REITs "Complete" Real Estate Portfolios

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The US economy has been marked by mixed economic growth results, elevated inflation, and higher interest rates. The confluence of these factors has resulted in increased uncertainty surrounding the economic outlook. At the end of 2022, the Bloomberg consensus forecast survey placed the odds of a US recession within the next 12 months at 70%. Amid this economic uncertainty, US commercial real estate operational performance has generally been strong, but total return and valuation metrics between public and private real estate have diverged. This uncoupling has increased the attractiveness of public equity REITs because they provide tactical and strategic opportunities to "complete" real estate portfolios.

Performance During Recessions

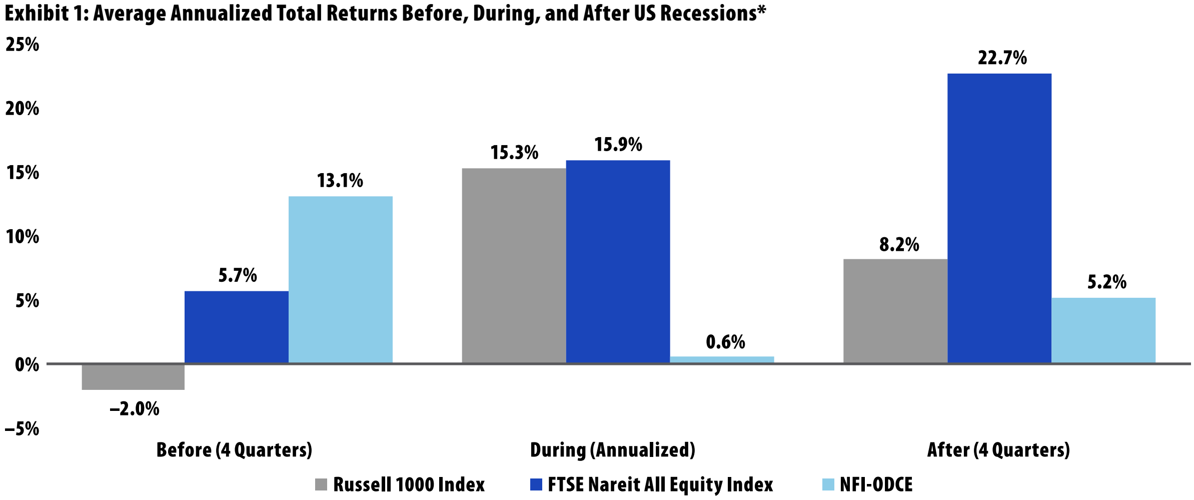
Given that economic growth is a key driver of real estate operational and investment performance, the specter of a US recession is a source of consternation for some real estate investors. An economic recession, however, does not have to equate to negative property total returns. Although not a guarantee of future results, a review of historical performance before, during, and after recessions may be instructive and alleviate some concerns for property investors.

Exhibit 1 displays the average annualized total returns for public and private real estate, as well as the equity market, before, during, and after US recessions. The FTSE Nareit All Equity Index, the NCREIF Fund Index–Open End Diversified Core Equity (NFI-ODCE), and the Russell 1000 Index are used to measure REIT, private real estate, and stock market performances, respectively. Though the analysis focuses on total returns, public real estate performance tends to be more responsive to economic and financial market changes than its private market counterpart because of its pricing mechanism.

An analysis of the last six US recessions reveals that, on average:

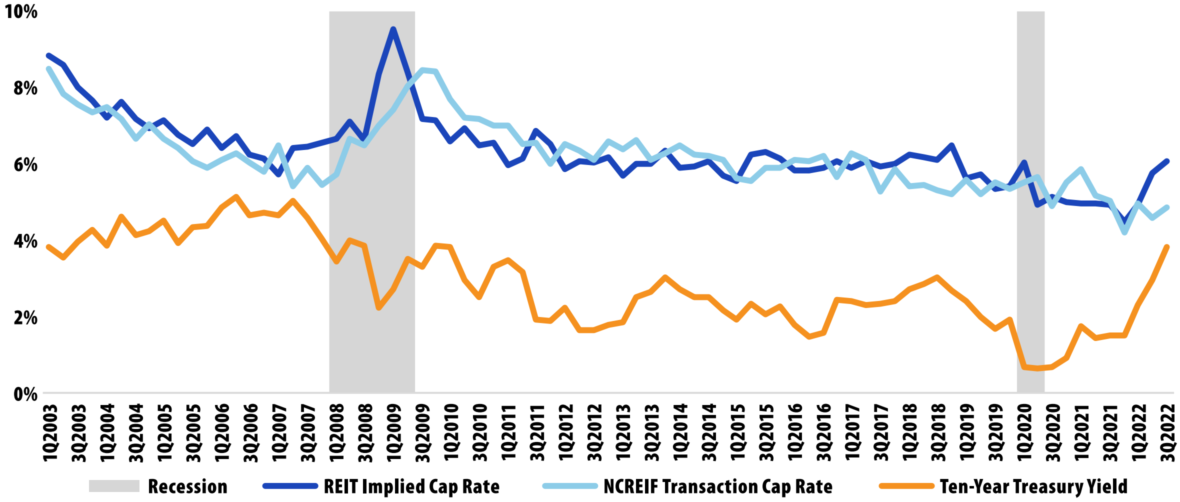
- REITs *underperformed* private real estate in the four quarters before a recession.
- REITs *outperformed* private real estate during a recession.
- REITs *outperformed* private real estate in the four quarters after a recession.
- REITs *outperformed* their equity market counterpart before, during, and after recessions.

Exhibit 1: Average Annualized Total Returns Before, During, and After US Recessions*



Sources: NBER, Nareit, NCREIF, FactSet
* Averages include the last six US recessions between 4Q1978 and 3Q2022.

Exhibit 2: Real Estate Cap Rates, Ten-Year Treasury Yields, and Recessions



Sources: FRED, Federal Reserve Bank of St. Louis; Nareit T-Tracker; NCREIF

REITs Are Well Positioned to Take Advantage of Economic Recoveries

Historically, REITs have been well positioned to take advantage of economic recoveries, and they remain well situated today. Data from the Nareit T-Tracker in the third quarter of 2022 show that equity REITs proved to be quite resilient from an operational perspective. REIT aggregate quarterly funds from operations (FFO) increased to $19.9 billion—a 14.9% increase from a year ago and an all-time high. Underscoring that REIT operational performance has been keeping pace with inflation, net operating income (NOI) and same-store NOI increased by 8.1% and 7.1% over the past four quarters, respectively.

Nareit T-Tracker balance sheet data also show that REITs have been mindful of their experiences through the great financial crisis. As of the third quarter of 2022, the

- average leverage ratio remained near its historical low at 34.5%.
- fixed-rate debt accounted for 87.2% of total debt.
- weighted average term to maturity on debt was 84 months.

REITs have not been immune from rising interest rates, but their debt costs increased only marginally compared to the surge in the ten-year Treasury yield. The weighted average interest rate on total debt was 3.6% in the third quarter of 2022; it was 3.3% at the beginning of the year.

Cap Rate Divergence Provides Tactical Buying Opportunity

Despite strong REIT operational performance and balance sheets, public and private real estate performance diverged in 2022. As of the fourth quarter, the FTSE Nareit All Equity Index and NFI-ODCE posted annual total returns of –24.9% and 7.5%, respectively—a difference of –32.4%. Note that REIT performance typically led private real estate performance by six to 18 months. A similar divergence was also evident with cap rates.

Exhibit 2 shows quarterly public and private real estate cap rates, ten-year US Treasury yields, and US recession periods from the first quarter of 2003 to the third quarter of 2022. The starting point for the examination period was selected because of a break in the NCREIF data.

A review of the chart shows that public and private cap rates had similar levels and movements over the examined time period. Although cap rates do not move in lockstep with rising interest rates, the public real estate market had a meaningful reaction to the surge in the ten-year Treasury yield in 2022; the private market response was more measured. From the fourth quarter of 2021 to the third quarter of 2022, the ten-year Treasury yield increased by 231 basis points (bps). Over the same time frame, the REIT implied and NCREIF transaction cap rates rose by 156 bps and 66 bps, respectively.


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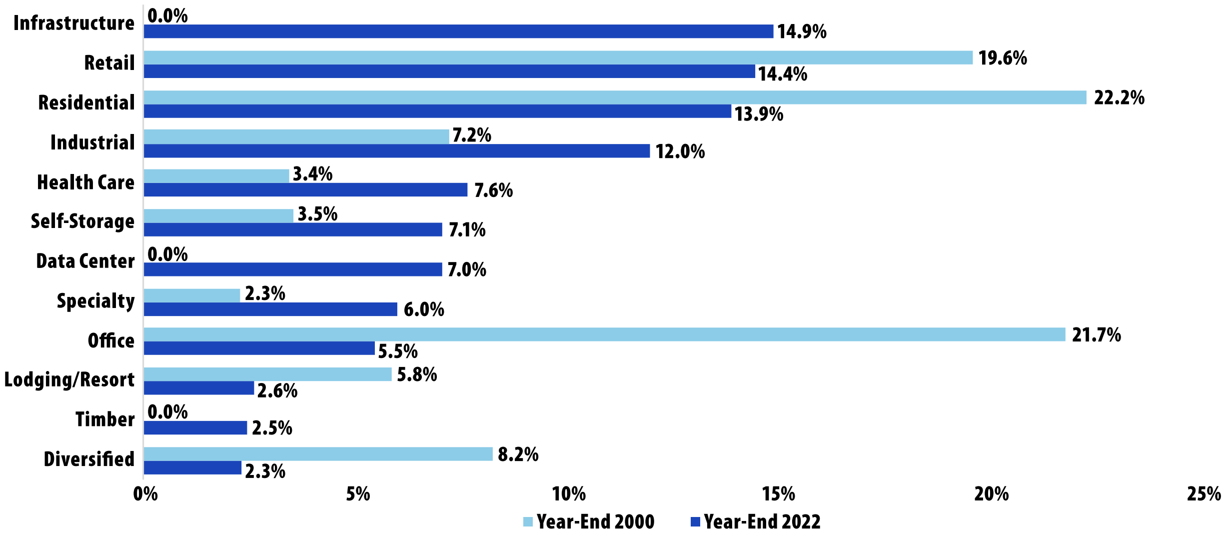
Exhibit 3: FTSE Nareit US Real Estate Index Year-End Property Sector Weights



Sources: FTSE Russell, Nareit

The differential between public and private market cap rates stood at 119 bps in the third quarter of 2022; it averaged 12 bps over the examination period. This cap rate divergence provides evidence of a dislocation between the public and private real estate markets.

It also presents a tactical buying opportunity for investors to add or increase REIT allocations to their real estate portfolios. All else being equal, this difference suggests the potential for private real estate market valuations to fall by 20% or more. This belief oversimplifies reality—typically, all else is not equal. In 2023, the gap between public and private cap rates is expected to close, most likely through changes in both REIT and private market valuations. Posting an appreciation return of –5.76%, NFI-ODCE results for the fourth quarter of 2022 show that the valuation adjustment process has started.

Strategic Opportunities: Diversification and ESG

The largest and most sophisticated institutional real estate investors widely use REITs in their real estate strategies. Approximately 64% of the top 25 largest defined benefit and sovereign plans in both North America and the world use REITs to optimize their real estate investment portfolios. In 2023, more institutional investors are expected to consider REITs as part of portfolio completion strategies.

A REIT completion portfolio utilizes REITs in a key investment role to complement, or complete, an aspect of a real estate portfolio. It can help investors achieve their targeted real estate exposures and/or investment objectives by accessing broader property-sector and geographic diversification, as well as enhancing environmental, social, and governance (ESG) profiles. It can also improve overall portfolio performance.

REITs Offer Access to the Modern Economy

Over the past two decades, the structure of the US and global economies has changed dramatically. Work, shopping, and leisure activities have become increasingly connected to the digital world. As the economy has changed, real estate that houses the economy has also evolved. REITs have been at the forefront of these developments. They are leaders in owning and operating real estate that supports the modern economy, including cell towers (infrastructure), data centers, and integrated logistics facilities (industrial) used in e-commerce.

Using data from the FTSE Nareit All Equity Index, Exhibit 3 displays the evolution of REIT property sectors over time by presenting individual property-sector market caps as a percentage of total REIT equity market cap as of Dec. 31, 2000, and Dec. 30, 2022.

The changing market cap weights over time highlight the shifting focus from traditional to modern-economy property sectors. At the end of 2000, the four major property types—retail, office, residential, and industrial (RORI)—were the dominant REIT sectors, accounting for 70.7% of the total equity REIT market cap. Today, these sectors comprise 45.8% of industry market cap. Three sector categories—infrastructure, data center, and timber—were in their nascent stages or did not exist in late 2000. By the end of 2022, infrastructure had become the largest REIT sector, with a market cap weight of 14.9%, and the data center market cap surpassed that of office. New and emerging sectors—infrastructure, data center, health care, self-storage, and timber—now account for 39.1% of total equity REIT market cap.

Investors that have focused on core private real estate investment strategies may find REITs' broad menu of property-type investment options particularly appetizing. Low correlations between traditional and modern-economy property sectors offer diversification opportunities. As of the fourth quarter of 2022, the RORI sectors comprised 92.0% of the market value of the NFI-ODCE. A REIT completion portfolio can further enhance portfolio diversification of core real estate portfolios by efficiently and cost-effectively accessing newer and alternative real estate sectors. Furthermore, limited or no exposure to non-RORI sectors effectively places a bet against them.

Easily Diversify the Geographic Footprint of Real Estate Portfolios

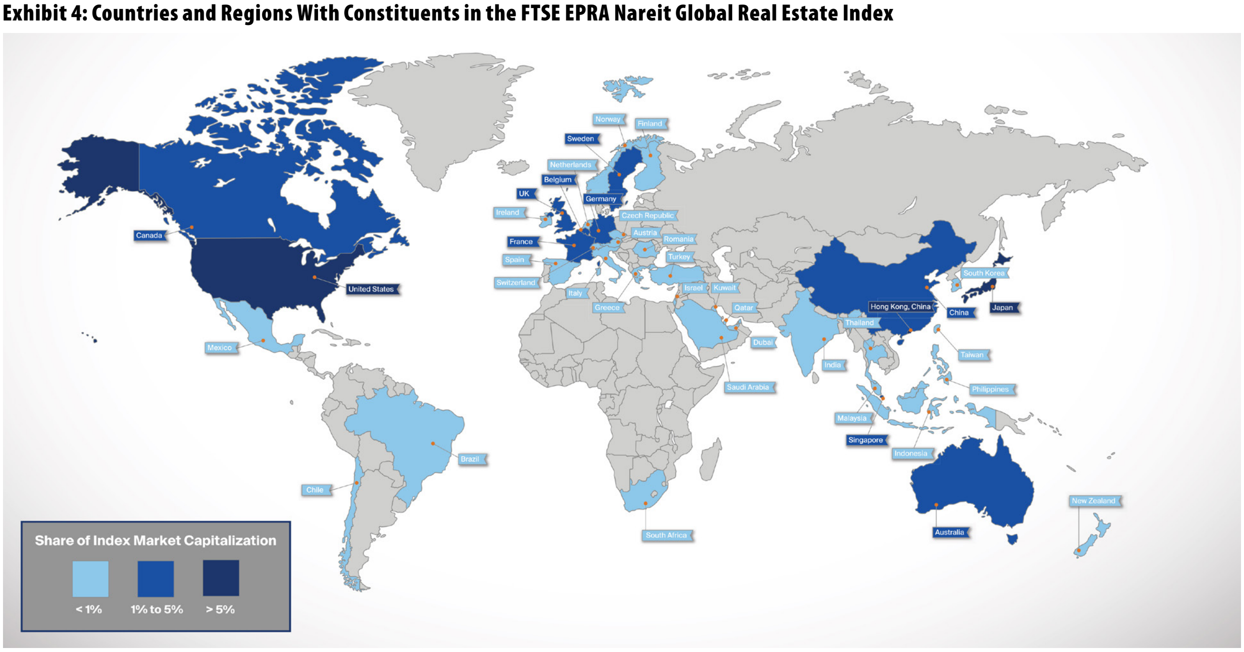
REITs can also offer investors broader geographic diversification with ease of access to global real estate. Exhibit 4 displays the countries and regions with constituents in the FTSE EPRA Nareit Global Real Estate Index as of Dec. 30, 2022.

At year-end 2021, there were 865 listed REITs with a combined equity market cap of approximately $2.5 trillion in more than 40 countries and regions around the world. Investors can easily diversify the geographic footprint of their real estate portfolios using REITs and listed real estate without the need to build out dedicated international teams or an on-the-ground presence.

REITs Provide Access to Best-in-Class ESG Performers

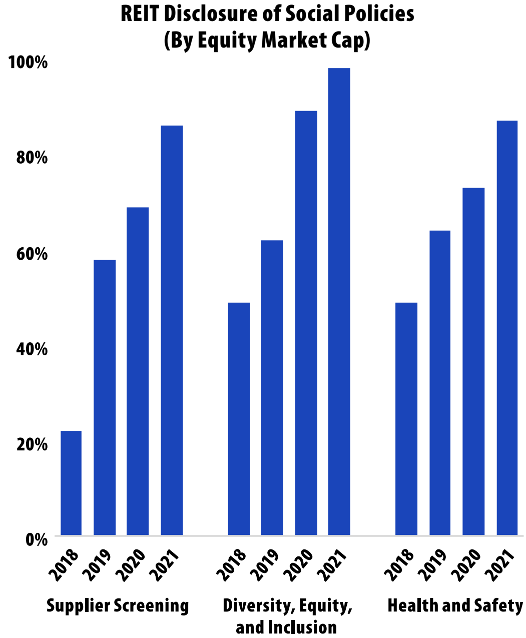
Over the past decade, institutional investors have become increasingly concerned with the ESG profile of their investment portfolios. For these investors, REITs provide access to best-in-class performers in environmental

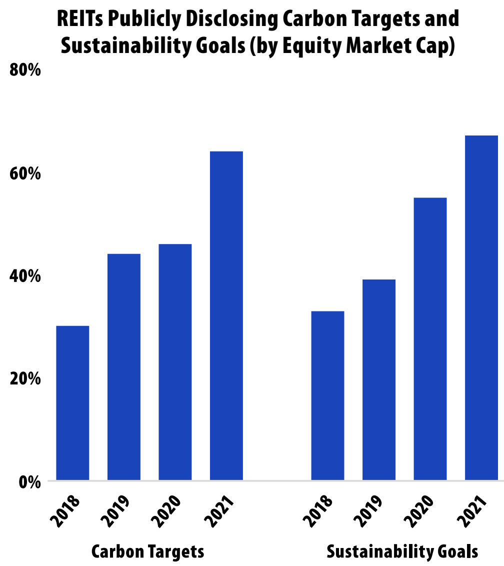
Exhibit 4: Countries and Regions With Constituents in the FTSE EPRA Nareit Global Real Estate Index



Source: Nareit and FTSE EPRA Nareit Global Index via FactSet; as of Dec. 31, 2022

Exhibit 5: REITs Expand ESG Disclosure





Source: Nareit ESG Dashboard

stewardship, social responsibility, and corporate governance. Over the past several years, the number of REITs reporting on ESG has continued to increase. In 2021, all the 100 largest equity REITs publicly reported on ESG efforts and outcomes.

In 2022, 69 US REITs participated in the Global ESG Benchmark for Real Assets (GRESB), up from 59 REITs in the prior year. GRESB measures and benchmarks the ESG performance of individual assets and portfolios based on self-reported data. In 2022, 13 REITs received a five-star rating, the top score, from GRESB; 25 REITs received a score of four or five stars. Six of the eight top performers in 2022 were office REITs.

Exhibit 5 shows that REITs are setting targets to address sustainability and climate change, as well as increasing disclosure around key social issues. The charts highlight REITs' ongoing environmental, social, and governance commitments. Since 2018, REITs have made consistent progress in disclosing their carbon targets, sustainability goals, and social policies.

According to the Nareit ESG Dashboard, 67% of REITs by equity market cap publicly disclosed their sustainability goals in 2021; 64% disclosed their carbon targets. From 2018 to 2021, the percentage of REITs by market cap disclosing diversity, equity, and inclusion policies doubled; the measure was 98% in 2021.

REITs are real estate and can help investors achieve their real estate investment objectives by offering relative value opportunities, complementing existing portfolio allocations through broader diversification and ESG enhancement, and improving overall portfolio performance. The uncoupling of total return and valuation metrics between public and private real estate has increased the attractiveness of public equity REITs, presenting both tactical and strategic opportunities for investors to complete their real estate portfolios. Although the US has not entered a recession, the economic climate is creating headwinds for future property performance. Given their current market valuations, strong operational performance, and solid balance sheets, REITs are well positioned to navigate the expected economic and market uncertainty in 2023. ■

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