Real Estate Investing in the Digital Age

Disruptive Forces in Investing

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Anu Rajakumar: While traditional office and retail investments have struggled in recent years, technology has ushered in a new age for real estate investments, driven by a surging demand for faster connectivity and greater data storage. Before life and business became disrupted due to COVID-19, the world had been rushing into the era of 5G, which requires huge investment into the physical infrastructure required for progress in the real estate market.

According to my guest today, Steve Shigekawa, Senior Portfolio Manager for the Real Estate Securities Group, investing in public real estate investment trusts, or REITs, can be one way to take advantage of these opportunities in this space.

Thanks for joining me today, Steve.

Steve Shigekawa: Glad to be here.

Anu: So Steve, let's start with the market volatility around the coronavirus. As a portfolio manager, what have you been sharing with clients regarding your views and potential REITs impact?

Steve: Well, we've seen a period of increased volatility and uncertainty as the coronavirus, or the pandemic, has escalated and spread across the country. From a real estate perspective, initially, the concern was related to travel bans that were being placed, limitations on large gatherings, and businesses and schools closing. So sectors like the hotel space, the retail sector, so shopping centers and regional malls that were closing, and nursing homes, which were obviously in the headlines, as it related to the coronavirus. So those were the sectors that we saw were most at-risk at the beginning.

As the pandemic escalated, there was increasing concern about its impact on the overall economy, in terms of higher unemployment, and a potential slowing of growth. And so then the concerns in the real estate market spread to other sectors, so that included the office sector and some of the residential sectors. This concern also sparked a concern in the financial market. So we saw certain markets where liquidity was limited. There were questions about ability for consumers, and citizens, to be able to pay their rents for businesses to be able to pay mortgages. And so that really escalated the concern in some of the real estate markets.

As it progressed, one of the things that we saw was a catalyst for a turn in the market was the amount of stimulus that was put into the system, both from the Federal Reserve as well as from Congress. And we think that stimulus really helped ease some of the concerns that related to the increasing risk of recession and job losses. We were telling our investors how we were positioned, which was to be focused in some of the non-core sectors, ones that were less cyclical, and companies that we think had the strongest balance sheets. We thought those would be the ones that would be able to weather the storm the best, in terms of the initial pandemic and closing of businesses. And as we look forward, the gradual reopening of the economy.

Anu: Great. That's super helpful. Maybe if I just dig in a little bit there, I would love some of your perspectives on the impact of shelter-in-place, and what affects you've seen or expect to see on office space demand in this new environment where so many are working from home.

Steve: Yeah. That's an interesting point. There is actually two stages that we saw. Obviously initially businesses were closed, and so, employees or enterprises were having their employees work from home. And so you saw that just usage was down obviously, quite dramatically. And we saw most impacted were the small businesses, and the office space where there were fewer users. As the concern grew as it related to the economy, the concerns around the office market, were added by the risk of recession. And so if you think about, like, social distancing, and work-from-home mandates that were in place, that are currently in place, that's going to have a long-term impact on office demand.

If you look back to 2000, what we were seeing was companies were using less and less square footage per person in terms of the floor plates, for large companies. So in 2000, it was roughly 300 square feet per person. Currently it's about 200 square feet per person. So, much more densely populated office space. That obviously goes counter to what we're dealing with today in terms of social distancing and work from home.

So we think that there are going to be long-term implications for office demand as people start gradually coming back into the office but are mindful of having that social distancing in terms of other employees and working in large groups.

Also, the work-from-home mandates have really highlighted that employees can be efficient and can do their jobs while working in multiple locations. And so the thinking is when we do start to come back – the economy does start to come back, how will enterprises change their policies as it relates to working from home?

Will there be a point where, you know, 10 or 20 percent of employees at a company will work from home on a consistent basis? We think that would be negative for demand for office space, but it could be offset by, if there are social distancing, if those types of concerns continue for the long-term, that densification would have to be reversed, and you would see enterprisers leasing more space on a per-person basis. So, you know, we're-we're keeping a close eye on that, and we'll see how that's going to impact office demand coming out of this crisis.

Anu: That's an interesting point. I actually hadn't thought about that the kind of idea of actually could result in some more space being leased out. So thank you for that. Now even before coronavirus, shopping centers were closing. Online shopping was increasing dramatically. Steve, what are some of the long-term implications for brick and mortar retail locations from your perspective?

Steve: Sure. Well, as you said, it was already a very challenging environment for brick-and-mortar retail. Growth of e-commerce from companies like Amazon, consumers were increasingly having goods sent directly to their home. And so that was negatively impacting brick-and-mortar retail.

We saw it in the market, in terms of the challenges as it related to department stores and other inline retail locations. What we think is going to happen now is it's really going to accelerate a necessary change in the overall business model for retail. Where our expectations are because of this slow economic environment, we're likely to see more bankruptcies of retailers and more store closings. And we think this is really going to put pressure on the regional mall landlords, to rebuild or rethink their business model.

We think that the best malls will survive. These malls are in good locations. They're in densely populated areas. And the landlords have historically – or the mall owners have historically been very good at re-tenanting their locations. So the first step is going to be, reopening of retail locations, having people feel comfortable coming back to the mall.

And then a little bit longer term is shifting of the business model away from apparel, taking advantage of some of the newer trends that you're seeing in shopping centers, which is having more, entertainment-type tenants, more restaurants, things that are really going to drive traffic because we expect to see continued pressure, on the department stores and the in-line, specifically in the apparel segment of the tenant roster. So our expectation is, this is really just, going to speed up a change in terms of the needed new business model for mall owners.

Anu: Great. Now, as I mentioned in the opening, technological advances have really disrupted the world of real investment trusts over the last few years. Give us a quick overview about how the REITs market has just evolved in general.

Steve: Sure. The public REIT market in the U.S. has changed quite dramatically. If you think back, you know, 20 years, the REITs owned the core property types, so these were the property types that most people think of, so, office locations, retail locations, residential, hotels, and, warehouses.

In 2000, less than 10 percent of the public REIT market was in non-core sectors. And so we've seen a growth in sec-new sectors such as healthcare, manufactured housing, single-family rentals, self-storage facilities, even timberland REITs. And so by 2010, these non-core sectors were about 25 percent of the overall market.

In 2010, technology-related sectors were less than two percent of the overall market. Today, those technology sectors make up over 30 percent of the public market. And this is primarily in data center companies and cell tower companies. So we've seen a dramatic shift in the types of real estate that you can own in the public market.

Anu: You mentioned these technology-related sectors. What are some of the key characteristics, of those sort of technology or digital-related infrastructure REITs?

Steve: Well, even before, the current crisis that we're dealing with, we recognized that we were later in the economic cycle, in terms of recovery from the GFC, or the global financial crisis. And so we were looking for sectors that had different demand drivers that would be better insulated, if the economy were to slow.

And so one of the key characteristics when you think about digital-related infrastructure REITs is that– we think demand is going to be driven by some of the secular trends that we're seeing in technology. So when you think about data centers, things like cloud computing is going to be a primary driver for demand. In the cell tower arena, we think 5G technology and the buildout of the 5G infrastructure is going to be a long-term driver. And we think that this is going to better insulate these companies through this current crisis, and will also be the growth drivers as we look further out.

The other thing to think about is the tenants for these technology infrastructure real estate companies are the leading technology companies that we know are in the market. So companies like Amazon and Microsoft and Google and Facebook, these companies have been the drivers of the overall economy over the last 10 years, and we think will continue to be. And these are the largest tenants for some of these data center companies. We see there's also other demand drivers in the technology area. So when you think about artificial intelligence or autonomous vehicles the FinTech or payment, digital payment, internet of things, even streaming video, all of this is going to require a more robust digital technology infrastructure, and we think that that will benefit companies like data center and cell tower REITs.

Anu: And just on that note, Steve, on cell towers and data centers, what exactly is the connection between those two?

Steve: Sure. When you think about cell towers and data centers, they're both important parts of the overall technology infrastructure. And so, when you think of cell towers and the connection in terms of mobile usage, cloud demand through the data centers, also factoring in small cells, which would be like mini cell towers or cellular locations that could be on light posts or signals that would give that greater density to the overall infrastructure. And this would all be connected through fiber optic lines, [which] would connect data centers to cell towers, and would really create this overall technology infrastructure.

So the connection between these two sectors is that we think they're both very important parts of the overall ecosystem.

Anu: Great. That's perfect. And just out of curiosity on that topic of the cell tower demand, what are some of those near-term catalysts that you can see?

Steve: Sure. When you really think about broadband data usage, that's going to be a primary driver, we think that's growing 30 percent per year. The other part of it is that increasingly, in order to improve capacity and the latency of our wireless network, new frequency, high-frequency spectrum is being added to the overall system. And so when the telecom companies are adding frequency spectrum to the overall infrastructure, we think that's going to require more equipment to be placed on cell towers, and that would mean amendments for the cell tower companies and higher rental rates.

When you think about higher frequency spectrum, we think it's going to require a higher density of cell towers just because of the distance that high-frequency spectrum can travel. So in an area that may have had four cell towers, because of this added higher spectrum, higher frequency spectrum, it may require a fifth cell tower. So you're not only having more cell towers or higher density, but also more equipment is being added to the cell towers. And then longer term, we think the demand driver is going to be the shift in the U.S. from 4G technology to 5G technology. And that's going to be the catalyst, and that could take up to 10 years.

Anu: Great. And I think as we – as we wrap up here, last question isn't related to infrastructure REITs, but I think it's worth a quick discussion. And this question is about millennials and younger generations of workers and how they are changing the traditional way of living and working. I think gig economy and the rise of WeWork spaces, again, this is all sort of, you know, trends pre-coronavirus. But we'd just love to talk through some of your outlook here on what the implications are on real estate, for those younger generations, and how they think about working. Um, and how has the current environment changed the dynamics of those trends?

Steve: Sure. You know, prior to the coronavirus pandemic, we were seeing that gig economy growing, independent contractors, people having the flexibility to work in different locations. Companies like WeWork allowed for these contractors to collaborate in-in a group setting. And so we were seeing a lot of growth in that area.

Unfortunately, the current situation and the likelihood that we're in a recession, and it's going to take some time to see that recovery, we think it's going to slow the growth of that part of the market. So, when you think about small businesses or

independent contractors, those types of businesses have been hit hard by the recession, in terms of job loss and higher unemployment. So that's going to be a challenge just from the economic condition.

Specifically, for a company like WeWork's, their business model was to – or is to -- lease long term from the owners of the real estate or from the landlord and then sublease that space on a short-term basis, to small businesses or independent contractors. Well, because of the challenges in the current environment, there's a higher risk that those short-term leases are going to expire and not be renewed. So there's challenges to the overall business model for co-working companies like WeWork's.

And if you think about the other aspect of it, part of what was appealing to young people in a co-working location was the ability to collaborate with other people and to work in little groups. We think the social distancing mandates are going to negatively impact that demand.

And then you also have the work-from-home trends that we're seeing now. We think it's going to be a gradual return to the office, but there will continue to be employees that are going to work from home. And that may lessen the demand for some of this co-working type locations. So, unfortunately, we think the pandemic and the resulting re-recession is really going to slow the growth of that area of the market.

Anu: Great. Well, Steve, really appreciate you taking the time to chat with me today, particularly your comments given the coronavirus situation. So, stay well and thank you very much again.

Steve: Thank you.

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