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Returning to REITs

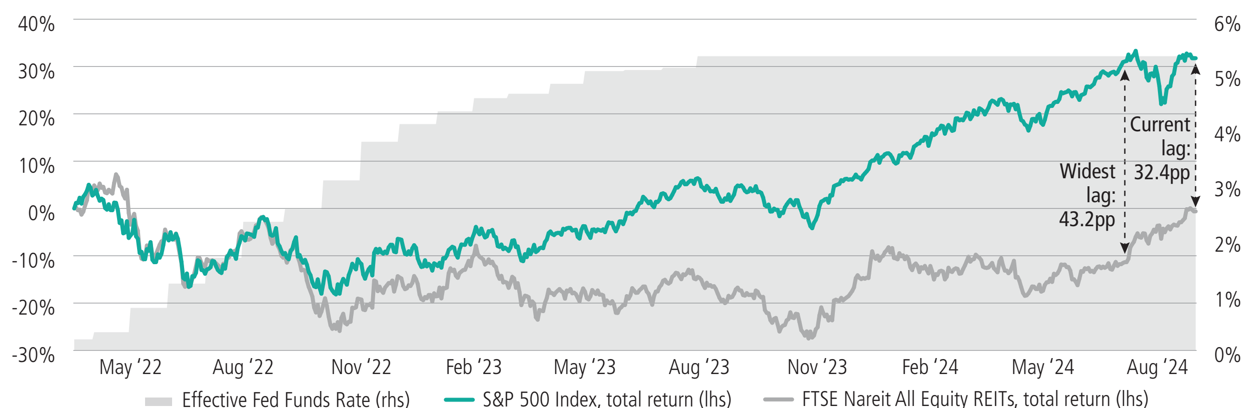
The U.S. Federal Reserve (Fed) has just delivered its first rate cut in the current cycle. With U.S. inflation and jobs data continuing to soften, and the rates market pricing for almost 200 basis points of further cuts over the next 12 months, we think this is a key moment for investors in Real Estate Investment Trusts (REITs) and other public real estate securities.

Some sub-sectors, notably Offices, face structural headwinds and uncertainties. But there is much more to REITs than Offices, and many of these companies combine strong balance sheets with diverse and non-cyclical demand at valuations that we believe have been dragged down by indiscriminate negative sentiment. With the sector already starting its comeback, we think it is time for investors to return to REITs.

Ever since the Fed started raising rates back in March 2022, REITs have generally underperformed the broader equity market. As figure 1 shows, the exception was the fourth quarter of last year, when markets prematurely priced for an aggressive set of rate cuts during 2024. When stubborn inflation meant those cuts failed to materialize, REITs fell behind the market again. The cumulative lag hit its widest point this past July, at 43 percentage points.

FIGURE 1. THE HIGH-RATE ENVIRONMENT HAS BEEN DIFFICULT FOR REITS

Cumulative total return since the first Fed rate hike of this cycle, March 2022 – August 2024



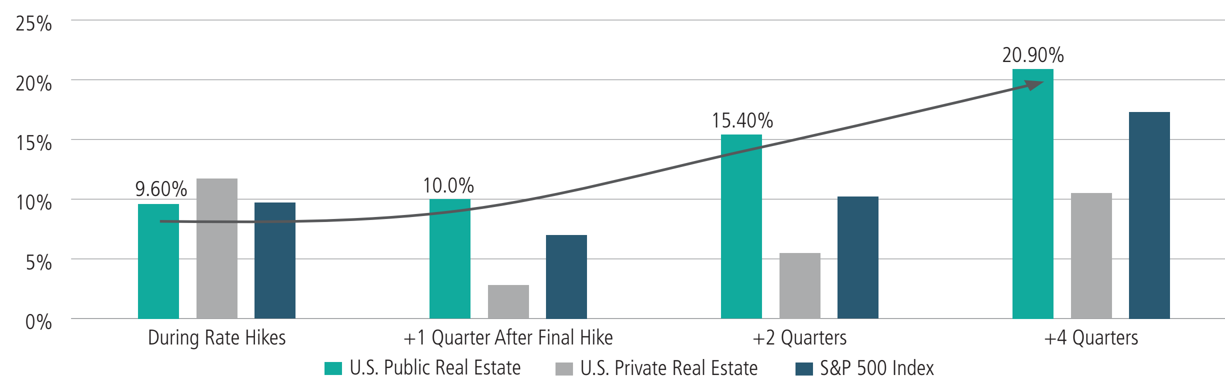
Source: FactSet. Data as of August 30, 2024. Nothing herein constitutes a prediction or projection of future events or future market behavior. Historical trends do not imply, forecast or guarantee future results. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed or any historical results. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

We believe this pattern is intuitive. Real estate generally has more leverage than other S&P 500 Index sectors. Higher rates not only push up costs on a lot of debt already incurred; they also dampen the transaction and recapitalization activity that relies on new borrowing.

Data from the interest rate cycles of the past 30 years, shown in figure 2, suggest to us that REITs begin to outperform from around the time of the final hike. By the time a year has passed, on average, they have returned more than 20%. This time around, since the final Fed rate hike in July 2023, REITs are up around 15%. Over the past two months, REITs have been rapidly closing their long-term performance gap against the wider market.

FIGURE 2. REITS HAVE TENDED TO OUTPERFORM ONCE RATES HAVE PEAKED

Average total annualized returns, 1992 – 2024



Source: Federal Reserve Board, NAREIT, NCREIT, FactSet. Data as of June 30, 2024. Indices used: FTSE NAREIT All Equity Index (U.S. Public Real Estate), NCREIF Fund Index – Open End Diversified Core Equity (U.S. Private Real Estate). Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. Nothing herein constitutes a prediction or projection of future events or future market behavior. Historical trends do not imply, forecast or guarantee future results. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed or any historical results. Investing entails risks, including possible loss of principal. **Past performance is not indicative of future results.**

Attractive Valuations

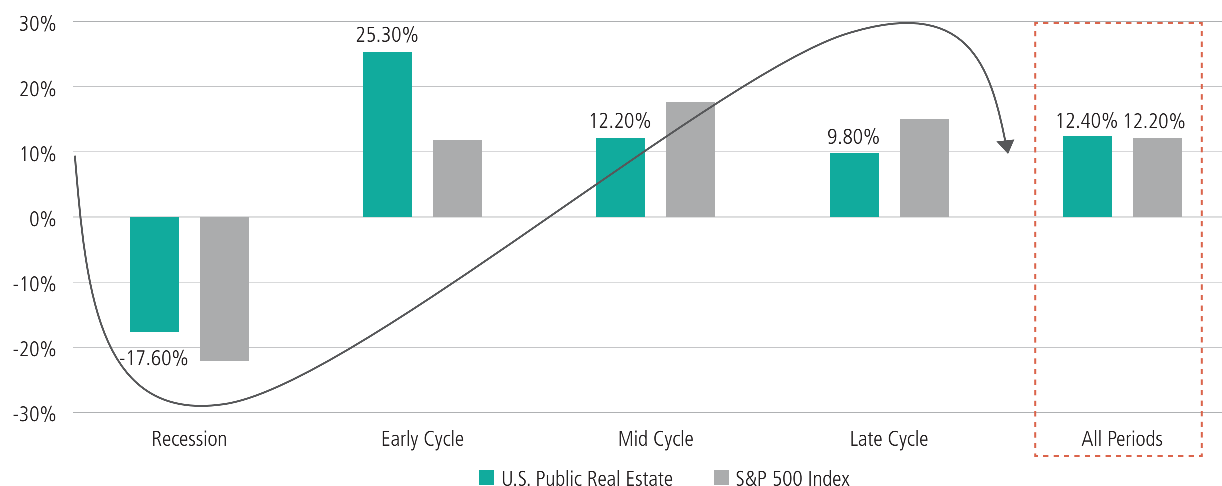
Investors considering REITs as a potential value opportunity are likely to have two main concerns. One is that looming interest rate cuts betray an underlying weakness in the economy. The other is that the 20% rally over the past five months has already removed that value opportunity.

While bonds and some other more defensive equity sectors are likely to offer more of a buffer against an economic slowdown than REITs, REITs' relatively stable and visible cash flows do have defensive qualities. As figure 3 shows, the sector has tended to hold up better than the broad equity market during the recessions of the past 30 years.

Moreover, most economists do not anticipate a significant U.S. recession in the near term, and we currently agree with this "soft landing" consensus. In addition, outright defensive equity sectors do not offer the same early-cycle potential that REITs have shown, historically. Should the economy manage a smooth transition between the late part of the current cycle and the early part of the next, we believe the resulting normalizing inflation, lower interest rates and positive growth could bring ideal conditions for REITs over the next 12 months.

FIGURE 3. REITS HAVE TENDED TO BE RESILIENT DURING RECESSIONS, WITH VERY STRONG EARLY-CYCLE RECOVERIES

Average total annualized returns, 1991 – 2024



Source: Datastream, UBS. Data as of June 30, 2024. Index used: FTSE Nareit All Equity REITS (U.S. Public Real Estate). We have categorized as "Early cycle" periods during which the Citizens Business Conditions Index (CBCI) was accelerating (104 of 402 months: 3/91–12/94, 11/01–12/04, 6/09–1/11); "Mid cycle" are periods when the CBCI was stable (193 of 402 months: 1/95–4/00, 1/05–9/06, 2/11–12/19); "Late cycle" are periods when the CBCI was decelerating (75 of 402 months: 5/00–2/01, 10/06–11/07, 4/20–6/24). Recessions are those reported by the National Bureau of Economic Research (30 of 402 months: 1/91–2/91, 3/01–10/01, 12/07–5/09, 2/20–3/20). Note that we categorize the pre-pandemic period of 1/19 to 1/20 as "Mid cycle." Nothing herein constitutes a prediction or projection of future events or future market behavior. Historical trends do not imply, forecast or guarantee future results. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed or any historical results. Investing entails risks, including possible loss of principal. **Past performance is not indicative of future results.**

On valuations, the recent rally has done little to correct the sector's cheapness due to the impact of the sheer size and rapidity of the 2022 and 2023 rate-hiking cycle, combined with other structural challenges such as the "amazonification" of retail and post-pandemic remote working.

Since the end of 2021, standard valuation multiples have declined by more than 30%—considerably more than any other S&P 500 Index sector. FactSet and Bloomberg data suggest that some 40% of real estate stocks are still trading with dividend yields higher than the U.S. 10-year Treasury yield. Stocks in the FTSE NAREIT All Equity REIT Index are trading at prices in line with net asset values (NAV), compared with a long-term average premium to NAV of 1.8%. Moreover, NAV estimates have themselves come down roughly 33% since the end of 2021, reflecting the impact of a higher rate environment.

Over the past two years, as the artificial intelligence theme led to a re-rating of mega-cap technology stocks, the relative valuation of REITs versus the broad equity market has plummeted. Figure 4 shows the growing divergence between the price-to-funds from operations multiple (P/FFO) for REITs and the price-to-earnings ratio (P/E) for the full S&P 500 Index.

FIGURE 4. BROADER MARKET VALUATIONS HAVE DIVERGED FROM REIT VALUATIONS

S&P 500 Index price-to-earnings ratio versus U.S. REIT price-to-funds from operations ratio

Source: Datastream, UBS. Data as of June 30, 2024. The Funds From Operations metric for U.S. REITs is derived from a UBS model. Nothing herein constitutes a prediction or projection of future events or future market behavior. Historical trends do not imply, forecast or guarantee future results. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed or any historical results. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

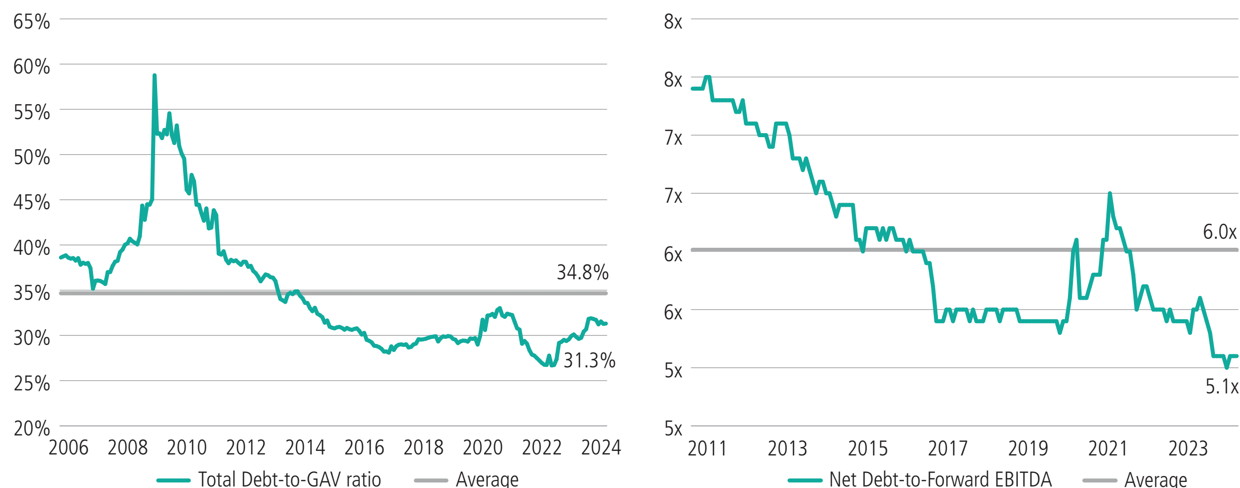
We have begun to see a broadening of performance in the U.S. equity market, with smaller stocks and value stocks starting to close the gap with the mega-cap technology sector. As we saw at the top of the article, in figure 1, REITs have also been closing that gap. Even so, these are early days and in our view there is still potential for a lot of rebalancing and rotation away from mega-cap tech to flow into listed real estate.

More to REITs than Offices

If valuations are still cheap, some investors may be concerned that they are cheap for good reason.

We do not see major, sector-wide problems with indebtedness, the obvious place to look for stress in a high-rate environment. Total debt as a proportion of gross asset value (GAV) has ticked up over the past couple of years, but that is due to property values declining rather than debt levels rising—and, as figure 5 shows, the ratio is still lower than the long-term average of 35%. As a proportion of forward earnings estimates, the sector's net debt is also well below the historic average, and has been steadily declining. In addition, like many other corporate borrowers, real estate companies used the long period of low rates and flat yield curves before 2022 to extend their debt maturities and thereby mitigate their sensitivity to higher rates.

FIGURE 5. U.S. REIT DEBT LEVELS ARE GENERALLY BELOW THE LONG-TERM AVERAGE



Source: Citigroup, FactSet. Data as of June 30, 2024. Debt metrics are weighted averages for the REIT universe. Nothing herein constitutes a prediction or projection of future events or future market behavior. Historical trends do not imply, forecast or guarantee future results. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed or any historical results. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

If low valuations are not about high indebtedness and interest costs, that brings us back to those structural headwinds, and particularly the working-from-home trend. Over the past four years, it is really only the Offices sector that has been hit with persistently high vacancies.

We believe sentiment around offices has been dragging on the entire U.S. Real Estate sector, and yet offices represent just 2% of the S&P 500 Index Real Estate sector, and 3% of the FTSE NAREIT All Equity Index. The private market, as represented by the NCREIF Fund Index – Open End Diversified Core Equity (ODCE), is 91% weighted to the traditional Industrial, Apartments, Offices and Retail sectors, with Offices accounting for almost 20% of market capitalization. By contrast, those sectors make up just 41% of the FTSE NAREIT All Equity Index, and there is a much fatter tail of well-represented sectors in the other 59%: Telecoms, Data Centers, Health Care and Self Storage, each accounting for more than 5% of the Index.

That offers a lot of scope for diversification and sub-sector selection. At the moment, for example, we take a relatively defensive view that prioritizes strong balance sheets and simple business models, and we particularly favor opportunities in sub-sectors such as Telecom Towers, Residential Property, Health Care and Self Storage.

When it comes to Offices, we would be cautious and very selective. That said, share prices are heavily discounted relative to NAVs, which have themselves come down 40 – 60% from their peaks—and the news is not all bad. Leasing volumes appear to have bottomed out.[1] Vacancy rates remain high and could still go higher, but there is meaningful bifurcation between the average vacancy rate of 17% for non-premier assets and 12% for premier central business district offices, according to CBRE Group figures.

[1] According to Cushman & Wakefield's *Market Beat U.S. Office Reports* for Q2 2023 and Q2 2024, nationwide leasing activity for the first half of 2024 is up 10.7% from the same period last year.

Return to REITs

REITs have been one of the equity sectors most badly hit by the past two years of rapidly rising interest rates and high inflation in operating costs. But with inflation declining and rates being cut, we can now see light at the end of the tunnel.

In some cases, that light is very bright. Many REITs are well capitalized, having termed out their debt during the period of low rates and flat yield curves before 2022, and cut operating costs as rates have gone up. Where these strong balance sheets back businesses with diverse and less cyclical demand, we see opportunity. And because high rates and structural uncertainties have had such a negative impact on some parts of the Real Estate sector, valuations across the entire sector have been dragged down.

We do not think this value opportunity will last forever. REITs have already begun to rally this year. As the U.S. economy slows, we think more investors will gravitate to the relative stability and visibility of the sector’s contractual leases, high operating margins, low labor intensity and limited supply. In our view, that makes it an opportune time to return to REITs.

Index Definitions

The **S&P 500 Index** consists of 500 U.S. stocks chosen for market size, liquidity and industry group representation. It is a market value-weighted index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to its market value.

The **FTSE Nareit All Equity REITs Index** contains all tax-qualified REITs with more than 50% of total assets in qualifying real estate assets other than mortgages secured by real property that also meet minimum size and liquidity criteria. It is part of the FTSE Nareit U.S. Real Estate Index Series, which is designed to present investors with a comprehensive family of REIT performance indexes that spans the commercial real estate space across the U.S. economy. The index series provides investors with exposure to all investment and property sectors. In addition, the more narrowly focused property sector and sub-sector indexes provide the facility to concentrate commercial real estate exposure in more selected markets.

The **NCREIF Fund Index—Open-End Diversified Core Equity Fund Index** is a capitalization-weighted, gross of fee, time-weighted return index of the performance of the net invested capital of open-end funds whose investing style typically reflects lower risk investment strategies utilizing low leverage and generally represented by equity ownership positions in stable U.S. operating properties diversified across regions and property types.

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