ALTERNATIVES

A Tailwind for Towers: A Closer Look at the Cell Tower REIT Sector

Darin Turner
Invesco Real Estate

Cell phone tower REITs are one of the most unique and differentiated areas of listed real estate. They offer a combination of structural growth, stability, and predictability unlike almost anything else in the real estate securities space. Cell phone towers provide the infrastructure that allows for wireless communication. The business model is exceptionally stable, low cost, and highly oligopolistic. New technologies such as 5G should provide a tailwind for cell phone towers as consumers demand faster speeds across a broader pool of devices over time. This article is a primer for one of the most interesting and innovative sectors in real estate.

The Importance of Towers

The increased utilization of mobile devices over the past 30 years has made towers a mission-critical component of infrastructure-related real estate. A tower is a pole structure on a property that hosts physical telecommunications equipment, including antennas and fiber cables. Antennas transmit and distribute different forms of radio waves that allow for the basic functionality of communications and technology devices. Fixed wire transmission lines are installed at a tower's base and are interconnected with an underground communications superhighway both domestically and globally. At the bottom of each cell phone tower is a station that has backup generators and other equipment to ensure constant service. In addition to large macro towers, which are highly visible and ubiquitous, small cell antennas are also being affixed to light posts and other structures in denser urban areas to increase data capacity.

The cost to operate a cell phone tower site is exceptionally low compared to other forms of real estate, allowing for the potential for outsized gross margins for this property type. The tower structure and land is owned or controlled by the tower operator. However, all other equipment associated with the site is the responsibility of the tenants, including antennas, radios, base stations, and underground fiber cabling. Cell phone tower structures are critical to telecommunications tenants, which generally do not own large tower portfolios and cannot provide significant service without them.

Cell Tower REIT Oligopoly

Roughly 100,000 cell phone towers (or about 80% of the market) are owned by American Tower, Crown Castle, and SBA Communications. These companies started from humble beginnings several decades ago but stand among the largest REITs in the world by market capitalization. They have likewise generated some of the best long-term annualized returns of real estate securities worldwide.[1] Private market operators, by contrast, do not factor much into the space, given the exceedingly high barriers to entry to form a cell tower network of tens of thousands of sites. Telecommunications providers AT&T, T-Mobile, and Verizon dominate the tenant base for cell phone tower sites. But there is scope for additional tenants over time as 5G and other technologies evolve.

The leasing structure for cell phone towers has some similarities and differences relative to more traditional real estate sectors. Telecommunications operators generally sign non-cancelable contracts with a weighted average lease term of roughly ten years. Tenants are required to pay 3% annual rental escalators, which often help keep pace with inflation. There are a couple of ways of increasing tower revenue over time. The first is a contractual amendment that requires a tenant to pay additional rent when adding more equipment to a tower. The second is through tenant colocation. The cash flow, gross margins, and return on investment of towers increases significantly when a second or a third tenant is added to a single tower. Today, the average number of tenants per tower nationally stands at 1.8

1. Source: FTSE EPRA Nareit as of March 31, 2023.

FIXED INCOME | EQUITIES | **REAL ASSETS** | MULTI-ASSET & SOLUTIONS

aegonam.com

TAILORED STRATEGIES, TIME-TESTED PROCESS

Our US CMLs offer investors the opportunity to access a customized strategy to invest in commercial mortgage loans through a time-tested and fully integrated debt investment platform.

We have a 40-year history of originating and managing high-quality US commercial mortgage loans. Using a disciplined, repeatable, and transparent process, we strive to deliver relative value to investors through disciplined underwriting and pricing of loans tailored to each client's objective and risk profile.

Learn more at aegonam.com/cmls

AEGON
Asset Management

communications providers. Supply growth of macro towers has stalled in recent years, which has helped contribute to the rising cash flow of existing structures.

Gradually, 5G is being rolled out and will eventually become the standard wireless technology in the US. It will be able to handle considerably higher data loads at much faster speeds and across a broadening array of devices. Mobile device owners will see faster download speeds, better wireless connectivity, and longer battery life. In addition, 5G will enable the future function of smart cities, with provisions for electric grids, streetlights, and water utilities. Self-driving cars will also become possible as 5G will offer the ultralow latency to tackle the real-time needs of driving. And more household devices will be connected to communications networks. The Internet of Things covered by 5G will allow for smart homes with connections to home security systems, cameras, thermostats, and lighting.

Expect to see a lot more small cell antennas in weaker coverage areas with network congestion. Small antennas will be affixed to streetlights, utility poles, and building roofs to ease congestion in dense urban corridors, stadiums, and other gathering areas to reduce the bottleneck challenges in situations with demand spikes. The oligopoly of cell tower REITs has collectively invested heavily in this area.

The Case for Cell Tower REITs

Cell tower REITS may offer a compelling alpha opportunity for investors in coming years, particularly with a growing likelihood of an economic slowdown. The demand inelasticity for cell tower REITS, tailwinds from tenants through 5G, and a broadening spectrum of applications could provide ballast in a more difficult fundamental environment for other property types. After a challenging calendar year in 2022 in which low cap rate and longer-duration sectors underperformed, cell tower REITs today offer a healthy combination of strong fundamentals and inexpensive valuation. Invesco Real Estate expects that cell tower REITs will offer low- to mid-single-digit growth in net operating income over the next three years. On the valuation front, after a challenging calendar year given the sharp rise in interest rates, cell phone tower REITs traded at roughly a –10% discount to net asset value and implied cap rates reset to 5%, as of March 31, 2023.

Are Cell Tower REITs Real Estate?

With so many attractive attributes of the cell tower business, the question may be whether such a differentiated sector is real estate at all. Invesco Real Estate believes that cell tower REITs are intrinsically real estate for many reasons:

- Cell tower businesses share many aspects of other types of real estate.
- The process for the business model involves siting, property acquisition, zoning, construction, and a source of value driven by tenant-generated rents.
- Cell towers are permanent structures situated on land sites and supported by fixed foundations.
- The Internal Revenue Service and the Treasury Department have determined that cell towers qualify as real estate and can organize themselves as REITs.
- The largest cell tower operators in the US have all structured themselves as REITs and began doing so more than a decade ago.

Despite weak performance in 2022, cell tower REITs have been among the best performers in the REIT universe over longer cycles.[2] Over the past 20 years, American Tower, Crown Castle, and SBA Communication achieved annualized returns of 20.7%, 18.8%, and 30.4%, respectively.[3] Those returns were well above the broader real estate securities index FTSE Nareit All Equity REITs Index and the S&P 500, which generated 9.4% and 10.4% annualized returns, respectively.[4]

Furthermore, with the potential for an economic slowdown as the Federal Reserve continues to tighten money amid persistent inflation, the cell tower REIT space could be poised to outperform, given its stability and inelastic demand characteristics. During the past two major economic downturns—the global financial crisis and the COVID-19 pandemic—cell tower REITs outperformed by a very significant amount versus the broader REIT market: +13% outperformance during the financial crisis and +34% outperformance during the COVID-19 pandemic.[5] The stability and relative inelasticity of the cell tower infrastructure business has created a relatively safe haven during downturns because occupancy rates and cash flows are relatively unaffected. Given the stickiness of prevailing inflation, another of the relatively attractive attributes of cell tower REITs is they have exhibited much less inflationary pressure in terms of operating costs and development versus other forms of real estate. The average construction cost of a cell tower is less than $500,000, and the tenants contractually cover much of the maintenance. Other operating costs are likewise relatively light, including monitoring equipment and ground rent if the land is not directly owned.

Conclusion

Invesco Real Estate believes that cell tower REITs should exhibit a strong pattern of structural growth for many years to come. The business model has strong demand drivers stemming from the way people consume data and use communications equipment. With the parabolic yearly increase in data consumption, cell tower REITs provide an essential service to society, and telecommunications companies could not be successful without them. As 5G opens a new window for consumers to receive faster speeds and more complex content, the relatively inelastic demand for cell towers will increase. Cell tower REITs, which are sometimes grouped with "specialty" property sectors, are among the largest listed real estate companies in the world. They have generated outsized returns versus broader equity markets, the S&P 500, and REITs, based on the FTSE Nareit Equity REIT Index over the past 20 years, as of March 31, 2023. They may have a path to adding value in listed real estate securities moving forward. ■

Darin Turner is Managing Director and Chief Investment Officer, Listed Real Assets, North America at Invesco Real Estate.

2. Source: FTSE Nareit as of March 31, 2023
3. Source: Bloomberg as of March 31, 2023.
4. Sources: FTSE Nareit and Bloomberg as of March 31, 2023.
5. Source: Morningstar. Past performance is not a guarantee of future returns.