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The REIT Newsletter for Advisors

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Real estate working for you

In this interview with Advisor Access, Sheila McGrath, a senior managing director covering equity REITs and real estate operating companies at Evercore ISI, discusses the strengths and weaknesses of the REIT market going into 2020.

EVERCORE

The Value Proposition of REITs

Advisor Access: ***You've been covering REITs for many years. Looking back, what have been the most evolutionary changes you have seen, from an operator's perspective as well as from the investor's perspective?***

Sheila McGrath: REITs have certainly changed dramatically since the early 1990s when I began covering the REIT industry. Management teams are more sophisticated and seasoned about operating in the public markets compared with the early days.

The supplemental packages REITs provide for investors, with relevant real estate metrics, balance sheet disclosures, tenant concentration, and lease expiration data, are comprehensive. They are also an important part of how REITs provide transparency to the investment community. Given REITs' history of tapping the equity and debt markets for new capital more than most sectors in the public markets, company disclosures are critically important. We have learned over time that investor capital rewards transparency. REITs with best practices for disclosures generally garner a better cost of capital.

REIT management teams have become better allocators of capital too. Post the global financial crisis, many REITs have adopted a more conservative dividend payout policy, paying out 100% of net taxable income—above the minimum requirement but much lower than historical norms, which were greater than 100% net taxable income. This strategy enables REITs to retain cash flow to fund growth. In my opinion, the discipline of having to pay a required dividend to shareholders also invokes discipline on thoughtful capital allocation.

From an operating perspective, REITs, in general, have larger portfolios, with state-of-the-art systems in place that track asset-level data. Companies also have the ability, and the access to capital, to roll out sophisticated initiatives to enhance operations, which could entail yield optimization, bulk purchasing, solar power, and other energy saving initiatives. REITs are really taking leadership roles in focusing on best practices to create a more sustainable real estate industry. A focus on energy-efficient properties benefits the environment and the bottom line.

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AA: ***Do you see REIT stocks playing a more significant role in retirement portfolio allocations going forward?***

SM: With bond yields near record lows, retirees are starved for investments with a decent yield. REITs have historically offered investors an attractive dividend yield, the opportunity for long-term capital appreciation, and some inflation protection.

According to the Population Reference Bureau (PRB), the number of Americans age 65 and older is projected to nearly double, from 52 million in 2018 to 95 million by 2060, which means the share of total population over 65 will rise from 16% to 23%. With REITs posting competitive returns versus alternatives, and considering this wave of retirees seeking yield, we believe REITs will represent a larger share of retirement portfolio allocations than they have historically.

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AA: ***What are some of the challenges you anticipate for REITs and REIT investors?***

SM: While not REIT-specific, I believe broadly that the challenge for public equity investors at this juncture is the wave toward passive investing. Active managers typically tend to meaningfully outperform industry benchmarks in market downturns. With the last downturn over 10 years ago—and memories short—passive investing is garnering a substantial amount of inflows. I think institutional investors should continue to create differentiated products that will not be easily replicated with an exchange-traded fund (ETF), and that will have an income component that appeals to the wave of retirees in the U.S.

As far as REIT challenges, I think that varies greatly by sector and at different points in the cycle. With the triple net lease and healthcare REITs currently trading at meaningful premiums to net asset value (NAV), these companies have access to both attractively priced equity and debt to fund external growth stories.

On the other hand, office and retail—both strips and malls—are not trading at premiums to NAV, and consequently must fund growth with retained capital and joint venture equity capital.

AA: ***Playing that forward, what REIT sectors do you think will post the most dynamic growth over the next five years?***

SM: Although I do not formally cover the alternative or non-core property REIT sectors, such as data centers or towers, I believe these will continue to have broad appeal, because the public REIT players have established brands, expertise, and a cost-of-capital advantage. Interestingly, five of the top 15 largest REITs by market cap in the S&P 500 are from the tower and data center sectors.

AA: ***On the flip side, what sectors are giving you concerns?***

SM: The consensus view is to highlight retail as the most challenged, given the spate of recent tenant bankruptcies and changing shopping patterns of consumers. The strip center and mall REITs reflect this mainstream view, with shares trading at larger discounts to consensus NAV estimates and lower multiples than other sectors. While retail undeniably has challenges, this near-term, broad consensus fear can create interesting long-term redevelopment or repositioning opportunities.

__Sheila McGrath__ is a senior managing director covering equity REITs and real estate operating companies at Evercore ISI. Prior to that, she was sector head for REIT research at Keefe, Bruyette & Woods (KBW), where she was a member of the Research Review Committee and a member of the Leadership Committee for the firm. Prior to joining KBW in 2007, McGrath was a managing director covering REITs at Stifel/Ryan Beck. Prior to equity research, McGrath was assistant vice president in the real estate advisory and valuation group at CB Commercial.