REIT Outlook 2024

Brighter Prospects Ahead After Two Disappointing Years

- **2024 Return expectations** –We expect REITs will generate 8-10% total returns in 2024, approximately half comprising of a cash dividend yield of ~4%. REITs are on track to generate about 3% total returns over 2023. This is slightly below our forecast of +5-7% for Y23 a year ago as the REIT sector and capital markets have declined as the Federal Reserve has raised interest rates to curb inflation. In 2024, we assume there will be an economic slow-down/mild recession with the economy likely to be improving by YE24. We expect inflation will trend down allowing the Fed to reduce rates (See "Key Macro-Economic, Stock Market Assumptions" in the Appendix below). We believe REITs will produce Y/Y earnings growth of 3-5%, pay a ~4% cash dividend yield and that the earnings multiple may expand 1-2 turns reflecting lower interest rates.
- **Earnings growth –** Over 2024, we assume earnings for most REITs will be largely supported by modest income increases derived from space demand and little new supply. As an offset, there will be upward pressure on operating expenses and from increased debt costs. Incremental gains from acquisitions/development seem likely to be limited.
- **Dividends** – The current 4.0% REIT sector dividend yield is ~2.5x the yield of the S&P 500 Index (1.6%) and roughly in-line with the current 10Y UST yield. We continue to believe REITs over the medium-longer term, can raise their dividends at 4-5% pa, broadly consistent with our cash flow growth expectations for the sector. All while raising return and lowering volatility in the typical stock and bond portfolio.
- **Fund Flow** – REITs are on track to raise ~$55bn of capital in 2023, similar to what they raised in 2022. Interest rates and weak share prices have suppressed issuance. Private Equity Real Estate funds have attracted reduced inflows but retain considerable untapped money to spend. We think the appeal of property to many long-term investors looks likely to continue.
- **Principal Assumptions and Risks** – We assume Y24 GDP Y/Y growth will be 0.75- 1.25% with a slowdown/slight recession in 1H/mid-year, unemployment will rise to the low/mid-4%'s, PCE Core inflation will decline to ~3.0% by YE24 and the Fed will reduce FFR to 4.75-5.00% by YE24. We regard the major risks to sector stock performance to include a more serious, long-lasting recession that depresses space demand. **Inflation** may persist at elevated levels and the Fed may maintain restrictive monetary conditions (interest rates and bond sales) which would be a headwind to REIT stock performance.

The availability/price of **debt** could continue to be restrictive. **CRE/REIT stock valuations** (specifically cap rates) may be perceived as not being reflective of 'true' market conditions. Excessive new development is commonly a cause of cyclical property risk but is a low probability at present.

Comment

Property markets over 2023 generally exhibited positive fundamentals continuing the steady improvement from the Covid lows of 2020. New supply has been limited while space demand for most property types has reflected the improvement in the economy/job gains. At variance with the overall picture, there has been an increase in new Sunbelt apartments and the slow office Return-To-Work has depressed tenant renter interest. Investment activity has remained very subdued with increased interest rates which have put upward pressure on the cost of debt finance and cap rates (and hence downward pressure on property valuations). The dearth of investment transactions means it is difficult to peg property valuations, but cap rates appear to have moved up over the last year or so by at least 100bps for even the quality properties and more for lesser quality assets. The Fed is presently regarded as being at or close to peak rates with expectations of future cuts to come. **If our macro call for 2024 of a slight-modest recession 1H24 with a reacceleration of the economy by 2H24 with some easing of monetary policy is accurate, then a reasonable case for improved space demand (and hence property income) and higher property/REIT valuations can be made.**

Ten Big REIT Themes for 2024

- **Inflation and Interest Rates** will continue to be dominant themes for investors. Next year should see inflationary concerns subside with the prospect of lower interest rates increasing. This should benefit property valuations (helping lower cap rates), the cost of capital and relative appeal of CRE/REIT's dividend yield. CRE/REIT inflation hedge qualities have been largely ignored over recent years but could become of greater interest in a higher longer term inflationary environment.

- **Dividend Yield and Long-term Growth Prospects** will look relatively attractive in a more stable environment.

- **Property Debt Markets Reopen** - An improved outlook for the economy should boost the appetite for risk and help in reopening debt issuance. This will underpin a revival of property deals.

- **Space Demand** to be the principal focus in the absence of much new supply for most property types in most markets. The much unloved office sector should see some modest improvement as ~50% Return-to-Office numbers slowly go higher. We do believe in a solid recovery over time, but no one should be holding their breath.

- **Sunbelt vs Coasts.** Sunbelt and selected secondary cities will likely continue to see growth driven by cost/quality of life considerations compared to the coastal metros. That said, we continue to believe the allure of the big coastal cities to higher growth industries will be more evident over time and support their revival.

- **Sub-sector Divergence.** A slowdown would likely put pressure on the shorter lease owners (lodging and apartments) though they would be the first to see an improvement with a better economy. We continue to think that the tech-related property types (Towers, Datacenters and Distribution Facilities) offer superior long term secular growth characteristics to most traditional property types.

- **M&A Activity** appears likely to continue albeit at reduced levels while debt markets remain challenging. The appeal of consolidation - scale considerations among the public companies will persist.

- **Insurance and Climate Risks Gain More Prominence** – Insurance costs have been rising and appear likely to escalate further. Greater attention will be paid to areas of greatest risk to climatic events. Properties in states including Florida and Texas which have enjoyed boom market conditions, look most at risk.

- **Cash flow growth** (not Net Asset Value) to remain the principal driver of stock performance with the incremental buyer/seller of REITs being the general investor versus the REIT dedicated crowd.

- **PERE/NTR 'Past Peak'** The higher rate environment has challenged these business models that were significant beneficiaries of the ultra-low rate/low cap rate environment of the 2010's. More questions will be asked about valuations, leverage, high fees, and lack of liquidity. *Modest debt levels and management with operational and redevelopment abilities are more commonly found in public REITs.*

REIT Earnings

Growth of the economy and labor market supported space demand across most property types/locations in 2023. Many REITs produced modest earnings growth from solid occupancy and rents offset by increased operating expenses and higher interest costs. REIT earnings growth over 2023 are on track to be 3-5% Y/Y. The best growth has come from Industrial and Shopping Centers and the weakest from the Office and Tower companies. Looking into 2024, subject to generally benign macro conditions including a shallow/brief recession/slowdown, Y/Y earnings growth could match the 3-5% of 2023. We believe, Industrial and Datacenter earnings should be solid as should Retail while growth for Apartments and Storage will likely be more modest though still positive. Offices, a small sub-sector in the REIT market, looks likely to

produce negative earnings change. Towers seem likely to be flat pending an improvement in 2025. **At this time, we think overall Y/Y REIT earnings growth in 2024 will be about 3-5%.**

Dividends

Given the REIT pay-out rules, dividends will largely grow at the rate of earnings growth (or higher), so as we expect earnings to grow in 2024, dividends can be expected to increase at a broadly similar pace. Over the medium-long term, we think overall REIT earnings growth will be of the order of 4-5% and we can expect dividends will grow at a similar if not higher rate. Some REITs have racked up some notable dividend payment records over many years: Realty Income (O) has paid a monthly dividend without a break 641 times (that's over 53 years), Federal Realty (FRT) has increased its annual dividend every year for the last 56 years and more recently over the last decade, sector giants Prologis (PLD) has raised its dividend on an 11% CAGR and American Tower (AMT) 17%. We note that **4-5% long term REIT dividend growth is double or more the rate that many economists would peg as the annual inflation rate over the longer term.**

Fund Flow into Property

The performance of public debt and equity markets in 2023 appears likely to prompt many institutional investors to look to rebalance their portfolio asset allocations (aka the denominator effect) again for next year. It seems likely that higher yields from UST and IG debt will attract increased allocations. We think investors should look more carefully at Alternative/Private investments where valuations can be questionable, and liquidity is frequently limited. CRE/PERE falls into the Alternative bucket for many investors, and we expect some will curb their new commitments and others to actively sell. That said CRE's 'inflation hedging' characteristics may gain broader recognition. Over the longer term, we expect institutional allocations to CRE (both equity and debt in REITs, PERE, Direct) to remain around 10-12%.

Capital raised by REITs in 2023 through the end of October, has totaled $45bn - on track for ~$52bn for FY23 which would be about the same as 2022 but only about 40% of the $133bn raised in 2021. YTD in 2023, there has been $25bn of unsecured debt raised and $20bn equity. Higher interest rates and depressed stock prices have not been conducive to raising capital. Prudently, many REITs had taken advantage of the years of low rates to lock in much of their debt at fixed rates for extended duration.

Property debt markets remained challenging over 2023 in the light of elevated interest rates. The failure of Silicon Valley, First Republic and Signature Bank in March sent tremors through the regional banks who are traditionally the biggest group of property lenders. Several prominent owners handed back the keys to their lenders including Blackstone, Brookfield, Pimco, Starwood and RXR. Lenders were concerned about reduced values (LTV's) and property income security (DSC's). Office properties caused the greatest worries followed by retail and lodging. Near term concerns have abated somewhat with interest rates appearing to have

peaked and at present, little contagion among the banks. There is $500bn/year of property debt maturing over the next 3 years so the challenge will not go away. It seems likely there will need to be debt work-outs involving write-downs, extensions, cash injections and distressed sales over the next few years.

High quality REIT issuers did tap the unsecured market paying much higher rates than they paid only a few years ago. Rates for 10Y and longer were in the 5%'s earlier in the year and in the 6%'s more recently. Notable examples include Alexandria (ARE) $1bn, 20Y blended at 4.95%, Public Storage $2.2bn, 4 tranches through 30Y at 5.3% blended and recently Kimco (KIM) $500m, 10Y at 6.4% and Simon Property Group (SPG) $1bn, 20Y blended at 6.25-6.65%.

New institutional commitments to North American **Private Equity Real Estate (PERE**) funds have declined this year to $82bn after they rebounded to a historic high of $150bn in 2021 and declined to $136bn in 2022, according to Preqin. At 1Q23, there was $1tr US PERE AUM including $250bn/quarter of 'Dry Powder' (assuming leverage of 60% implies they have in excess of $600bn of spending power). We think some of this future investment may be directed more towards debt. We have expressed the view that we believe PERE is 'Past Peak' (June '22 - see Uniplan Whitepapers) meaning that future returns are very unlikely to approach the returns generated by many PERE funds over the last decade.

The **Non-Traded REITs** (BREIT, SREIT and others) have enjoyed considerable support from retail investor inflows over recent years. They have however 'gated' (limited) investors from selling their stock over 2023 as redemption requests exceeded monthly limits. (BREIT had redeemed $12.5bn shares by end Oct 2023 since End Nov 2022) Retail investors have been learning of the value of stock liquidity the hard way. These investment vehicles, like Private Equity Real Estate (PERE), thrived during the 'free money' era (2008-2021) but seem likely to be seriously challenged in a higher rate environment. Their business models look less likely to generate attractive risk-adjusted returns in the future than they did in the past. Some institutional investors in PERE funds do however appear to have few doubts about CRE's prospects – Blackstone (BX) recently raised $30bn equity for BREP X to invest globally across property sectors.

Development activity has been at a low level with few projects penciling out with current rents and increased costs. Obtaining debt finance has been challenging. Looking into 2024, we think only a few REITs will increase their development programs though some will likely look to buy land and prepare sites for starting their activities if a brighter outlook comes more into focus. We continue to think selected redevelopment activities from their existing portfolios will continue and generally offer attractive returns for those companies with the ability to manage the activity.

Some large investors with a long term perspective continue to selectively show an interest in partnering in development/investment deals of late – SL Green (SLG) and Japan's Mori Trust have an office JV at 245 Park Ave (total $2bn/$1,200psf), Boston Properties (BXP) and unnamed institution in 343 Madison Ave (~1m sf office by Grand Central), Digital Realty (DLR) has formed a number of JV's to develop datacenters, and American Homes 4 Rent (AMH) and UDR (UDR) for residential investment ventures.

Mergers & Acquisitions/CRE Transactional Activity.

M&A activity over 2023 featured Public-to-Public deals as Public-to-Private deals were frozen out by higher debt costs. Most public consolidation deals are driven by access/cost of capital, elimination of G&A of one of the companies and maybe some scale benefits. Notable transactions over 2023 include the Extra Space/Life Storage self-storage combination valuing Life Storage at $14bn EV; Realty Income/Spirit triple-net combination valuing Spirit at $9.3bn; Peakhealth/Physicians Realty healthcare deal at $5bn and two shopping center deals – Kimco/Retail Properties and Regency/Urstadt Biddle – both featuring big companies swallowing little ones.

We anticipate M&A activity in the sector will continue in 2024. Public-to-public/consolidation deals will be driven by access to capital, modest economies of scale and executive compensation. PERE does have money to spend and if the property debt markets reopen with lower rates, they could come back with renewed vigor.

PERE was a more active seller than buyer over 2023. Blackstone sold a $3.1bn industrial portfolio to Prologis and BREIT sold Simply Self Storage to Public Storage for $2.2bn and a 22% interest in the Bellagio, Las Vegas for $950m (values 100% at $4.3bn) to Realty Income.

Leading Sub-sector Outlooks

Stock performance has gone in opposite directions over 2023 for **Datacenters and Cell Towers.** AI mania has propelled Datacenters to be the best performing REIT sub-sector YTD. By contrast, reduced CapEx by the big telco carriers has weighed on the Towers and left them the worst sub-sector performers. We think AI optimism is a little premature for the Datacenters and believe 5G adoption will underpin tenant increased demand for space on the Towers. **Industrial/Distribution space** (13% of NAREIT Index by equity market capitalization at end November) demand has been led by e-comm and modest new supply continues to support positive fundamentals. **Collectively, the 'tech-related' Cell Towers, Datacenters and Industrial/Distribution companies had a weighting of 38%/NAREIT.**

Residential (15%/NAREIT) continues to be generally favored as a relatively stable and resilient property type. The 'For-Sale' housing market has been impacted by the rise in rates/increased mortgage costs – cooling price gains and locking owners into staying put. Renter demand has remained resilient though rent growth has decelerated in 2023. There are some locations principally in the Sunbelt which will see increased new supply over the next year or so but the dearth of construction loan finance from the regional banks seems near certain to mean supply shortages in the next 2-3 years. **Single Family Housing**, a beneficiary of the rise of the suburbs, has been generally solid as have **Manufactured Homes.**

Retail (15%/NAREIT) has benefited from a strong consumer who has returned to 'brick and mortar' shopping post Covid and virtually no new supply has underpinned solid fundamentals

for retail landlords. Many retailers have adapted to 'omni-channel' models combining e-comm and physical stores. They have been keen to pay for space in the better-quality properties in both shopping centers and malls. We think competition from e-commerce will continue to increase for online sales currently represent about 15% of total sales. We think the best retail properties will continue to do well but pressure will persist on many secondary and tertiary properties.

Other sub-sectors of note that individually represent between 5-10% of NAREIT by market weight include: **Healthcare** properties: Senior Housing has rebounded in with limited new supply and its long-term demographic tail-wind demand driver. Life-science space demand has been somewhat impacted by reduced VC funding for some of the tenants. Medical Offices Buildings and Hospitals have been generally steady. **Self-Storage** earnings have decelerated in 2023 after posting very strong growth in 2022. Limited new supply suggests the pace should pick up next year. **Office (less than 5% of NAREIT)** markets have been slow to revive with daily occupancy <50% in several major metros. Investor concerns about capex requirements, debt financing and the uncertain outlook for financial services and tech tenants have also weighed. We believe longer term that CBD office demand will return but the challenges faced by offices are unlikely to be resolved any time soon. **Lodging (only 3% NAREIT weighting)** properties continued to show improvement from the Covid closures of 2020. Leisure travel has come back with international visitors picking up ahead of business. Recession concerns appear likely to weigh on sentiment looking into 2024. The **Gaming REITs** now form their own sub-sector; they continue to attract investor support.

Conclusion

We have a relatively positive stance on the performance prospects of REIT stocks over 2024. Looking to next year and assuming a brief recession followed by a reacceleration of the economy, inflation continuing to decelerate and some Fed interest rate cuts in 2H, this should provide a fairly favorable backdrop for REIT stocks. REITs should begin to reflect the prospects of an increase in space demand and higher property prices. Property will not lead an economic recovery but REITs as inflationary hedges with a relatively secure high dividend yield that will grow over time, offer attractive diversification benefits to investors. After their weak performance in 2022/23, REIT stocks today are priced at a more attractive entry level than previously (~4.0% dividend yield vs ~3%).

Appendix

Key Macro-Economic, Stock Market Assumptions

US economy suffers a mild-modest recession/slowdown in 1H-mid 2024 (GDP ~0.5-1.0% decline over 2-3 Quarters). Full Year GDP growth 0.75-1.25%

Unemployment rises to low-mid 4%'s. Consumer spending is subdued.

Inflation does decline but slower than some expect (Core PCE ~3.0% by YE24) & the Fed will hold back from reducing the FFR until late in the year (~4.75-5.0% by YE23).

UST/Bonds Real yields remain positive supporting yield orientated investments. Nominal yields stabilize.

Corporate earnings growth after a flat Y23 turn positive – we assume SPX EPS Y24 growth in the mid-upper single digits. Other than tech, sales are generally positive but higher operating costs and interest rates pressurize margins and there are FX headwinds.

The Stock market is volatile with more downside risks over 1H but turns more positive 3Q/4Q in anticipation of improved economy in 2024. Elevated stock market valuations limit Y/Y market returns despite a brighter economic/earnings outlook later in the year.

CRE regains more attention as yield/growth options continue to be limited, there is little new development and there is the prospect of better tenant space demand in 2024/2025. REIT earnings growth is relatively modest in 2024 but should accelerate in 2025.

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