The Continued Rise of Non-Traditional REITs and the Uniplan Portfolio

The Uniplan REIT Portfolio has been available to investors since 1989 as a simple and effective way to add broad-based commercial real estate exposure to their investment allocation. Since inception the strategy has maintained an approximate sector neutral exposure to its benchmark the NAREIT All Equity Index. Instead of making sector bets, we preferred a strategy of giving clients benchmark exposure to each sector with an emphasis on supply and demand fundamentals in the local real estate markets which time and again drive local real estate values. This approach has provided index like returns over time with lower volatility while often generating higher income than the benchmark.

In the beginning, the public REIT market was divided into what was often called the four basic food groups: Office, Industrial, Retail and Apartments. Over time we observed new groups emerge as alternative or specialty real estate asset classes which then gained exposure and support in the capital markets and ultimately emerge as newly defined sectors of their own. This is true of sectors such as self-storage, hotels and timber which all began as “specialty” REITs. Our sector neutral approach often gave us the cause to study and invest in these new property types long before they were on the radar of larger dedicated REIT managers. This over time has provided us with greater diversification and lower volatility than many of our peer managers and has served our clients well. We continue to believe this will be a source of new and interesting investment opportunities and have produced this Whitepaper to examine the history and the future of this growing opportunity set in public real estate.

The Journey from Specialty to Institutional Real Estate – An Opportunity

The embrace of previously non-institutional property types (such as Self Storage and Healthcare facilities) has been a notable development of the public REIT market since the start of the modern REIT era in 1992. Early investment in some of these non-traditional property types has generated attractive returns to those investors willing to do the analysis to understand the potential risks and rewards. Today, over 25% of public REITs (by equity market capitalization) own and operate properties that would be considered non-traditional by many real estate investors, with a similar percentage of the index comprising of companies owning properties that are recently or only partially on their way to being fully accepted by institutional property investors. If history is a guide, many of these non-traditional REITs will continue to grow in importance and to offer above average return prospects through a combination of the potential for higher income growth (and dividend growth) and market-based revaluation. In some cases, these non-traditional properties are associated with the faster growing parts of the economy such as tech-related cell towers and datacenters or ‘experiential’ plays such as gaming and entertainment properties.
The NAREIT Index Comprises a Diverse Range of Property Types

Turning the clock back two or three decades, investment in real estate meant buying (or lending on) office and retail property. Apartments and industrial properties later gained acceptance and have been followed by the likes of healthcare properties, self-storage and lodging. NAREIT has progressively created new sub-sectors within its Index to reflect this expanded range and relatively recently created separate categories for datacenters and infrastructure companies (principally cell towers). Currently, the FTSE All Equity NAREIT Index (NAREIT Index) is divided into 12 sub-sectors and comprises about 170 companies owning a diverse range of property types with the largest – residential – representing only just over 15% of the total market equity capitalization.

Figure 1. NAREIT Equity Index Sub-Sector Break-down, Percentage by Equity Market Capitalization

The Rise of Non-Traditional Property Types

Uniplan divides up the NAREIT Index sub-sectors into established Traditional sectors and two other categories called “Becoming Traditional” and “Non-Traditional”. We regard Traditional as being well established investments in the eyes of most institutional investors where there is a fairly high degree of comfort in underwriting the risks and rewards of an investment based on historical data and experience. Becoming Traditional is considered not yet being fully accepted as an established institutional property type while Non-Traditional is thought of as being in the early days of institutional acceptance. Typically, property types other than Traditional have traded at higher cap rates/lower prices reflecting the greater perceived uncertainties even though they may exhibit higher income growth. It should be noted that within NAREIT’s sub-sectors there are less well-established property types such as Student Housing that are included in the Residential sub-sector that have been counted as Traditional.
At the end of June 2019, based on the equity market capitalization of these sub-sectors in the NAREIT Index, REITs are divided as depicted below in Figure 3.

**Figure 2. Traditional and Other NAREIT Sub-sectors**

<table>
<thead>
<tr>
<th>Traditional</th>
<th>Becoming Traditional</th>
<th>Non-Traditional</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail</td>
<td>Healthcare</td>
<td>Infrastructure</td>
</tr>
<tr>
<td>Office/Industrial</td>
<td>Self-storage</td>
<td>Datacenters</td>
</tr>
<tr>
<td>Residential</td>
<td>Diversified</td>
<td>Specialty</td>
</tr>
<tr>
<td></td>
<td>Lodging</td>
<td>Timber</td>
</tr>
</tbody>
</table>

Source: Uniplan Investment Advisers

Based on this analysis, Traditional property types represented a minority of the weighting in NAREIT at mid-year 2019. They are smaller than the combined weight of Becoming Traditional and Non-Traditional.

In June 2016, the Index weightings were Traditional 52.2%, Becoming Traditional 26.8% and Non-Traditional 21.0%. Accordingly, over the last 3 years, Traditional sub-sectors have declined by 5.2% as a percentage of the Index mirroring the same increase in the weighting of the Becoming and Non-Traditional sub-sectors. Note there has been a slight decline in Becoming Traditional which has been more than offset by the growth of Non-Traditional.

*Given the higher growth rates of many of the property types in the Becoming Traditional and Non-Traditional categories and the potential for revaluation (see below), we would expect today’s Traditional property categories to continue to decline in relative size within the REIT universe.*
Asset Price Gains from Cap Rate Compression/Reduction in Risk Premium

A substantive part of the attractive returns that have been generated by REITs related to this acceptance of new property types is frequently attributable to a compression (decline) in cap rates over time. These declining cap rates provide appreciation in the underlying portfolio of assets along with the higher growth and larger dividend yield. A simple example shown in Figure 4 below illustrates the increase in value that can accrue from a decline in the cap rate from upper single digits (more typical of a non-traditional property type - in our example we have used 9%) to a more institutional core asset like cap rate of 6%. For the sake of simplicity, we have conservatively chosen to include no increase in net income. At the property level, a 300bps decline in cap rates (9% to 6%) results in a 50% increase in the property asset value. Moreover, such an investment if financed by 50% debt, would produce a doubling of the equity value. (note: 50% leverage is higher than generally employed by a public REIT – typically 30-35% - but lower than might be used by private/institutional investors – typically up to 65-70%). Self-storage properties are a good example of an asset class/sector that has experienced a dramatic increase in value from declining cap rates over the last several years.

Figure 4. The Impact on Valuation of Property/Equity Values on Cap Rate Decline

<table>
<thead>
<tr>
<th>$10 of income</th>
<th>Asset Value</th>
<th>Cap rate</th>
<th>6.00%</th>
<th>16.7x</th>
<th>Asset Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>9.00%</td>
<td>111</td>
<td></td>
<td></td>
<td></td>
<td>167</td>
</tr>
</tbody>
</table>

Change in valuation (167/111) 50%

<table>
<thead>
<tr>
<th>Financed at Start by 50% Leverage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt 55.5</td>
</tr>
<tr>
<td>Equity 55.5</td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>

Change in equity (111.5/55.5) 101%

Source: Uniplan Investment Counsel

Note that some investors in Non-Traditional types may think Net Asset Value (a frequently used metric among REIT investors), not to be of much use. Here we are thinking of Cell Towers and Datacenters (combined weighting of more than 20% in NAREIT Index) in particular, where many investors feel a cash flow metric such as EV/EBITDA is rather more relevant. For such stocks, an upward revaluation would imply an expansion of the EV/EBITDA multiple as the principal point of reference.

How can this decline in cap rates be rationalized?

Property cap rates have generally declined along with interest rates and yields across most markets. Since the Great Recession of 2008/09, interest rates and by association, finance costs for many creditworthy borrowers have been low. For much of the last decade until relatively recently, the Fed’s short rates have been close to zero with long term (10Y UST) Treasury bond yields at historic lows below 2%. As of this writing, Treasury yields are barely above 2.0% having fallen back this year from a
Jan. 2019 high of around 2.80%. However, the general rate environment is only a partial explanation for falling cap rates which have declined more for some of these new property categories than they have for traditional property types. Assuming little change in the underlying property growth rate, we believe lower cap rates reflect a reduced risk premium (the additional return investors seek to compensate for holding riskier assets). As investors become more familiar with a new property type and develop a better sense of risk and reward, they may find reason to reduce their assessment of risk which would lower the cap rate and underpin an upward revaluation of the property.

**Risks** – To be clear, investment in non-traditional property types is not without risks. Uncertainty about future cash flow should warrant a discount (higher cap rate). Income growth rate assumptions may prove to be optimistic and competitive new supply might emerge. Some of these properties can be specialized which might require substantive new capital investment to adapt it to an alternative use if demand for its original purpose falters. There can also be questions about tenant credit standards; there being a challenge to manage the properties; and to the ease of an eventual sale. Not all new non-traditional property types will be accepted as part of the established categories. Some may take a long time to be accepted, some may not enjoy a full revaluation, and some will remain esoteric investments that continue to trade at a discount to the sector as a whole.

**Investment Portfolio Benefits** – The addition of new property types adds the benefit of diversity to the REIT sector. These new property types have drivers of space demand that can differ from other established property types and supply characteristics that can also vary. This can give rise to different performance at various times over the economic/property cycle. Several large companies we regard as non-traditional property owners have become REITs over recent years such as cell tower companies American Tower and Crown Castle International; datacenter company Equinix; timber company Weyerhaeuser; and paper storage company Iron Mountain. Many of these companies were well established companies with experienced management that became REITs with a substantive weighting in the Index. Many offer good liquidity for stock trading. Some general investors may well be more familiar with these companies and their businesses than REIT investors. Following the creation of the new real estate GICS category by S&P (September 2016), we think general investors have been willing to embrace these non-traditional property type owning REITs which has helped accelerate their broader acceptance. Uniplan wrote a whitepaper on this subject that can be found at the following link ([https://uniplanic.com/reit-flash-2015q3-2/](https://uniplanic.com/reit-flash-2015q3-2/)).

The prevalence of low interest rates has underpinned a strong investor demand for yield which has lent general support to REIT stock prices. REIT valuations at Net Asset Value (or at a premium) have helped encourage the flow of new entrants into the REIT public market. Should low rates and the demand for yield persist, it seems likely that there will continue to be new companies and new property types added to the REIT sector. We believe that some of these new entrants will challenge the understanding of investors, but many will likely offer the prospect of above-average returns for those who are willing to analyze and invest in these emerging categories.

David Harris

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All investments carry a certain degree of risk, including possible loss of principal. REITs are subject to illiquidity, credit and interest rate risks, as well as risks associated with small- and mid-cap investments. It is important to review your investment objectives; risk tolerance and liquidity needs before choosing an investment style. Value style investing presents the risk that the holdings or securities may never reach their full market value because the market fails to recognize what the portfolio management team considers the true business value or because the portfolio management team has misjudged those values. In addition, value style investing may fall out of favor and underperform growth or other style investing during given periods.

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