Rates and REITs

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Anu Rajakumar: As global central banks pivot towards interest rate cuts, the time seems right to discuss Real Estate Investment Trusts, or REITs, which potentially generate long-term capital appreciation, steady income, and diversification benefits in a liquid publicly traded vehicle but given the current investment landscape, what makes REITs attractive now? Which sectors are poised to benefit going forward? How can investors take advantage of this asset class? My name is Anu Rajakumar, and joining me today is Archena Alagappan, Associate Portfolio Manager for the Real Estates Securities Group. Archena, welcome to the show.

Archena Alagappan: Thanks, Anu. Great to be here.

Anu: Arch, let's start off with some basics. Tell us about the current state of REITs, and why now is a good time to be discussing this asset class.

Archena: As you mentioned, we're embarking upon a period of rate cuts and that's a good thing for REITs. Besides debating the size and the timing of the rate cuts, what's important is that we have clarity with the direction of rates. REITs usually tend to be inversely correlated with rates, so if rates go up, REITs go down, and if rates go down, REITs go up.

Over the last call it two and a half years, REITs have significantly underperformed the broader market as we embarked upon these 11 rate hikes of 525 basis points. Because again, it was just more lucrative to invest your money in large-cap technology sectors, or if you wanted to preserve your capital, it made sense for you to park your money with money market funds.

As we enter into this newer period, folks are quick to realize that they are underweight REITs, and as they want to rotate out of money market funds, again, REITs become a valuable option as they think about getting higher yield. Folks who are also looking to rotate out of large-cap growth look at REITs as a good option given that you have stable, steady revenue streams across different asset classes, which pretty much mirror what you're seeing with the broader market.

To the extent that you think about consumer discretionary, you could invest in malls or shopping centers. If you wanted to invest in technology or AI, you have data centers and towers. If you think about residential, you have apartments, single-family housing, or manufactured housing.

Archena: Another interesting sector within real estate is healthcare. Especially with the aging demographic in the US, we are seeing that silver tsunami that you've been hearing and there are very few options for these folks to age gracefully in place, and Seniors Housing offers that opportunity to do so. There are very limited ways of investing in Seniors Housing in a private format, but you do have senior housing focused REITs that offer you the opportunity to participate in those trends more actively.

There is the opportunity to invest in these stable, steady-growing sectors that are being re-rated because of lower rates.

As we look forward and rates move down, this allows for REITs to be revalued. You have folks who are sitting on the sidelines get more involved with recapitalization and transactions. You have folks who are waiting on the sidelines, as it relates to refinancing their debt, become more actively involved, and folks who are looking to invest more on a grander scale, you have M&A coming back into the picture, and that's what makes REITs interesting today.

Anu: That's great. I'm glad that you mentioned valuations because so many folks are focused on equity valuations being such record highs, but you said an 11-turn discount for REITs, which is important for investors to be aware of. How is all of this impacting sentiment around REITs?

Archena: If you take a step back, I think the tradition has been that when rates go down, REITs go up, and when rates go up, REITs go down. I think the moment that we had rates moving up, generalists and investors were very quick to reducing their weight in REITs, and in many cases, not owning REITs at all because they had the opportunity to park their capital elsewhere in, as

mentioned, the money market funds or in higher growth sectors. Now, as rates are coming down, folks are becoming acutely aware that there are underweight REITs. Now, we're starting to see that rotation back into REITs.

Also, money market funds have been a source of funding for REITs in the past, and we are starting to see that again today. I think, overall, the sentiment has improved towards REITs, especially as we're embarking upon rate cuts. The other thing to keep in mind is we're constantly bombarded with news headlines around a commercial real estate bubble or a wall with $1.5 trillion debt that's coming due that needs to be refinanced. Headlines like those keep investors at bay, but if you dig through the details and look at the different sectors that make up real estate, for the most part, most asset classes have been growing steadily over the years, including the last two to three years.

Where we are seeing some trouble, if at all, is within certain pockets of office real estate. Now, office makes up a small piece of that overall $1.5 trillion. Where we are seeing problems are largely in the hands of private real estate office landlords who have a significant amount of debt. Now, if we take a big step back, if you look at the US real estate landscape, it's roughly $15 trillion, and most of this is in the hands of the private real estate space. If you think about the private real estate space, it's roughly a quarter in industrial, multifamily residential, retail, and office. However, office makes up 3% of our index. If you think about those four core groups, they make up about 40% of our public real estate space, which is roughly $1.3 trillion.

All in all, the problem child, if you may, which is the office sector, is only a small piece of that public real estate puzzle. If you think about the other 60%, that's in non-traditional sectors, which is your data centers, your towers, self-storage, single family, these are all newer, more modern sectors that have evolved over the years to mimic what you're seeing in the broader S&P 500 or the broader market. We are seeing increased inflows and interest into sectors like data centers, for instance, to capitalize on the demand that you're seeing with AI, ChatGPT, or with burgeoning technology trends.

We are seeing inflows into the single-family residential space because the new generation of to-be homeowners can't exactly afford a 7% or an 8% mortgage rate and there's frankly very limited supply of existing houses because of very low existing home sales given that most people are locked into 4% or lower mortgage rates. Overall, we are still seeing stable and growing revenues for most asset classes, and for some, like I just mentioned, we are actually seeing increasing demand.

Anu: That's great. Actually, I was going to have a follow-up question just to talk a little about supply and demand, especially as we move into it is a cycle, and we're going to see rates being cut, but we're also potentially seeing a slowing economy as well. How does that affect supply, demand dynamics for REITs?

Archena: Sure. We did have a decade of significantly lower rates that did prompt a lot of construction activity. We did have, call it the last two and a half, three years, where construction activity has significantly slowed. Overall, construction as a percentage of existing supply, or starts as a percentage of existing supply still remains at very reasonable levels. It really depends upon the asset class.

In certain asset classes, like residential, for instance, where we have a housing shortage in the United States, we just don't have enough homes. In other sectors, like towers, for instance, we haven't had a significant building of new towers. However, in sectors like office, we are seeing, again, more of a focus on quality, a key spaces, and we are seeing some vacancy pickup.

Construction activity in office has still continued to offer a newer, better space, but there is an issue of existing class B and class C office spaces in the suburban areas of Collin, New Jersey, or Texas, for instance. It really depends on which asset class you are looking at and which location.

Anu: Sure. Then just out of curiosity, e-commerce is pretty much how everyone, including myself, buys things today. How does that affect the warehouses that the big folks, the Amazons, the Walmarts, et cetera, are using? Is there an opportunity there, or is that been saturated at this point?

Archena: E-commerce was definitely a huge trend, call it in the early 2000s that picked up steam even more during COVID. We did see the industrial space within the REIT sector grow on the backs of that. However, if you look at the industrial warehouse space today, it has evolved and there has been a significant pull forward of demand during COVID. While we are bullish on warehouse demand over the long term, we do think that relative valuations are high in the industrial space. There is a right sizing of demand that is happening currently.

We've seen malls shrink over time to being, again, class-A quality malls. If you look at the current generation today, it's again cool to go back to a mall. We are starting to see foot traffic and retail sales in key malls be higher than pre-pandemic levels.

We're starting to see an evening out of certain trends, but we still believe in the importance of having strong distribution channels and good logistics warehouse plan and our bullish over the long term.

Anu: Great. Interesting to hear that malls are back in, everything old becomes new again at some point, right?

Archena: Yes.

Anu: Sure. You spoke a moment ago a little bit of the evolution it sounds like, because of the REITs index. I want to dig into that a bit more. You'd said that office makes up about 3% of the REIT index today, but how has that evolved over time and if REITs assuming it has probably gone from a higher allocation in the index to a lower allocation, at what point is that an inflection point to actually be attractive again, potentially?

Archena: Office was definitely at one point a big part of the index. It was over 20% of the index call it in 2000. It's been shrinking over time, roughly 13% to 14% 10 years ago. Now it makes up 3% of the index. We have seen this period of reckoning within the office space where, again, there's been a greater emphasis on quality, well amenitized Class A trophy assets in key locations. We're getting to the point where, again, within office we've had certain trends like work from home and a desire to move to Class A trophy assets to provide a better work culture for employees. Again, bringing back to the point that, yes, there is a place for office in the United States and in the world, but not just any type of office in any location.

We're again getting back to the point that we need core Class A office in quality locations. As we see these work from home trends stabilizing and companies ask their employees to come back into the office, there is a sense that, "Hey, offices are here to stay." The question is how much office do we really need? I think that's a question that's still evolving. However, what's encouraging to see is that we're seeing leasing trends start to pick up. We're seeing folks who were downsizing their space start to take better quality space and other locations and look to either keep that or expand that in similar type locations. One could argue that we're actually seeing that inflection point today, we are seeing some office companies within our portfolio and our index that are actually saying, "Hey, we are seeing increased leasing."

We see more interest in our development pipelines. We are seeing capital coming back into the office space, looking to invest and partner in good quality locations because they're looking for yield, but they're looking for good quality yield.

Anu: Yes, no, that's great. It's such a big focus for people whenever you talk about real estate. As you said, it's only 3% of the index. For being such a small part, I know we speak about office a lot, but it's certainly helpful to hear your views and the fact that this actually could be an inflection point. There are some certain cases where offers actually may be attractive in the REITs universe. Arch, you had spoken earlier a little bit about private real estate as well.

Of course, private real estate is something that our listeners know very well. Typically, it tends to be a large allocation for many investors. Could you just highlight some of the differences between publicly-traded REITs versus private real estate and how should listeners be thinking about the trade-off between one versus the other?

Archena: Sure. We think about, again, private and public real estate as just different points in the spectrum. They're all different parts of real estate. I think there's a different, there's a time to be bulled up on private real estate. Again, there are different times where we get more interested in public real estate. As it relates to public real estate, it offers investors the opportunity to invest in a variety of asset classes, whether it be shopping centers, malls, industrials, data centers, opportunities that don't typically exist in the private space, and the ability to do that in a very liquid and transparent manner.

If you've done your homework and you feel like, "Hey, I fully believe in this AI trend, and I want to be invested in data centers because that's the real estate wrapper where AI sits, then you could invest in these publicly traded data center vehicles that are global data center companies that have the best access to capital, and possibly even the best quality data centers across the world. The ability to do that quickly and easily is the opportunity that public real estate offers, or public real estate investing offers.

If you think about the other side of the spectrum with private real estate, there are chances and opportunities to invest in private real estate. When you feel that maybe valuations are looking to stretch down the public side. Maybe you felt doing your deep dive and doing the work, you felt like there was a great opportunity to invest in an apartment building in Miami or get in on this hot new investment that your uncle was looking at. Those are opportunities as well.

The difference there is that it takes a long time, and there is a certain degree of complexity in understanding and setting that vehicle up and exiting that vehicle too. Again, there are different pieces in that spectrum between private and public with different blends of both. At this point, we think that public real estate is very attractively valued. We've gone through the period of higher rates where people were quick to shooting first and asking questions later and were quick to being underweight rates and selling their REITs.

Even though we didn't see a deterioration in fundamentals, we continue to see dividends being stable or increasing. We saw revenue streams coming in, and despite that, REITs sold off. At this point, REITs look pretty attractive compared to the broader market and compared to private real estate, because public REITs also tend to have lower leverage than your private real estate vehicles. Even though rates are going down, one could make the statement that the absolute level of rates will be higher than what it was for the last decade.

In that kind of environment, lower leverage is better than higher leverage. If you're getting into this environment where you have a gap between public real estate and the broader market, public real estate and private real estate, public real estate cap rates are roughly 120 basis points higher than private real estate cap rates at this point. You're looking to rotate your money out of money market funds into something that provides you a similar degree of liquidity and transparency but a higher yield, then REITs offer you that opportunity today.

Anu: Great. No, you've made a very good case for the reason including REITs in a portfolio while also acknowledging that there can certainly be opportunistic investments in private real estate as well, of course. Given that this is potentially an attractive entry point for REITs, what are some of the key risks that investors should be considering when they're weighing up this asset class?

Archena: No, of course. With liquidity and transparency comes volatility. We've felt a little bit of that over the last few years. Obviously, investors should be aware that they are entering public real estate securities that can be traded up and down very easily, and that's something to keep in mind.

Apart from that, again, REITs are a different animal altogether. If you think about REITs and how they classify themselves as REITs is that, again, how these REITs attain their tax status or not pay a substantial amount of income tax is because they distribute 90% of their taxable income as dividends. To the extent that any of these rules or possible rules around environmental regulations, zoning laws, or different state regulatory risks, all of these risks are important to consider with REITs. Obviously, these management teams have been doing this for a while and are very well-acclimatized and understand the different risks and are very good about being ahead of these risks. It's still important for investors to consider these as they make their investment decisions because even if these management teams are on top of these risks, they can alter the financial performance or the market attractiveness of a particular sector.

It's important as investors get more comfortable with REITs to understand that within REITs, you have a spectrum based on different asset classes. Diversification is important. We've been talking about office for a while. Before office, we had the death of the mall. You definitely do have secular trends as macroeconomic trends come up and those are important to consider. It's really about marrying what you're seeing on the macro front with a broader market and marrying that with bottoms-up valuation, understanding operations, risks, balance sheet, management abilities, et cetera, with these individual companies to make your investment decisions.

That's where active management does play a role because there is a significant amount of heavy lifting as it relates to understanding these trends and understanding these companies and staying a little ahead of the curve that active managers can do a little better.

Anu: Yes, absolutely. No, I want to highlight again that discussion point about the evolving nature of this particular asset class. Arch, that's all super helpful. Thank you for giving us a terrific lay of the land for REITs

Anu: Now, Arch, I can't let you go without asking a quick bonus question. I happen to know that the New York City area is not the only place that you have ever lived. What is the best place you've resided outside of the Tri-state area and why?

Archena: I actually grew up on this little island called Bahrain which is off the coast of Saudi Arabia. It was a really fun experience growing up in Bahrain because it's a very small island where you probably know every single person living there. I actually

went to a Christian Catholic school living in a Hindu household in an Arabic Muslim country. We definitely had a full diversity of cultures and I think it only added to our experience.

Anu: That's great. Now as an investor, I see that you also take that diversification into your day-to-day work as well. Thank you for sharing that. That's very cool. Arch, today we discussed a lot of great topics as it relates to REITs, the investment landscape, the macro trends, sectors that may be poised to benefit. I also appreciate your comments on public versus private within real estate, and again, opportunities in both, but just hearing you share those points was really helpful.

You talked about the importance of active management in this asset class where there is an aspect of this which is somewhat evolving too. I just want to say thank you so much for being on here today and we look forward to hearing from you again soon.

Archena: Thanks for having me, Anu.

Anu: If you'd like to learn more about REITs, I invite you to check out the latest insights paper written by Arch and her team titled Returning to REITs. It's available on our website, nb.com/insights, and from there you can also find previous podcast episodes as well as more information about our firm and offerings.

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