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The Hidden Growth Themes in REITs

Amazon founder Jeff Bezos is the world's wealthiest person. Amazon is one of the world's five largest companies by market capitalization. Its revenues put it in the top 20, but its annual revenue growth, at some 30%, again puts it among the top handful of global firms.

One cannot find Amazon in a Real Estate Investment Trust (REIT). That leads some investors to put them completely out of mind—surely apartments, shopping malls, offices and warehouses carry minimal exposure to the exciting growth trends powering today's economy?

We would encourage a second look.

We have already written about the huge impact that e-commerce is having on real estate—much of it surprisingly positive.[1] Amazon's new Eastern-U.S. headquarters and further expansion in places such as Nashville and Washington D.C. will create substantial demand for office and residential space. And potentially outstripping both of these impacts is the fact that Amazon Web Services accounts for much of the group's 30% year-on-year revenue growth: AWS is a world leader in cloud computing, which requires datacenters, a real estate sector that now constitutes more than 6% of the FTSE NAREIT All Equity REITs Index.

Maybe one can find Amazon in a REIT after all.

This goes well beyond Amazon, and even beyond the technology sector. A REITs allocation can be surprisingly diversified, surprisingly exposed to a number of long-term growth themes—and less defensive, income-oriented and interest rate-sensitive than one might assume.

[1] See "Shopping Maul" at https://www.nb.com/pages/public/global/insights/shopping-maul.aspx

Growth Themes with Real Estate Impacts

On the one hand, listed real estate offers what we might call endogenous growth stories. A good example is the increasing access to U.S. single-family residential property (as opposed to the more usual rental apartments). A handful of dedicated companies own a couple of hundred thousand of these homes, and the majority are, of course, owner-occupied. But there are still more than 15 million non-securitized single-family rental homes across the country, representing 14% of the overall U.S. occupied housing stock, according to Green Street Advisors—potentially one of the largest residential REITs sectors.

When people talk about thematic investing, however, they tend to mean exogenous growth stories such as e-commerce, cloud computing, artificial intelligence, next-generation mobility and autonomous vehicles, 5G connectivity, climate change and the environment, the emerging consumer and demographic aging.

We would argue that every one of these themes has a real-estate impact.

The negative impact of e-commerce on some retail real estate assets is likely to be offset by its positive impact on warehouses, infill service centers, and self-service locker and pick-up locations. The advent of 5G is likely to increase demand for cellphone towers and fiber cable assets—and cellphone towers may be an important element in creating the communications network required to make next-generation mobility a reality, particularly outside urban centers. Both cloud computing and the processing power required for artificial intelligence generate demand for datacenters. In his February 13 "Keyword" blog, Alphabet CEO Sundar Pichai revealed that his firm will invest $13 billion in datacenters and offices across 14 U.S. states this year.

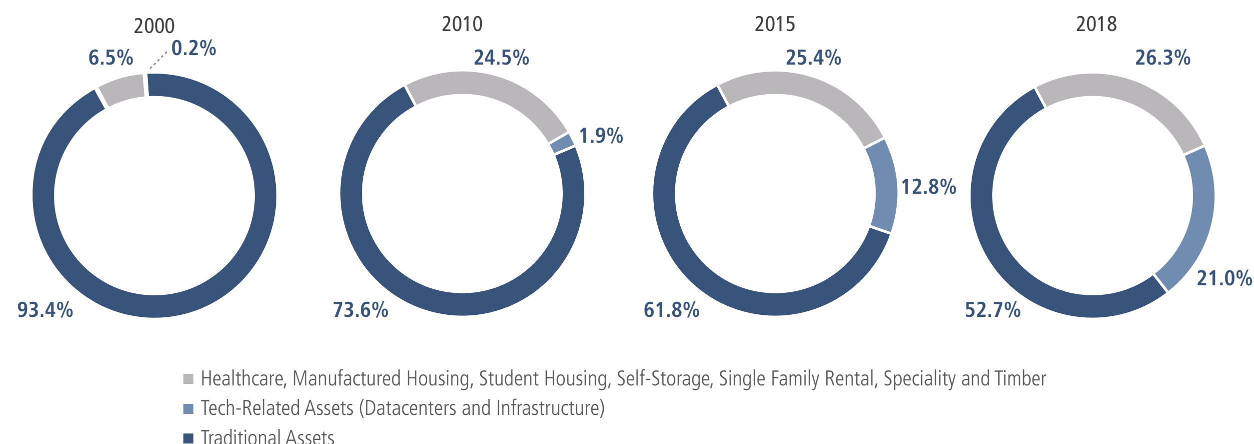
Away from technology themes, an aging population requires more localized healthcare facilities. An important part of the emerging consumer theme is a bigger leisure spend, which, in addition to its impact on retail assets, is already generating more demand for hotels, casinos and related assets in both emerging and developed markets. And turning to the environment, resource-efficiency is an important quality differentiator across real estate assets in general, while timberland in particular is exposed to themes of climate change and sustainability.

Where the U.S. Leads, the Rest of the World Follows

These assets were not always available in the listed real estate market. At the turn of the century, of course, some of them simply did not exist, and those that did were rarely securitized.

However, as figure 1 shows, the picture has changed dramatically in the U.S. These non-core, non-traditional assets that constituted just 7% of the FTSE NAREIT All Equity REITs Index in 2000 now represent 47%.

FIGURE 1. THE GROWTH OF NON-CORE SECTORS IN U.S. LISTED REAL ESTATE MARKET

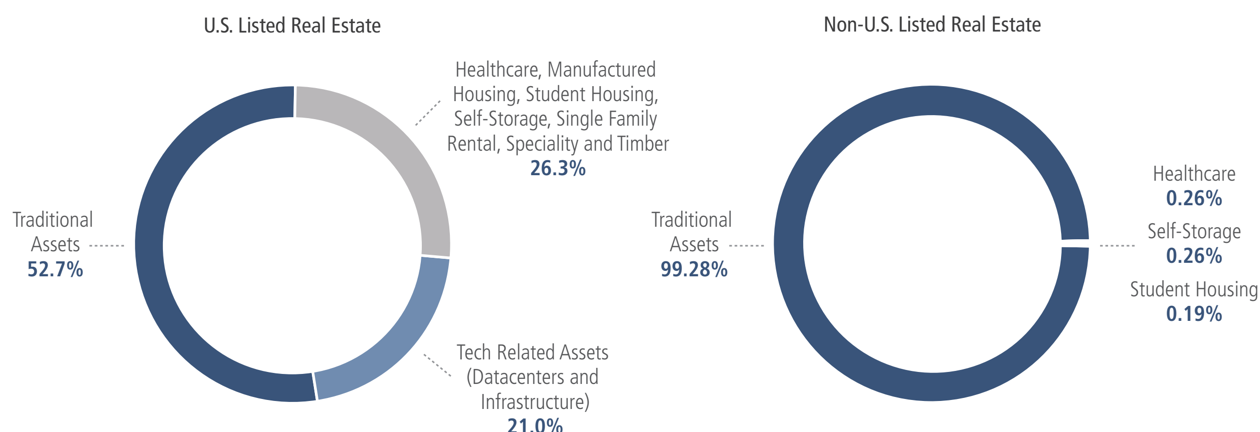


Source: FTSE Russell.

The situation is not as advanced in Europe or Asia, as figure 2 shows. But then, the listed real estate market in general is not as advanced as it is in the U.S. Even after the expansion in both the size and the regional diversity of Europe's listed real estate universe over the past seven years or so, the global listed real estate universe is still 50% U.S., which is in no way proportionate to GDP—or indeed to the amount of real estate assets available for securitization around the world.

Nonetheless, the expansion of the European market does indicate that where the U.S. leads in securitization, the rest of the world eventually follows. Indeed, in many cases, the securitization of European and Asian assets is led by U.S. companies before local competitors spot the trend and begin to spin-off and list assets themselves. We have seen that in the evolution of German residential and office markets, for example. We think it is only a matter of time before European and Asian technology and telecom companies begin to see the potential for securitizing some of their numerous real estate and infrastructure assets.

FIGURE 2. THE U.S. LEADS EUROPE AND ASIA IN NON-CORE SECTORS



Source: FTSE Russell.

New Opportunities

Over time, these developments will change the nature of REITs as an asset class and broaden the potential for what can be done by active managers in listed real estate.

First, the market is becoming more regionally diverse on three levels: locally, suburban single-family homes and e-commerce infrastructure are adding to traditional central business district residential and commercial properties; nationally, we see the spread of large, human capital-intensive technology businesses outside of the traditional coastal business hubs; and globally, we see the rest of the world picking up on the U.S. trend for listing real estate assets.

Second, in terms of style we see REITs becoming a less interest rate-sensitive and a more growth-oriented asset class, with a greater diversity of demand drivers. This has already happened in U.S. REITs: new sectors such as manufactured homes, datacenters and cellphone towers generally outperformed the broader REITs market during the 2016 – 18 period of rising bond yields; and whereas in the nine years leading up to 2008 capital appreciation accounted for, on average, 55% of the FTSE NAREIT All Equity REIT Index total return, in the 10 years since it has accounted for 67%.

On reflection, this is intuitive. REITs hold those assets that are the basic infrastructure of every economy, and which enable those economies to work and grow; it should therefore come as no surprise that REITs are exposed to many of the same drivers of growth as the economy as a whole. In previous decades growth-supporting real estate was factories and warehouses; today, it is datacenters and cellphone towers.

That makes understanding the dynamics of the listed real estate market for the purposes of effective active management increasingly demanding, but it also opens up exciting new opportunities for tactical and strategic portfolio positioning on a global level.

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