Making the REIT Move In Real Estate

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Anu Rajakumar: REITs, or Real Estate Investment Trusts, can be an important diversifier in asset allocation. About a year ago, we spoke to the global head of REITs at Neuberger Berman, Steve Shigekawa, on the impact of the digital age on REITs as the pandemic was amidst its peak. But today I'm joined by Steve's colleagues, who will share their perspectives on their respective regions and dive in deep into what's going on in the REITS market as we return to a post-COVID normal. My name is Anu Rajakumar and with me today are Gillian Tiltman and Brian Jones, portfolio managers for our global REITs offerings, covering EMEA and U.S. REITs respectively, to share more about the main factors disrupting REITs today. Gill, Brian, thank you for joining me.

Gillian Tiltman: Thanks, Anu, great to be here.

Brian Jones: Thanks for having us. This should be fun.

Anu: So as I mentioned, we spoke about REITS on the show last year. I actually think it was one of my first pandemic recordings that I had. And during that conversation, we touched on the digital revolution of today. But tell us a bit more about what's been going on over this volatile past year, and maybe an overview for what you foresee going forward within your respective regions?

Brian: Yes, you're right. 2020 was, was really a tough year for the US REIT sector. A number of REIT sectors were severely impacted by the COVID-19 pandemic. You consider the retail, hotel, or even healthcare REIT sectors. Each saw significant occupancy and cash flow declines driven by the pandemic. Today, investors are thinking about things very differently, with a focus on the likely end of the pandemic's disruption of the economy and are more focused on how inflation and higher interest rates will impact REITs and less concerned about the specific impacts of the pandemic. As portfolio managers, we continue to consider what changes in daily living brought on by the pandemic will be more enduring and which will fade away as the virus recedes. Will the work from home flexibility meaningfully impact office demand over the long term? Will the population migration from the urban core to the suburbs and the Southeastern part of the US continue? These are the types of questions we're considering as we think about 2021 and beyond.

Anu: Terrific. And Gill, any comments from your perspective in the EMEA market?

Gillian: Yeah. Actually I think Brian gave a super overview about how the COVID-19 pandemic affects the US real estate market. And I think that very similar trends were seen in Europe. The UK has been lucky enough to get a vaccine program off the ground. At this time last year obviously the continent and the UK were both struggling in terms of number of COVID cases, number of hospitalizations and just trying to get the pandemic under control, and that impacted all areas of the real estate market in Europe. What's really interesting, I think, is that COVID-19 has accelerated trends that we already saw in the real estate market. Meaning that the millennial generation is completely changing the way people are living and working. We're seeing that in terms of what office space needs to look like, we're seeing that in terms of online shopping trends and how that's affecting the industrial warehouses and that sort of thing. We're seeing how that's impacting the technology sectors. And as work from home continues, or at least leads to more flexibility, with folks working at home, I think that there will certainly be winners and losers. But what we've seen from the COVID-19 pandemic is absolutely an acceleration of trends that we already saw in real estate. Because at the end of the day, real estate has to be the first thing that responds to change.

Anu: Great, thank you so much. Now, Brian, you mentioned a little bit earlier that investors today are more focused on the path of inflation and interest rates. Would love for you to talk through the characteristics of REITs as they relate to those factors.

Brian: Well, it goes back to the structure of real estate leases, and these leases really enable real estate landlords to capture higher inflation in the form of escalating rental rates. For shorter leased assets, such as residential, real estate, self-storage, hotels, landlords can bump rents on leases as they roll on a nightly or annual basis. For the longer leased assets such as office or industrial warehouses, there are typically annual escalators, either fixed bumps in the two to three percent range, or escalations that are specifically tied to CPI or other measures of inflation. So for many REIT sectors, the rental rate trends will accelerate as inflation accelerates. Another interesting aspect for real estate is that most of the, the costs are fixed rate in nature. So the investment in the property has already happened. There are relatively few property level employees, if you think about how many people it takes to run a warehouse or an office building. It's relatively few employees for the amount of rental rates that are generated. So a lot of that top line revenue growth can fall to the bottom line in terms of higher cash flows and earnings. As it relates to interest rates, I think the question's a little more nuanced. But if inflation or if interest rates are moving higher because inflation expectations are higher, we think that's generally a positive scenario for real estate. Uh, the higher inflation can translate into better cash flow. And the threat of higher interest rates is moderated because interest rates are still very low on a historical basis. We've published a recent paper called "REITs and Rates" that discusses this question in greater detail and highlights that historically REITs have delivered solid returns in periods of higher inflation and in periods where the 10-year Treasury yield was rising.

Gillian: I think Brian covered that beautifully in terms of how real estate performs during periods of inflation. And the one thing that I will add from my perspective is just when you think about the uncorrelated nature of the asset class, simply that REITs tend to trade unlike every other asset class in terms of equities, bonds, cash, and real real estate. Over the long term, the correlation is actually a lot higher with physical real estate than it is with any other asset class. So, when you're thinking about inflation hedges and you're thinking about, why interest rates are going up, and if it's for an improving economy, that speaks very well in terms of perspective returns. So we just really like to always talk about the uncorrelated nature because it is an asset class unto itself. And it does trend to trade that way. And in times of rising inflation, when interest rates are rising because of an improving economy, REITs will benefit.

Anu: Yup. Terrific. Thank you so much. I think important notes there that you both touched on. You know, REITs can be a great inflation hedge. Particularly important in this environment. You know, with reopening of economies across the globe, I'd love for you to talk about what sorts of shifts or growth themes that you've noticed, particularly based on consumer behavior, that you think could change or even have been changing the REITs landscape. How have REITs markets been able to pivot to meet some of these new demands?

Brian: We think demand trends and ultimately cash flow trends from real estate are driven by the ways corporations and consumers utilize real estate. And the pandemic has meaningfully altered how real estate is utilized. One of the obvious examples is within the office sector. The work from home experience has generally been positive, a positive one for corporations and employees, and should continue to some degree post-pandemic. Recent employee surveys suggest that a majority of office workers would prefer to have some level of flexibility to work from home a few days a week, and employees even place a monetary value on this work location flexibility. This has the potential to hurt office demand over the coming years. However, many corporations are concerned about how work from home impacts corporate culture, collaboration, the integration of younger and new workers. The hotel sector saw a significant decline in leisure and business travel. We've seen leisure travel recover substantially in recent months. But corporate travel has been slower to recover. On the retail side, retail centers were hit by social distancing requirements, but retailers and landlords have been able to innovate with concepts such as buy online and pickup at the store that have improved the safety of shopping trips. On the other hand, there have been a few sectors that have been positively impacted by the pandemic. One that stands out is the single-family rental sector that has experienced a strong positive disruption from the pandemic, driven by young families choosing to accelerate their decision to move from urban areas towards the suburbs.

Gillian: And I think it's really interesting to think about, from a REIT perspective, the types of business that we're investing in today vs. something 15 years ago. Back then when you talk about real estate investment trusts, it was really all about offices and shopping centers and the more typical property types. And now there are so many different property types to invest to take advantage of the trends of the way people are living differently, like as Brian mentioned, single family housing, like data centers and cellular towers. And that's not just a U.S. trend. That's all over the world. And you know, industrial, which has become a big winner of the changing demographic and the changing way that people are shopping. So, um, the REIT market globally has really been able to pivot to meet this new demand of how people are using real estate. We think that's really encouraging for the asset class, to be one who invest in for years to come.

Anu: Yeah, Gill, I think those are some really good points. And as you were talking about the evolution over the last, you know, 10, 15 years, I was just thinking about, you know, the famous quote, which is, “the only thing that is constant is change.”

Gillian: Absolutely, yeah.

Anu: Even before the pandemic, there were already shifts happening just based on our culture and demographics and technology, but certainly helpful to hear some of those points. So thank you. Now here in the U.S., rent payments were deferred during the pandemic, and of course we've seen huge amounts of stimulus. Brian, maybe we can ask you some thoughts on policy changes that may have impacted REITs, here domestically in the U.S. And then maybe Gill any other thoughts outside the US as well would be great.

Brian: Sure. The level of government support has been quite tremendous in the US. The stimulus-related spending has exceeded 5 trillion dollars. And this unprecedented level of government support has supported the economy, enabling tenants to continue to pay rent there otherwise may have been more substantial shortfalls. Whether it's residential tenants who are paying rent with enhanced unemployment benefits or hospitals and skilled nursing operators who have remained solvent because of funding to offset their COVID related expenses, these programs have really served as a bridge between where, the pandemic is disrupting operations and to the point where we see a more robust economic recovery, which is beginning to occur now. One other program that I would highlight is President Biden's infrastructure spending proposal, which could boost a few individual REIT sectors. The funding of bridges, roads and particularly public transport could support the recovery of central business districts that are important to office and residential REITs. There's also a proposal to fund affordable high-speed data for rural and low-income communities that could benefit the cell tower REITs and the data center REITs. And there's also commitment to build more affordable housing and less in residential development restrictions that would support the residential construction industry, lumber prices, and timber REITs, eventually.

Gillian: There's a couple of interesting policies in the UK that I think are worth mentioning, like our furlough scheme that has been ongoing since March of 2020, which is basically enabling companies to claw back 80 percent of employee salaries from the government, just to keep people being paid. That's something that has continued until October of '21. There have also been in a 20-billion-pound total around 2 billion of additional spending on infrastructure, extra spending on employment job search programs, including the new Kickstart scheme; 6 billion for the job retention bonus, which is like I mentioned, the furlough scheme. Last summer there was a tremendous stimulus package for hospitality and tourism, which as we know, those industries have been particularly hard hit by this crisis. And the need for social distancing, many businesses in the UK and Europe were forced to close for long periods, so here in the UK the VAT paid on takeaway or eat in food, non-alcoholic drinks, accommodation, tourist attractions, etc., was reduced from 20 percent to 5 percent from July of last year, all the way through March of this year. Last summer also, the stamp duty cuts were announced in the UK, which has actually been extended through this year, basically raising the threshold for a tax on house purchases from 125,000 pounds to 500,000 pounds. And various measures to tackle unemployment due to the coronavirus crisis by bringing forward infrastructure spending to create job growth and wage growth. So we think that many of these schemes are still ongoing. And looking across Europe, as we head into the new normal post-pandemic, a lot of money has been spent trying to confront this crisis and make our way out. But you know, hopefully we're almost there.

Anu: Absolutely. Hopefully we're almost there. You know, Gill, you mentioned a couple times in this episode the new normal for the REITs markets. And I'd just love to hear, what does that look like in the next decade? What are your thoughts?

Gillian: Well, I think the new normal, like I've said before, and I say it often and I'm sure it gets a bit boring, but I think that real estate absolutely has to be the first thing that responds to change, right, and changing the way people are living, working. I think the new normal looks like people maybe not traveling to the office five days a week, embracing some more flexibility. I think that what the pandemic has taught in general is a lot to do with taking care of the environment more, maybe consumption goes down. What that means for the REITs sectors I think is that online shopping and, having multiple deliveries a day to your house, that's something that's probably here to stay. I think that flexibility and enabling folks to sort of create their own balance in their lives from a work/life balance perspective is definitely here to stay. I think that people will continue to use more and more data in their daily lives as we become ever more connected and we're very lucky that we, uh, we're able to access those trends in the REIT market. We wrote a fantastic paper in 2019 entitled "The Hidden Themes in REITs," which, you know, I would encourage anyone interested in those trends to take a quick look at. So I think the new normal is, is not just about getting a return, capital appreciation and income from the tradition real estate assets, but it's about being able to think about, uh, how people are living and working and – and access those trends in the REIT market, and that will continue.

Brian: Yeah, I think that's spot on. The one thing I would add in terms of how we're positioning our investments is that we, we still believe in the sectors that are benefiting from the digitalization of our economy. So data centers, cell towers, warehouses through e-commerce should deliver better and more consistent growth over the long term relative to, to many of the traditional sectors. So we think that, that theme continues to resonate within the REIT environment overall and within our investment portfolios. There have been some COVID-generated share price disruptions from 2020 that present some unique opportunities within the retail, hotel and office sectors that were disrupted by the pandemic. I mean if you think about retail, we have been pleasantly surprised that first quarter of 2021, retail sales were up over 12 percent vs. the pre-pandemic level of the first quarter of 2019. So even in a sector that has some significant, longer term fundamental challenges, there are opportunities for REIT landlords and tenants to adjust to the new normal, to roll out services like buy online and pick up at the store, that benefit both the retailers and the owners of retail shopping centers. So I think we're very encouraged because the REITs are being flexible and creative in terms of adjusting to the new normal. And that allows us to, to really pick and choose between subsectors and individual REITs to understand, which areas and which companies are really positioning themselves for the future.

Anu: Perfect. Thank you very much. You know, I think this has been a terrific conversation, uh, really shining the light on how diverse the REITs sector is from retail, office, residential, technology, and so much more. So I think there's something for everyone to learn, from today's chat. Now my last question, just for fun, you know, we've been talking a lot about travel, hotel, leisure, in the context of REITs and with summer upon us and hopefully one day being able to travel again, my question for both of you is, uh, would you rather have a holiday where you see more places but stay in cheap accommodation or stay in one place in luxury accommodation? Brian, you first.

Brian: Oh, I'm, I'm very much a more places and more experiences kind of person. So I love to, to hit more, locations, see everything. And if I have to be slightly down market in my accommodation to, to add a few days, or a few locations, I'm happy to do that. So you know, call me cheap and cheerful in terms of my travel budget and where I like to stay.

Anu: Perfect. And Gill, what about you?

Gillian: You know, for me, I've been pretty lucky in my life in the sense that I have gotten to see so many places around the world. So I'm kind of good. Um, I like to go back to Barbados every year and stay in the same place and do the same thing and see the same ocean. Um, and that would definitely have to be a little bit more luxury, especially since I haven't had a holiday in two years. So for me, I've seen all the world I want to see, I'm done. I want to stay in luxury.

Anu: Fabulous. I love it. Thank you so much for joining me today. Really appreciate getting your thoughts and insights about the REITs market globally. Um, it's been a pleasure having you both. Thank you, Gill. Thank you, Brian.

Gillian: Thank you so much.

Brian: Thanks, Anu. It's been great to dig into these topics with you.

Anu: And to our listeners, if you've enjoyed this episode of "Disruptive Forces," I encourage you to subscribe to the show via Apple podcast, Google podcast, or Spotify. And if you'd like to learn about our REITs team's offerings, including both of the papers that were mentioned today, the "REITs and Rates" paper, as well as "The Hidden Growth Themes in REITs," I encourage you to visit our website, www.nb.com/disruptiveforces, for previous episodes as well as more information about our firm and offerings.