All In: REIT Sector Innovation and Gaming

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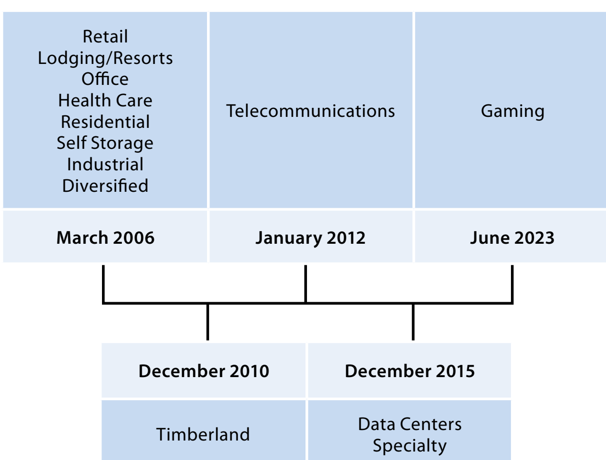
When it comes to property sectors, US public equity REITs are “all in” on innovation. By adapting to the changing economic and commercial real estate (CRE) landscapes, REITs have moved beyond the status quo with ongoing introductions of new property sectors. Today, REITs offer 13 total and 11 “pure-play” property sectors, an expansive menu of investment options with broad investor appeal.

The newest REIT property sector, gaming, highlights the creativity of the public real estate markets. While potentially conjuring unwarranted notions of risky business, the sector offers investors access to experiential real estate that includes casinos and entertainment properties through long-term, risk-mitigating triple net (NNN) leases. In these structures, assets are often characterized as mission critical real estate to their tenants, tenants are typically best-in-class operators, and the leases generate reliable, escalating cash flows.

Continued REIT sector innovation has offered a boon to property investors by providing choices and opportunities. Gaming REITs, like all other REITs, offer efficient and cost-effective ways to enhance diversification and “complete” private real estate portfolios, as well as implement strategic and tactical investments.

Exhibit 1: Time Line of REIT Property Sector Launches



Sources: Nareit, FTSE Nareit US Real Estate Index Series

Sector Innovators

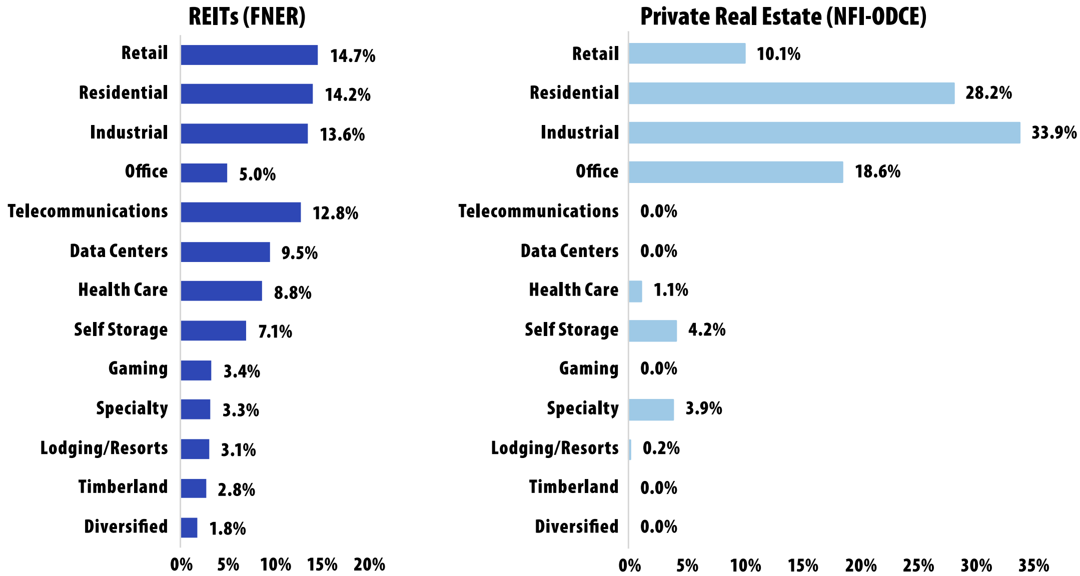
The US economy has undergone dramatic changes over the past two decades. New technology, increased interconnectedness, and digital transformation have changed—and continue to alter—the ways we work, live, and play. As the economy has changed, so too has the real estate that houses it. The FTSE Nareit US Real Estate Index Series aptly chronicles the evolution and innovation of the US CRE and REIT markets through its introductions of new property sectors and subsectors. Exhibit 1 presents a time line of this evolution.

When Nareit partnered with FTSE Russell in the calculation of the FTSE Nareit US Real Estate Index Series in March 2006, the index series included eight property sectors. Since that time, five additional sectors have been launched. Each of the new property sectors is unique.

- Timberland REITs own and manage forest-related real estate and focus on the harvesting and sale of timber.
- Telecommunications REITs own and manage infrastructure real estate that includes cell towers, fiber cables, wireless infrastructure, and energy pipelines.
- Data center REITs own and manage highly specialized facilities that house the critical IT infrastructure that powers today’s economy.
- Specialty REITs own and manage properties that do not fit within the other REIT sectors, often acting as an incubator for new property sectors.
- Gaming REITs specialize in owning experiential real estate such as casino and entertainment properties and leasing those properties through long-term, NNN structures.

The creation and inclusion of a new property sector requires that its companies maintain a combined investable market capitalization weight greater than 3% of the FTSE Nareit All Equity REITs Index for two consecutive quarters. Of today’s 13 sectors, 11 are considered pure play, meaning they focus on a singular type of investment.

Exhibit 2: REIT Sector Weights for Public and Private Real Estate



Sources: FTSE Nareit All Equity REITs Index equity market capitalization as of March 31, 2024, via FactSet; NCREIF Fund Index—Open End Diversified Core Equity ending market value as of first quarter of 2024 via NCREIF

Moving Beyond the Status Quo

The ongoing introductions of new property sectors demonstrate that REITs have embraced innovation and adapted to the changing CRE landscape. They are at the forefront of owning and operating real estate that supports the modern economy. Today, REITs' broad menu of property-type investment options stands in stark contrast to the narrow, less evolved focus of their private core real estate counterparts. Exhibit 2 presents sector weights using the REIT classifications for the FTSE Nareit All Equity REITs Index (FNER) and NCREIF Fund Index—Open End Diversified Core Equity (NFI-ODCE) as of the first quarter of 2024. For the NFI-ODCE, the specialty sector is used as a catchall grouping and includes parking and other categories.

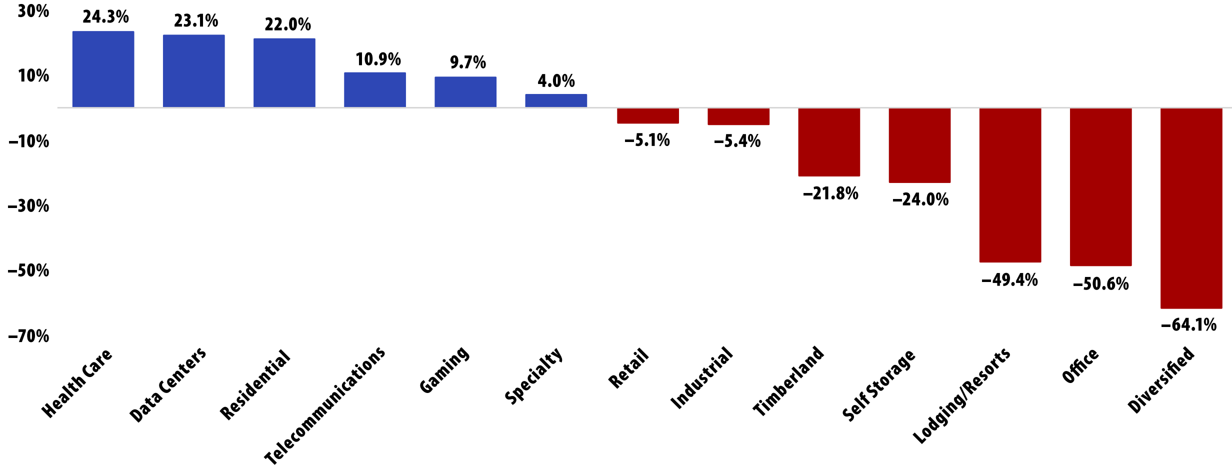
Maintaining the status quo, private core open-end real estate funds have continued their focus on traditional property types. In the first quarter of 2024, the retail, office, residential, and industrial (RORI) sectors accounted for 90.8% of total NFI-ODCE market value. Limited or no exposures to non-RORI sectors have effectively placed bets against them. For REITs, the RORI sectors composed 47.5% of total FNER equity market capitalization. New and emerging sectors—telecommunications, data centers, health care, self storage, timberland, and gaming—rivaled the RORI weight, accounting for 44.3% of market cap. These newer sectors can provide efficient and cost-effective ways to enhance private core real estate portfolio diversification.

Betting on the Modern Economy

One unique aspect of REITs is the large, dedicated, active management investment community. These active managers have been critical to the long-term success of the REIT model because of their real estate investment expertise and analysis. Tracking actively managed, dedicated REIT funds and how they allocate their assets provides insights critical to understanding the evolution and current state of the CRE and REIT markets. Prospects for the property sectors can also be gauged by this expert investor sentiment.

Nareit's Actively Managed Real Estate Fund Tracker follows the quarterly investment holdings for the 27 largest actively managed real estate investment funds that focus exclusively on REITs. Collectively, these funds had $36 billion in assets under management in the first quarter of 2024. Exhibit 3 presents property sector over- and underweights by assets under management for actively

Exhibit 3: Property Sector Over- and Underweights of Actively Managed Dedicated REIT Funds



Sources: Nareit; Morningstar Direct; data are as of first quarter of 2024

managed REIT funds relative to sector weights in FNER for the first quarter of 2024. Four funds did not report data for the quarter.

Over the first quarter of 2024, average active manager shares in each of the RORI sectors declined. With the declines, residential maintained a healthy overweight of 22.0%, while retail and industrial moved from over- to underweight index positions. Over the same time, all the non-RORI sectors, except self storage and diversified, enjoyed increases in their average fund positions. With the gains, telecommunications went from under- to overweight. Gaming moved from a near neutral but positive position to a 9.7% overweight.

(Not So) New Kid on the Block

Although the gaming sector has gained significant interest from active, dedicated REIT investment fund managers, conversations with institutional real estate investors have revealed that some are unfamiliar with the sector's business model. The capital-intensive nature of casinos provides an impetus for operators to sell their real estate assets. Gaming REITs own experiential real estate, primarily casinos, and lease them through long-term, risk-mitigating NNN lease structures.

Despite being the new kid on the block, the gaming sector has two constituents, Gaming & Leisure Properties, Inc. (GLPI), and VICI Properties Inc. (VICI), with corporate histories that predate the sector's launch.

GAMING&LEISURE PROPERTIES, INC

Gaming & Leisure Properties, Inc., created the gaming real estate asset class with its formation as the nation's first gaming REIT in 2013. Since then, GLPI has been engaged in the business of acquiring, financing, and owning real estate property to be leased to gaming operators in NNN lease arrangements. Its shareholders enjoy the stability and strength of a diverse asset portfolio, which consists of 65 premier gaming and related facilities spread across the nation and operated by recognized industry leaders. The GLPI management team's industry experience, unique perspective, and ingenuity have enabled it to successfully deploy a differentiated and creative approach to portfolio growth. The bespoke solutions GLPI has originated for its tenants have generated strong returns for shareholders. Going forward, GLPI's focus remains on leveraging its unique capabilities to build long-term, enduring value for shareholders.

VICI

VICI Properties Inc. is an S&P 500 experiential REIT that owns one of the largest portfolios of market-leading gaming, hospitality, and entertainment destinations, including Caesars Palace Las Vegas, MGM Grand, and the Venetian Resort Las Vegas—three of the most iconic entertainment facilities on the Las Vegas Strip. VICI Properties' goal is to own the highest quality and most productive experiential real estate portfolio through a strategy of partnering with the highest quality experiential place makers and operators.

Exhibit 4: Commercial Casino States, Casino Counts, and Annual Gaming and Tax Revenue

Source: American Gaming Association "State of the States 2024"

GLPI was spun out of gaming operator Penn National Gaming in November 2013. VICI emerged from Caesars' bankruptcy in October 2017. Both REITs possess the specialized industry and regulatory knowledge necessary to successfully execute their investment strategies.

Well-Oiled, Revenue-Generating Machines

Gambling is a mature industry. On its 2024 State of Play map, the American Gaming Association (AGA) indicated that the 1,011 commercial and tribal casinos in the US produced $328.6 billion in estimated annual economic impact. Land-based commercial casinos, which are subject to tax and licensing at the state level, accounted for roughly half these casinos. Using data reported by the AGA, Exhibit 4 presents a cartogram of the US in which squares represent states. States with commercial casinos are highlighted in dark blue and include four data points: state abbreviation and number of casinos (first line), annual gaming revenue (second line), and annual state and local tax revenue (third line) for 2023. Commercial casino states with gaming REIT ownership are outlined in orange.

While limited in number, commercial casinos have proved to be well-oiled, revenue-generating machines. The 486 land-based commercial casinos located across 27 states generated record-breaking gaming revenue of $64.8 billion in 2023, resulting in $14.4 billion in state and local tax payments. According to a recent AGA survey, annual casino visits have been on the rise, and the average age of casino-goers has been declining. In 2023, 102 million US adults (with an average age of 42) visited casinos. Although gaming revenue is not immune

to economic downturns, historically, it has proved to be resilient, with revenue from regional casinos tending to be less volatile than that of destination (Las Vegas Strip) casinos, which depend on tourism.

A review of the cartogram reveals that, not surprisingly, Nevada had the greatest number of casinos (225) and highest gaming revenue ($15.5 billion) of the states with commercial casinos. It accounted for 46.3% of commercial casinos by number and 24.0% of total associated gaming revenue. The Las Vegas Strip generated $8.8 billion in gaming revenue, or 56.9% and 13.6% of state and overall totals, respectively. Nevada's tax revenue, however, was not the highest. Pennsylvania and New York boasted higher tax amounts even though both states had considerably fewer casinos and lesser gaming revenues. This seeming anomaly stems from differing licensing policies and gaming tax structures across states.

Nevada and five other states (Colorado, Iowa, Mississippi, New Jersey, and South Dakota) are unlimited license states; all other states with land-based commercial casinos, including Pennsylvania and New York, are limited license states. Unlimited license states tend to have significantly lower gaming tax rates than their limited license counterparts. For context, the tax-to-gaming revenue percentage in unlimited license states ranged from 7.8% to 19.8% and averaged 12.2% in 2023. The same measure ranged from 15.2% to 50.5% and averaged 31.5% for limited license states. Under both regimes, commercial casinos generate significant funds for state coffers that play critical roles in state budgets.

Owning nearly one-quarter of commercial casinos in the US, gaming REITs play an important role in the industry. VICI owns 46 gaming properties across 15 states; GLPI has 65 properties across 20 states.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Collectively, these REITs have a presence in 21 of the 27 states with commercial casinos. The six commercial casino states without gaming REIT ownership (Arkansas, Florida, Kansas, Nebraska, Oklahoma, and Virginia) tend to have limited numbers of commercial casinos and/or modest gaming revenues.

Risky Business?

Through an association with gambling, some investors may view the REIT gaming sector as risky business. This perception, however, is markedly different from reality. Gaming REITs are not gaming operators. They were born out of the desire, or need, for operators to monetize their real estate assets. Their business model and practices are predicated on risk mitigation. Proper lease structuring de-risks investments. The regulatory environment provides additional transparency through its reporting and vetting processes.

Gaming REITs derive their income mainly through rent collections from NNN leases. These leases mitigate owners' risks because tenants pay property maintenance and capital expenditures, taxes, and insurance. Asset and operator financial transparency tends to be high because of state regulatory reporting requirements and public company disclosures. Given the mission critical nature of the underlying properties and the regulatory environment, operator turnover is typically limited. As a result, analysts generally view gaming NNN lease cash flows as predictable and reliable. While many property sectors struggled with rent collections during the pandemic, GLPI and VICI collected 100% of their rents in 2020.

Capital expenditures can prove to be costly and burdensome for real estate investors. Given the experiential nature of their business, casino operators are incentivized to maintain and improve their assets. Consequently, their capital expenditures can be sizable, especially for destination casinos. Given the NNN lease structure, a gaming REIT would face these costs only upon the expiration (and nonrenewal) of a lease or in the event of an operator bankruptcy. Even in these instances, material cash outlays would be unlikely because a new operator would typically absorb these costs with the execution of its lease. Green Street has ranked gaming REITs as having the lowest capital expenditure to net operating income ratio among all property sectors.

Master leases are another tool gaming REITs commonly use to limit risk. They pool multiple properties under one lease to provide additional rental payment protection. Lease terms are typically long, often starting with an initial term of 15 years and including several multiyear extensions. They stipulate a variety of required covenants, such as minimum rent coverage ratios and annual capital expenditure outlays, as well as technical default clauses. They may also include corporate guarantees. If a tenant does not renew its lease, the gaming license stays with the property. While providing protection against single asset distress, master leases do little in the event of operator bankruptcy.

Embracing Change

By embracing innovation and adapting to the changing CRE landscape, US public equity REITs have moved beyond the status quo. They are at the forefront of owning and operating real estate that houses the modern economy. Today, REITs offer a broad menu of real estate investment options. The launch of the newest REIT sector, gaming, is a testament to the creativity of the public real estate markets, offering investors access to experiential real estate that includes casinos and entertainment properties through long-term, risk-mitigating NNN leases. Continued REIT sector innovation has offered a boon to property investors by providing choices and opportunities. Like all other REITs, gaming REITs provide efficient, cost-effective ways of improving diversification and "completing" private real estate portfolios, executing strategies, and implementing tactical investments. ■

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