices.

That began to change at the end of 2018, as the prospect of slowing global growth and tighter liquidity battered financial markets. In Q4/18, U.S. REITs defended much better than broad equities, with just half the drawdown of the S&P 500. Real estate securities in Europe and Asia were also resilient, and REITs continued to outperform through the first two months of 2019.

While there have been other brief periods of relative strength for REITs in recent years, the current one looks a lot more like the beginning of a broader shift in market leadership, as the U.S. economy transitions from mid- to late cycle. Historically, such periods have been a great time to own REITs.

In late-cycle periods—which we define, for this purpose, as a broad deceleration in Conference Board economic indicators—REITs have outgained the S&P 500 by more than 7% on average since the start of the modern REIT era in 1991. In recessions, the margins of outperformance have historically been even wider.

While REITs are not immune to changes in the business cycle, several likely reasons exist for their outperformance in late-cycle environments:

1. **Predictable, lease-based revenues:** In tough times, you can always put off upgrading your smartphone or buying a new car. But if you're an office tenant with a ten-year lease, you're contractually obligated to pay your landlord regardless

of economic conditions. As a result, REIT earnings growth has generally been far more consistent than that of most sectors in the stock market.

That said, revenue stability can vary greatly depending on the property type. For example, hotels are highly cyclical, with one-day leases and reliance on business and leisure spending. By contrast, cell tower leases are typically structured with five-year rolling opt-outs, providing stable, long-term cash flows. It also helps that demand for tower space has little to do with the business cycle, driven instead by the ongoing expansion of wireless networks to satisfy customers' increasing data usage.

2. **Attractive dividends:** In a low-growth environment, dividends tend to play a greater part in total returns, giving investors a potential head start. At the end of 2018, real estate was about even with the energy sector as the top-yielding segments on the S&P 500. This is typical for REITs, resulting from cash-flow-oriented business models focused on operating, acquiring, and developing properties that generate recurring income streams. Whereas distributions are optional for most other companies, the Internal Revenue Service requires U.S. REITs to pay out at least 90% of their taxable income to shareholders.

3. **Slower growth may ease the pressure from interest rates:** Though U.S. inflation has been rising, a peak in economic growth and a more challenging global economic backdrop means bond yields are unlikely to move much higher from current levels. Additionally, the Federal Reserve has already struck a more dovish tone and could soon put a hold on further rate hikes.

A Favorable (but Divergent) Backdrop for Real Estate

Defensive characteristics alone are not enough to protect investors. We have adjusted our outlook for property values and cash flows to account for slower but still healthy economic growth in 2019. Even with those adjustments, REITs continue to offer the potential for attractive relative returns amid a generally favorable backdrop for U.S. commercial real estate.

Supply and demand should remain largely in balance, giving landlords some level of pricing power, which should translate into healthy earnings and dividend growth in the mid-single digits. In our view, REIT balance sheets are stronger than they have ever been, after spending the past decade reducing leverage and extending maturity durations. Meanwhile, REIT correlations with equities are back to pre-crisis levels, ending 2018 at 0.53, underscoring the portfolio diversification potential of real estate.

Some REIT sectors are drawing the attention of private investors after lagging behind both the broad equity market and private real estate in recent years. Managers of private real estate funds have been raising capital faster than they can put it to work, which, according to Preqin market intelligence, has led to a record $300 billion of uninvested capital sitting on the sidelines, with investors looking to buy the types of assets REITs already own. If the market environment turns more challenging, that could serve as a potential floor of support for REIT valuations.

"REIT balance sheets are stronger than they have ever been."

But with growth rates and valuations within the REIT market diverging significantly, it's important to be selective.

One of our favorite sectors for 2019 is cell tower REITs. These companies have long runways for growth as carriers continue to invest in their networks and begin preparations for the much anticipated 5G rollout. Similarly, data centers continue to see healthy tenant demand and strong development pipelines due to the growth of information technology (IT) outsourcing and data-intensive web applications.

We also like nearly all forms of rental housing, including apartments, single-family rentals, and manufactured homes. In addition to seeing significant inflows of institutional capital, we believe these sectors benefit from the strong demographics and job growth driving above-average household formation at a time when new housing supply is well below normal.

At the other end of the spectrum, we continue to avoid most regional mall owners, which are struggling in the face of brick-and-mortar store closures and the rise of e-commerce. In the long run, the best malls should emerge stronger after the weak-

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er ones die off. In the meantime, many REITs will need to invest significant capital to modernize their properties, weighing on their ability to grow cash flows.

Defense through Diversification

As we've seen with the strong relative performance of REITs since October, having defensive, lease-based revenues and high dividend yields can be attractive in an environment of heightened uncertainty. As you consider how to help clients protect their portfolios from what may be a more challenging and volatile environment, it could be time to give REITs another look.

Tom Bohjalian is head of U.S. Real Estate and a senior portfolio manager at Cohen & Steers.

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Advisor-Access LLC was designed to bring compelling investment ideas to investors in the form of in-depth interviews with company management and the latest fact sheets and corporate presentations, in a concise format: the critical pieces of information an investor needs to make an informed investment decision.