ACG Atlanta Consulting Group

# ACG Insights: All the REIT Moves

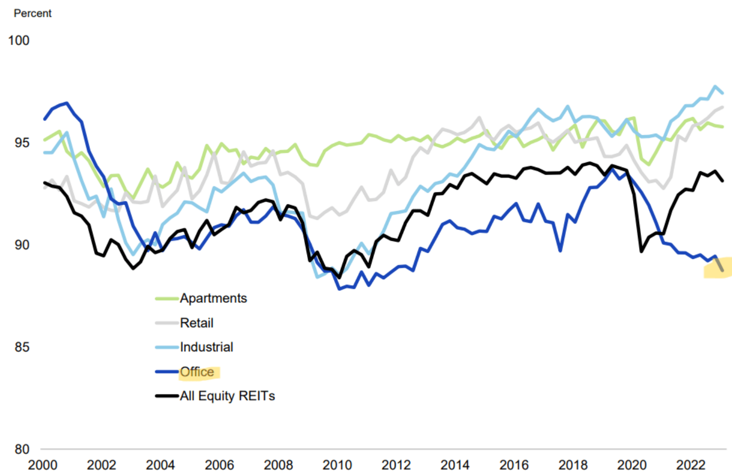
## Executive Summary

- **With the changes brought about during and in the aftermath of the pandemic, occupancy rates for commercial office space have decreased and may be a key reason that investors have questioned the prospects for Real Estate Investment Trusts (REITs) (Exhibit 1)**
- **Historically, REITs were very exposed to the office sector, but they are increasingly representative of a much larger and broader opportunity set (Exhibit 2)**
- **REITs often trade at a premium to their Net Asset Values (NAV), however, with the current overhang surrounding commercial real estate, many segments are trading at discounts to NAV (Exhibit 3)**
- **REIT yields, typically higher than fixed income equivalents, are not as advantaged currently, but still offer a strong yield component (Exhibit 4)**
- **REITs may also be well positioned for a future where inflation is higher than the past. Historically, REITs tend to do best when inflation is moderate (defined as between 2.5% and 6.0%) (Exhibit 5)**

## Background

Similar to Tom Cruise's character in *All the Right Moves*, Real Estate Investment Trusts (REITs) are looking for an opportunity to escape their past and transition into a brighter future. The post-COVID environment has acted as a cloud over the future of real estate investing due primarily to decreased demand for office space that looks unlikely to meaningfully improve, and more difficult financing conditions due to a rapid rise in interest rates from near-zero. It may be a big hurdle, but if property owners and lenders can adjust to a higher rate environment, depressed sentiment in the broader REIT market due to a problematic sub-sector may be an opportunity for investors to increase or initiate exposure to an asset class that has historically provided equity-like returns with low correlation to public equity markets.

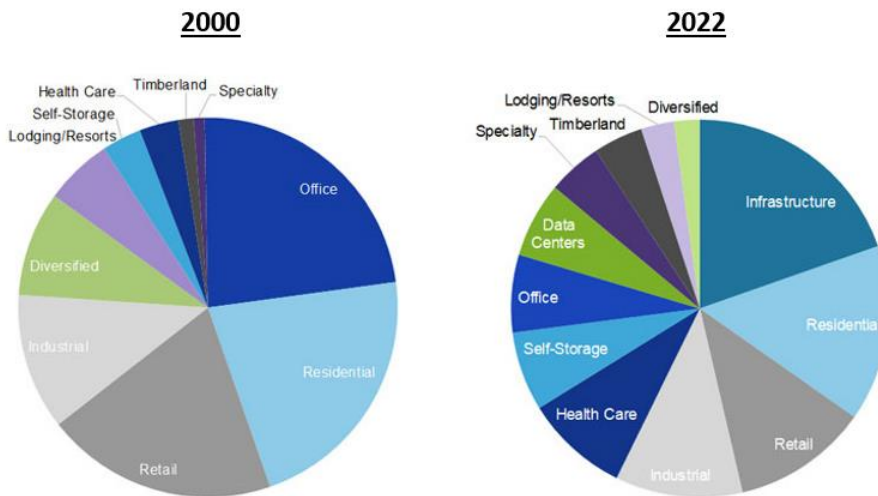
**Exhibit 1: Occupancy Rate by Property Type** [1]




## Is a hybrid future already baked into valuations?

Many areas of commercial real estate maintained relatively high occupancy rates throughout and post-pandemic. Office occupancies have been the notable exception. The attention on this decline has, arguably, led to investors becoming more cautious across all segments rather than specifically those sectors most impacted by demand shortages. Diversified REITs were among the worst performing asset classes in 2022 and have failed to rebound alongside stock market indices so far in 2023. The question for future returns will be whether REITs continue to trade at depressed valuations, or whether investors can look past weakness in certain sectors that has seemingly infected the broader REIT universe. One argument in favor of the latter is that the REIT universe has become more diversified over time, and less dependent on the performance of sectors like office and retail that have been the most disrupted by COVID.

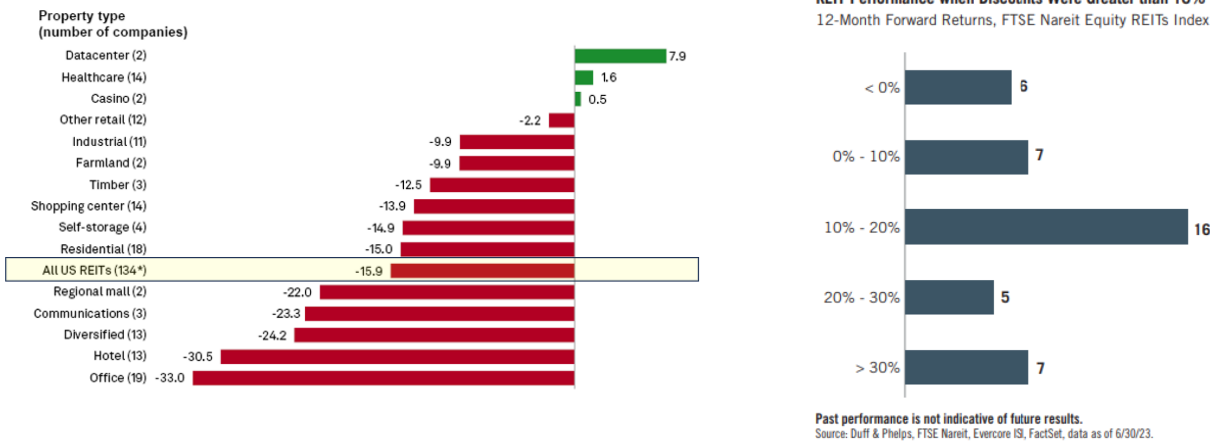
**Exhibit 2: Broadening Opportunity Set in REITs** [2]




While office has decreased in size in the REIT index, E-commerce sectors (infrastructure, data, and industrial) have grown considerably. These changes highlight that REITs in aggregate may only be marginally impacted by weak demand for commercial space despite what current discounts to net asset value would imply.

[1] Source: NAREIT
[2] Source: NAREIT/ FactSet

**Exhibit 3: Premium / Discount to Net Asset Value and Forward Returns** [3]

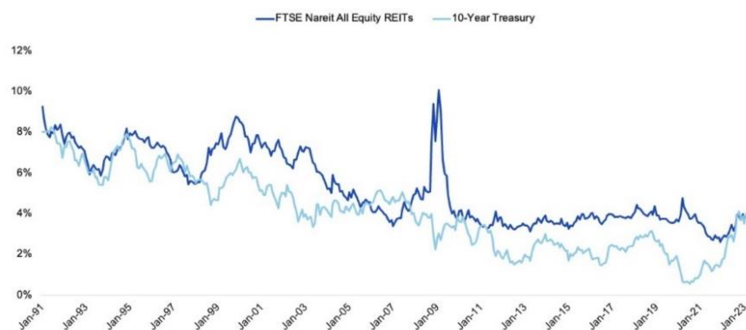



The chart on the left of Exhibit 3 above shows where discounts to NAV currently stand across multiple property types. In total, US REITs are trading at around a 15% discount to what valuations of their underlying properties would dictate. Office properties are especially discounted, but most sub-sectors have been pressured well into discount territory. REIT discounts to NAV in the double-digits have often been a sign of strong returns over the next 12 months. Pictured to the right side of Exhibit 3, REITs exhibited a strong return profile in the next year after discounts of greater than 10% using data going back to 1996.

## Dividend Yield Component of Equity REITs

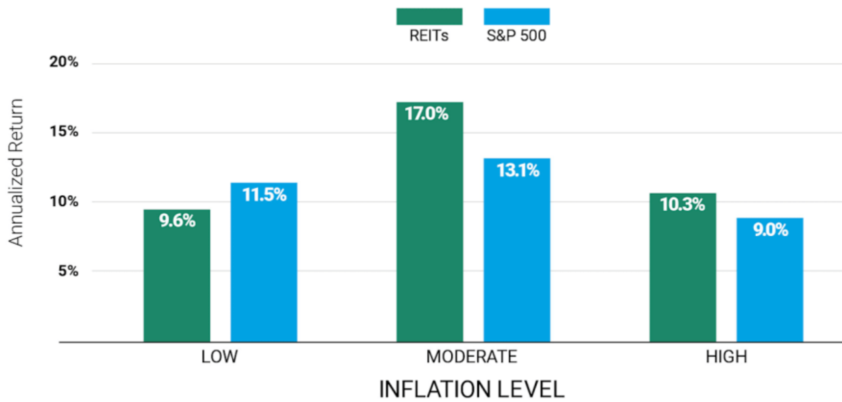
Reinvested dividends have historically accounted for a little over half of total returns for equity REITs. The S&P 500, in contrast, can attribute only about one-fifth of its total return to dividends over the last 30+ years[4]. If investors assume that yield will be an important component of REIT returns going forward, it follows that rising yields should positively impact performance. Exhibit 4 shows the relatively tight relationship between treasury yields and REIT yields, with REITs generally enjoying a slight yield premium over the 10-year treasury bond. If REIT yields and treasury yields maintain a high degree of correlation, it would be reasonable to assume that higher yields in the bond market will boost forward returns for REITs, even without considering possible price appreciation.

**Exhibit 4: Yield of REITs vs. 10 Year Treasury** [5]




[3] Source: NAREIT, Virtus
[4] Source: NAREIT
[5] Source: NAREIT, FactSet, FRED

**Exhibit 5: REITs vs. S&P 500 in different Inflation Regimes [6]**




Another factor that could work in favor of REITs over the next months and years is the inflation environment. REITs have tended to outperform public equities when inflation is at a moderate level (Exhibit 5), defined for the purposes of the lookback period as between 2.5% and 6.0%. The current inflation environment falls squarely in this moderate bucket and recent data, arguably, has shown that returning to an inflation environment near 2.0% could be a prolonged process. Past performance never guarantees future results, but real estate and real assets have generally enjoyed strong relative performance to other asset classes when inflation is elevated.

## Conclusion

Equity REITs have come under pressure and in some cases are trading in stressed or distressed territory as investors question the future commercial properties in a higher interest rate and lower demand environment. The pressure has led to wide discounts to NAV in many sectors that might not have the same gloomy outlook as office properties. While NAV discounts can always get worse, there is precedent that current discounts in the broader REIT market portend a high probability of strong forward returns for REITs. Investors in the asset class can also point to higher yields and inflation-hedging properties as reasons that now may be an opportune time to allocate to REIT funds. Headwinds remain, however, in the form of a more difficult lending environment in commercial real estate than the market has seen in over a decade. It is always important to evaluate REITs in the context of a broader portfolio considering things like overall risk appetite, investor objectives, and as a complement to other portfolio positions.

[6] Source: American Century Investments, Data is 1972 -2022. Low inflation is less than 2.5%. Moderate is 2.5% to 6.0%. High is 6.0% and above.

***Disclosure***

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