

Real Estate's resilience in a higher rate regime

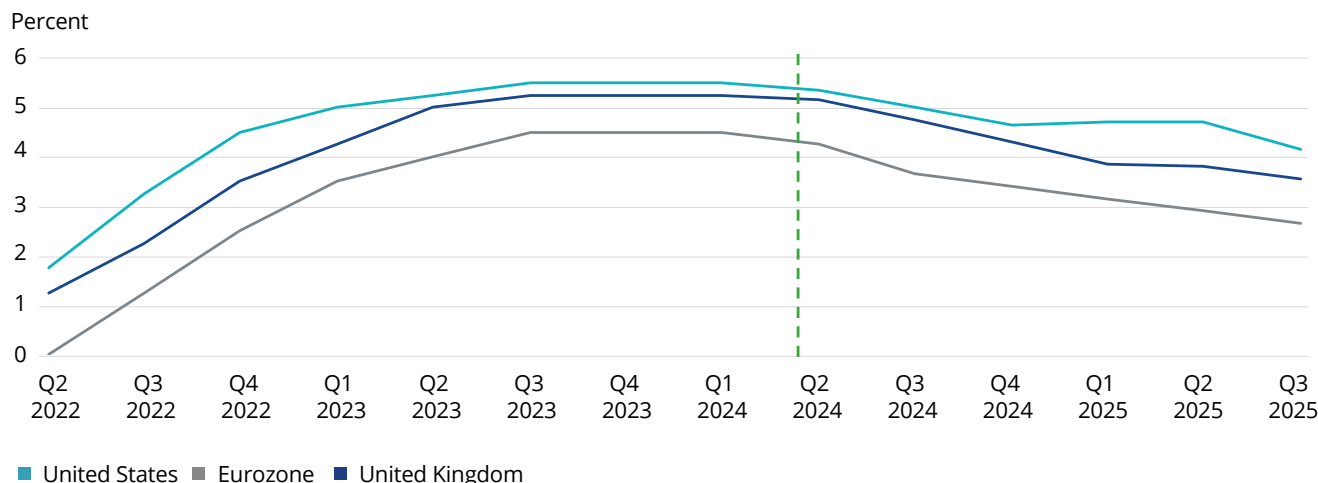


- **Evaluating the fundamentals of real estate investment trusts (REITs) reveals healthy levels of occupancy and relatively low financial leverage.**
- **This suggests that there may be a disconnect between REITs' robust fundamentals and relatively low valuations.**
- **Furthermore, the diversity of the real estate sector is likely to add to its resilience, further indicating that the low valuations may be an over-reaction.**

Just over a decade after the global financial crisis (GFC) sparked a long period of low interest rates, this

exceptional period of easy financial conditions is ending. With inflation in the U.S. and Europe proving unexpectedly stubborn, there is growing acceptance that the 2010s were an aberration. It looks like interest rates will be 'higher for longer'—closer to pre-GFC levels—with implications for rate-sensitive sectors like real estate. Views on the outlook for interest rates are constantly changing. In mid-2024, though, the forward rate curve suggests that while central banks' policy rates will fall over the next 12 months, they will not come close to the lows of 2022 (see Figure 1).

Figure 1: Rates projected to stay 'higher for longer' (forward rates curve)



Amid this uncertainty, real estate stocks are trading below their medium-term average valuations. The asset class is particularly sensitive to high interest rates, which can subdue demand for real estate and therefore valuations. They can also drive up the cost of debt financing. Yet stock prices may well be over-reacting to the interest rate outlook.

Why? Because real estate companies' fundamentals seem in good shape. That would suggest companies are well-prepared for a world where interest rates do not decline as far as once hoped.

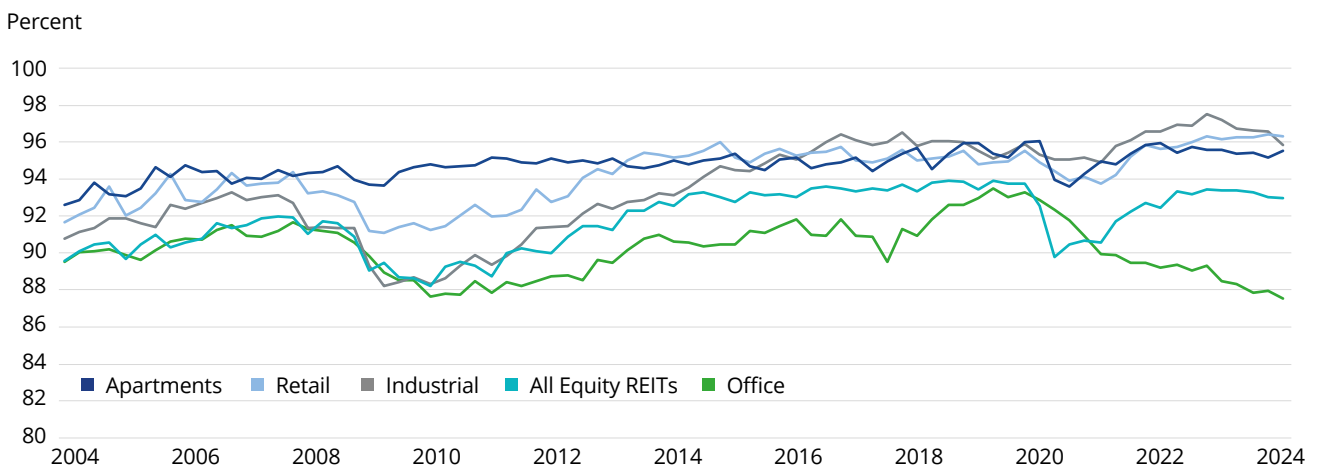
Adding to this picture of resilience, the sector is diversified as never before. Reflecting the needs of its tenants in the modern economy, the sector has evolved to include many different types of real estate. This diversification makes investment vehicles such as REITs likely to be still more hardy if there are unexpected economic shocks.

Robust fundamentals: from occupancy to financial leverage

Evaluating the data from across the U.S. real estate equity market, the world's largest, indicates that occupancy is generally healthy, while financial leverage is within sensible limits. This forward-looking analysis concentrates on the United States because it has the most readily available data. Reflecting its size, the country also tends to be by far the biggest component of broadly-based real estate investment vehicles.

The starting point for any analysis is occupancy, and this is high across almost all sub-sectors. Industrial, retail and apartments (housing) are thriving, according to the data charting U.S. equity REITs (see Figure 2). The exception is offices, which continue to suffer from low occupancy following the lingering structural change to hybrid working triggered by the Covid-19 pandemic.

Figure 2: Healthy U.S. occupancy rates

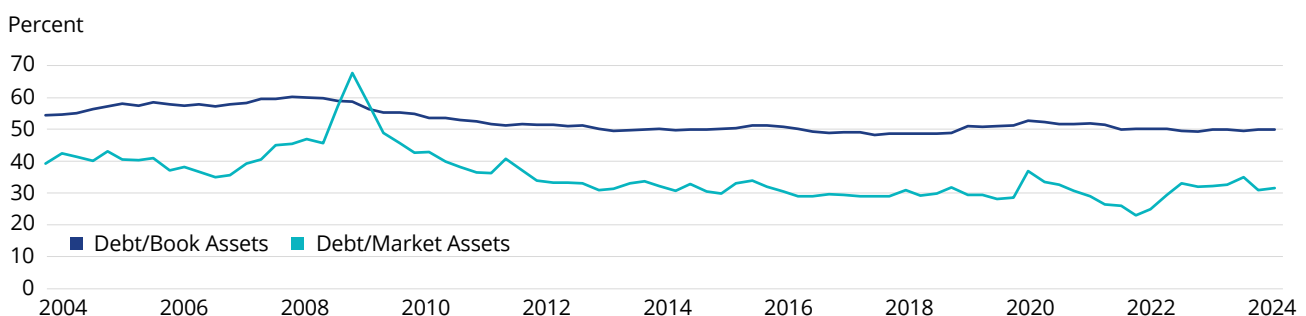


Source: Nareit, based on the FTSE NAREIT Equity REITS Index.

Moving on to borrowings, REITs have far more conservative finances than at the time of the GFC. The low ratio of debt to total assets indicates that they are far less vulnerable to shocks—whether from unforeseen spikes in the cost of finance or a sudden fall in occupancy (see Figure 3).

Finally, REITs' cashflows (mostly rents) comfortably cover the payments on their bank loans, despite the prevailing high interest rates, (as Figure 4 shows). This is, of course, an average—there may be exceptions.

Figure 3: Prudent leverage: low debt to total assets



Source: Nareit, based on the FTSE NAREIT Equity REITS Index.

Figure 4: Further prudence: REITs have high weighted average interest coverage ratios

Source: Nareit, based on the FTSE NAREIT Equity REITS Index.

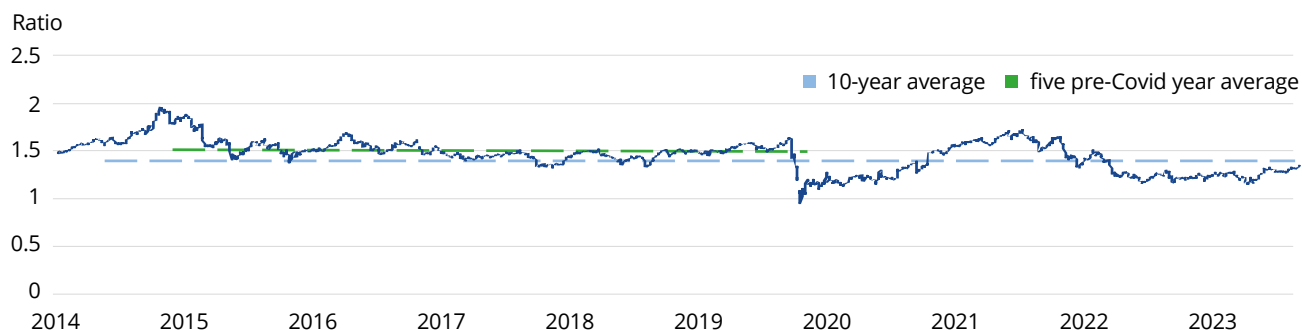
Are valuations too cheap?

Given the health of REITs, the sector's valuations look disconnected from reality. Viewed through several different valuation lenses across global markets, they are below their medium-term averages.

The possible market over-reaction is apparent across multiple ratios. Take price-to-book value, for example. Like many asset-heavy businesses, real estate depends on its assets for generating revenue, making book value a relevant valuation yardstick. A recent price-to-book value ratio of about 1.3 for the FTSE EPRA Nareit

Developed Index, covering REITs across global markets, is significantly lower than historical averages of 1.43 over the last 10 years and 1.50 over the five years prior to the Covid-19 pandemic (see Figure 5).

When focusing on another important valuation ratio for the FTSE EPRA Nareit Developed Index, price-to-cash flow from operations, a similar story emerges. Even though the average cash flow from operations has risen by more than half (54%) over the last 10 years—and remains at historical highs—the ratio is significantly lower than its historical average for the same period (see Figure 6).

Figure 5: The key price/book value ratio is below average

Source: Bloomberg, based on the FTSE EPRA Nareit Developed Index, data as of 31 March 2024.

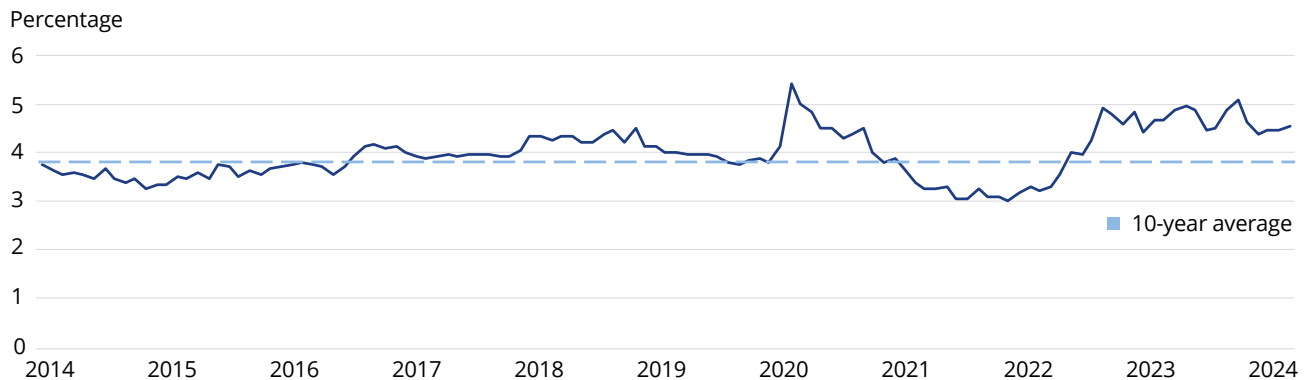
Figure 6: Price/cashflow from operations also languishes below average

Source: Bloomberg, based on the FTSE EPRA Nareit Developed Index, data as of 31 March 2024.

Another way of looking at REIT valuations is by way of the average dividend yields. These remain significantly higher than the 10-year average (see Figure 7),

although dividends have not fallen. Again, this shows how valuations are not in line with fundamentals.

Figure 7: Above average dividend yields



Source: VanEck, based on the GPR 250 Index, data as of 31 March 2024.

The 'free lunch' of diversification

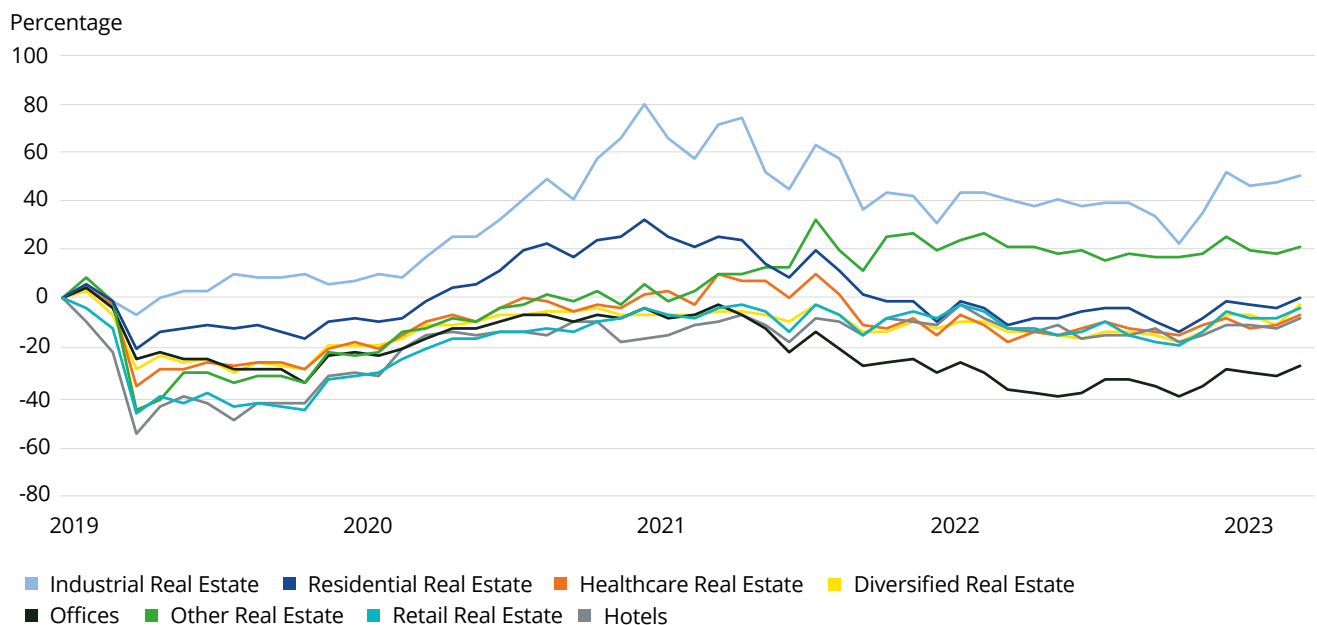
When evaluating the prospects for global real estate investing, it is also important to consider the sector's increased diversification. Nobel laureate Harry Markowitz famously called diversification the 'only free lunch in investing' because it spreads and reduces the risk of investing. As the real estate sector has become more diversified to meet the needs of the modern economy, so it has increased the sector's inherent diversification.

Real estate still includes its traditional four sub-sectors: retail, residential, office and industrial. But added to that are telecommunications towers, data centers,

health care facilities, self-storage facilities, hotels, gaming facilities and others. Each sub-sector brings different sensitivities, reducing the overall sector's exposure to events like spikes in interest rates.

The five years from 2019 to 2024 were the ultimate stress test. As Covid-19 swept across the globe in 2020, office REIT share prices fell as workers stayed away from the office (see Figure 8). Yet other sectors were more resilient. Notably, industrial REITs performed well as warehouses and distribution centers flourished in the pandemic's e-commerce boom.

Figure 8: Five years that show the value of diversification



Source: VanEck, based on the GPR 250 Index.

Real estate's different flavors

Below are six of the main types of publicly-listed real estate companies including REITs. Each has differing levels of sensitivity to interest rates and other economic factors.

1. Industrial: rising with online shopping

Industrial REITs own and manage industrial facilities and rent space in those properties to tenants. The rise of online shopping has driven demand for warehouse and logistics properties. This has resulted in a favorable operating environment, allowing some of these REITs to grow their dividends and deliver strong total returns.

2. Residential: supported by rental growth

Residential REITs own and manage various types of homes, charging tenants rent. They include REITs that specialize in apartment buildings, student housing, manufactured homes and single-family homes. Resilient rental demand and the pricing power to raise rents have supported their returns in recent years.

3. Offices: struggling with lower occupancy

Office REITs own and manage office real estate, again renting space to tenants. Generally speaking, office REITs have struggled following the Covid-19 pandemic, which triggered a rise in work-from-home or hybrid working, reducing office occupancy.

4. Hotels: recovering with the travel industry

Hotel REITs own and manage hotels and resorts. Hotels suffered due to travel restrictions during 2020 and 2021 but then recovered significantly in 2022 as the travel industry rebounded.

5. Retail: battling e-commerce headwinds

As the name suggests, retail REITs own and manage shops. They include REITs that focus on large regional malls, outlet centers, grocery-anchored shopping centers and power centers that feature big box retailers. Retail REITs have faced headwinds in recent years due to e-commerce disruption and changing consumer behavior, as well as high interest rates.

6. Healthcare: mixed fortunes

Healthcare REITs own and manage a variety of health-care-related real estate, including: senior living facilities, hospitals, medical office buildings and skilled nursing facilities. While many healthcare REITs have defensive revenue streams during uncertain times, their performance has been mixed due to the wide variety of different types of healthcare REITs.

Understanding REITs and publicly listed real estate companies

REITs and publicly listed real estate companies both offer shares providing exposure to physical real estate assets. However, they are structured in different ways, with varying business models and income sources. They also have differing tax implications, especially in the United States.

REITs:

REITs were first established in the United States in the 1960s to allow investors to invest in large portfolios of income-producing real estate. They have since spread to other countries. REITs own, operate or finance income-producing real estate across a range of property sectors. As diversified investment vehicles, they are modeled on mutual funds. Some of their key characteristics are as follows:

- **Income distribution:** In the United States, REITs are legally obliged to distribute at least 90% of their taxable income to shareholders in the form of dividends. This can make them attractive for income-seeking investors.
- **Tax treatment:** REITs do not pay U.S. federal income tax at the corporate level, provided they comply with certain regulatory requirements, most importantly the income distribution requirement mentioned above.
- **Investment focus:** True to their original purpose, REITs focus primarily on generating income from property rentals and leasing. Their revenue is usually derived from the rents collected on the property they own.
- **Diversification:** Many REITs have diversified portfolios of properties, which might include offices, apartments, shopping centers, hospitals, hotels and more.

Publicly listed real estate companies:

Publicly listed real estate companies trade on public stock exchanges but do not qualify as REITs. Some of their characteristics include:

- **Taxation:** Unlike REITs, publicly listed real estate companies pay corporate taxation on their income. This can limit their dividend payouts, as taxes reduce the net income available for distribution to shareholders.
- **Income and growth:** These companies often retain more of their income for property development and business growth, rather than distributing it as dividends. They typically invest a larger portion of their profits back into the business to buy, develop or renovate real estate, aiming for capital appreciation of their assets over time.
- **Business activities:** Publicly-listed real estate companies often engage in a broader range of real estate activities, including development, management, and sales, in addition to—or instead of—owning and renting property.
- **Capital allocation:** They have more flexibility in their capital allocation decisions. Depending on their strategic goals, they may distribute dividends or reinvest their profits.

In summary, while both REITs and publicly listed real estate companies offer exposure to real estate assets, REITs focus primarily on income. In the United States, they have specific tax advantages and income distribution requirements. By contrast, publicly listed real estate companies tend to prioritize growth and capital appreciation. They are also subject to traditional corporate tax rates. Note that the characteristics of U.S. REITs are not always the same in other countries. Other countries might also not have REITs-like regimes at all.

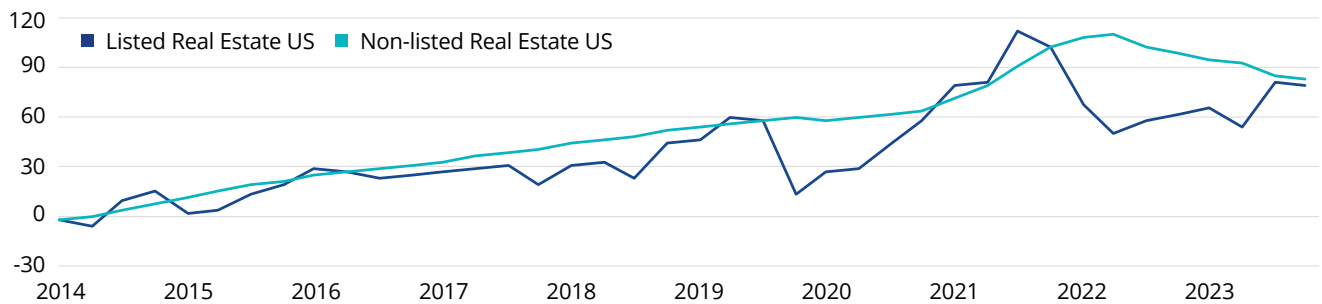
Looking back to the future

Reflecting on the past may give insight into how publicly listed real estate stocks could perform in the future. As the chart below shows, their value has reacted far more to the crises of the past few years than the value of private real estate. In fact, they have often traded at wide

discounts to underlying net asset values. However, the discounts have narrowed as confidence has improved. At time they have even experienced brief periods when stocks have traded at premiums, and there is no reason to think this cannot happen again.

Figure 9: Listed real estate's sensitivity to crises

Comparing listed real estate share prices against private real estate valuations

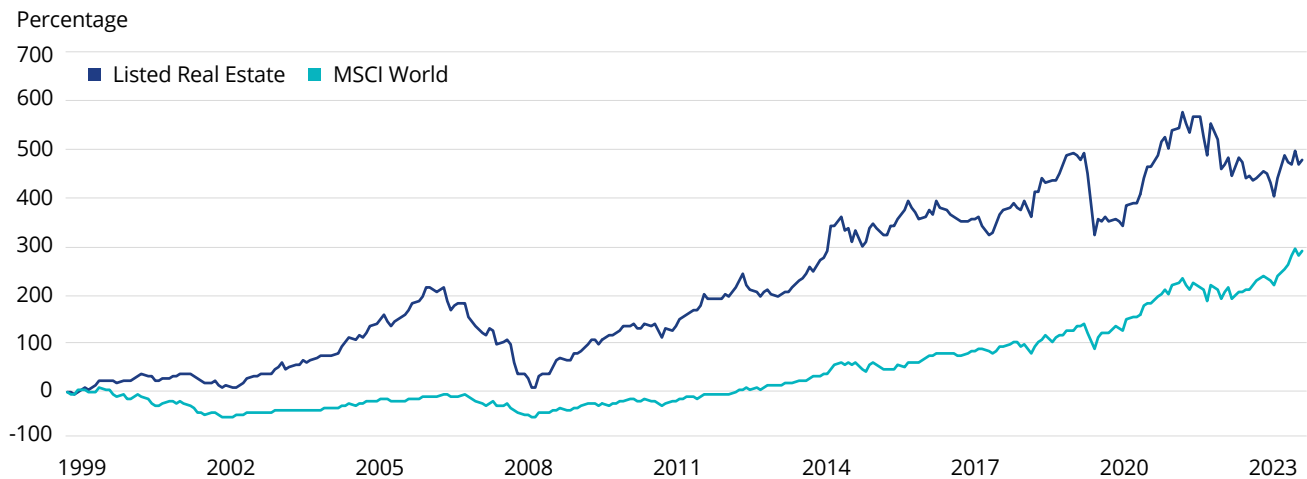


Source: Bloomberg, Listed Real Estate US is represented by the FTSE Nareit All Equity REITs Index, Non-listed Real Estate US is represented by the NCREIF Property Index.

Looking further back over the long term, real estate stocks have outperformed global equity markets. In fact, over the past 24 years since 2000 (see Figure 10), a broad average of global real estate equities (as represented by

the GPR 250 Index) has generated returns significantly ahead of the MSCI World Index. Notably, real estate outperformed in the pre-GFC years of more 'normal' or higher rates—not just the 2010s when rates were low.

Figure 10: 20 years of real estate outperformance



Source: VanEck, Listed Real Estate is represented by the GPR 250 Index

Given the U.S. REITs universe's robust fundamentals, and the attractive valuations that REITs trade at more widely, it seems reasonably likely that listed real estate will resume its long-term outperformance. The sector's diversification also reduces the downside risks.

The past gives one more reason for optimism. In past inflationary times, rents and interest rates have risen together. Yet after the inflation spike has passed, interest rates have fallen and rents have remained high, providing a lasting benefit to real estate companies' operating incomes.

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