hazelview
INVESTMENTS

THE CURRENT OPPORTUNITY IN REITs

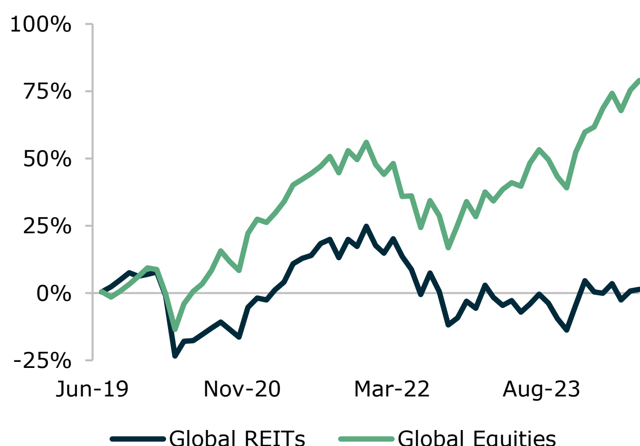
Inflection Point in REITs?

Discover why global REITs, despite recent underperformance, present a promising investment opportunity as macroeconomic conditions shift and valuations hit historical lows, positioning them for potential gains.

Recent Underperformance

Over the past few years, global REITs have significantly underperformed compared to other assets like global equities. While global equities have seen substantial gains driven by the impressive performance of major technology firms, global REITs have remained relatively flat. Figure 1 below illustrates the stark divergence in performance of REITs versus equities over the past five years[1].

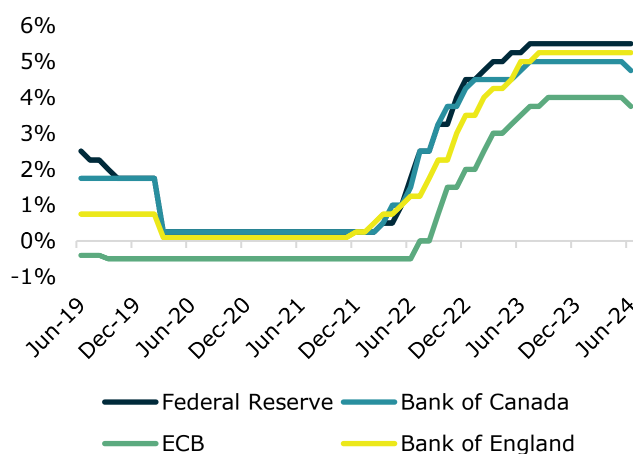
Figure 1 – Global REITs v Global Equities Performance – 5 YR



This divergence in performance can be attributed to several key factors that have created a challenging environment for REITs. Firstly, the COVID-19 pandemic had a profound impact on the real estate sector, disrupting operations and causing declines in rental income. As lockdowns and economic uncertainty took their toll, many REITs faced challenges in maintaining occupancy rates and rental revenue.

Secondly, the post-pandemic economic recovery has been marked by a rapid increase in interest rates starting in 2022. Central banks worldwide, including the U.S. Federal Reserve, have aggressively hiked interest rates to combat rising inflation. In the U.S., the federal funds rate rose from near-zero levels at the start of 2022 to over 5% by mid-2023. The rapid increase in central bank policy rates is displayed in Figure 2 on a five-year timeframe[2].

Figure 2 - Central Bank Rates – 5 YR



This monetary tightening has caused property values to decline and increased borrowing costs for REITs, creating a headwind to earnings and making it more expensive to finance operations and acquisitions. Furthermore, higher interest rates have made fixed-income investments more attractive, prompting investors to shift capital away from REITs in favor of higher-yielding alternatives. This rotation has further depressed REIT prices, despite improving underlying fundamentals in the real estate market.

The combination of these factors—the initial shock from the pandemic and the subsequent rise in interest rates—created a challenging environment for REITs. However, as the macroeconomic environment begins to shift, depressed REIT prices, along with potential rate cuts, present a considerable **opportunity** for investors.

The Opportunity

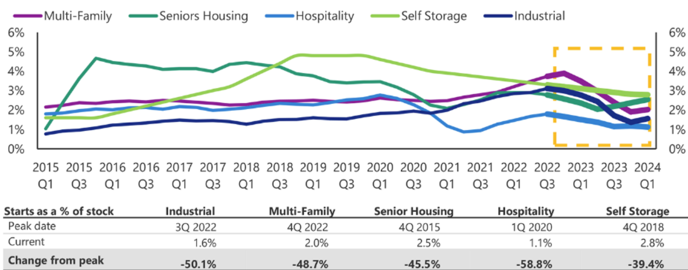
Given recent underperformance and the evolving macroeconomic and capital markets environment, we believe REITs may be at **an inflection point**. Current valuations are attractive due to past underperformance, operating fundamentals remain resilient and with recent interest rate cuts in Canada and Europe, as well as anticipated cuts in the U.S., the environment is becoming increasingly favorable for REIT investments and the prospect for higher asset values.

Fundamentals

The fundamentals of the real estate market hinge on two primary factors: supply and demand. Currently, across most sub-sectors of the market, we are observing a stagnation in supply while demand remains healthy.

One critical aspect that has not received enough attention is the forecasted decline in new supply for 2024 and 2025. Inflation has significantly increased construction and financing costs, leading to a steady decline in construction starts across various real estate sectors. This decline in new supply is expected to result in greater landlord pricing power, a more sustainable rent growth environment, and lower vacancy rates. Figure 3 highlights this trend in declining supply across several major U.S. commercial real estate sectors[3].

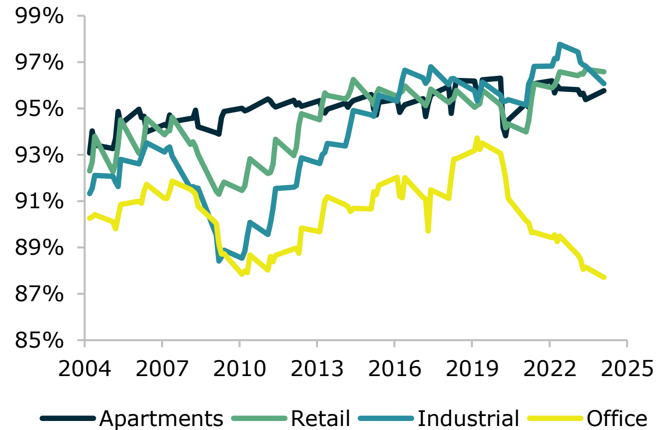
Figure 3 - U.S. Construction starts by sector (% of inventory) – Q1 2015 to Q1 2024.



Starts as a % of stock	Industrial	Multi-Family	Senior Housing	Hospitality	Self Storage
Peak date	3Q 2022	4Q 2022	4Q 2015	1Q 2020	4Q 2018
Current	1.6%	2.0%	2.5%	1.1%	2.8%
Change from peak	**-50.1%**	**-48.7%**	**-45.5%**	**-58.8%**	**-39.4%**

On the demand side, appetite for the residential and commercial real estate space remains strong across most geographies and property types, with the notable exception of office space. This healthy demand is driven by a resilient global economy supported by ongoing job growth. The moderation in supply, coupled with strong demand, is highlighted by resilient occupancy rates in major U.S. real estate sectors. According to recent data from NAREIT, industrial, apartment, and retail REITs in the U.S. have consistently exceeded 95% occupancy rates, underscoring considerable strength and stability in these markets[4].

Figure 4 – U.S. REIT Occupancy Rates – 20 YR



Outside of traditional real estate sectors, specialty sectors like healthcare and data centers are noteworthy for their demand/supply dynamics. In the senior housing healthcare space, the growing need for senior housing is driven by the aging baby boomer population. During the next 20 years, the population growth rate for seniors aged 80+ is expected to be 3.7% for the U.S. and 4.3% for Canada[5]. This outsized growth in the senior population provides a robust, long-term tailwind for senior housing demand over many years, contrasting sharply with decreasing new construction starts due to rising costs and decade-high interest rates, making development economically challenging.

Additionally, technology REITs, such as data centers, are experiencing secular growth trends with the adoption of AI, significantly increasing demand. In Q1 2024, total data center leasing volume in North America set a record with over 1,800 MW of new leasing activity. Vacancy rates in top markets dropped to record lows, leading to a 10-20% growth in market rents. Q2 was also very strong, with net absorption at approximately 1,371 MW[6].

Operational Resilience

During the recent rate hiking cycle, many REITs have focused on improving their operational efficiency and strengthening their balance sheets by reducing debt. Data from NAREIT shows that, after an extended period of capital discipline dating back to the Global Financial Crisis (GFC), the REIT sector today operates at historically low levels of leverage.

During the onset of the COVID-19 crisis, REITs capitalized on the decline in interest rates, locking in new long-term debt at low, fixed rates. This strategic move has positioned them well in the face of the tighter capital environment that followed. Moreover, REITs have been able to achieve this while steadily growing their

NOI. Figure 5 and Figure 6 below highlight REIT leverage and debt ratios, showcasing their success in bolstering balance sheets and reducing debt ratios while continuing to grow NOI[4].

Figure 5 – U.S. REITs Leverage and Interest Expense – 20 YR

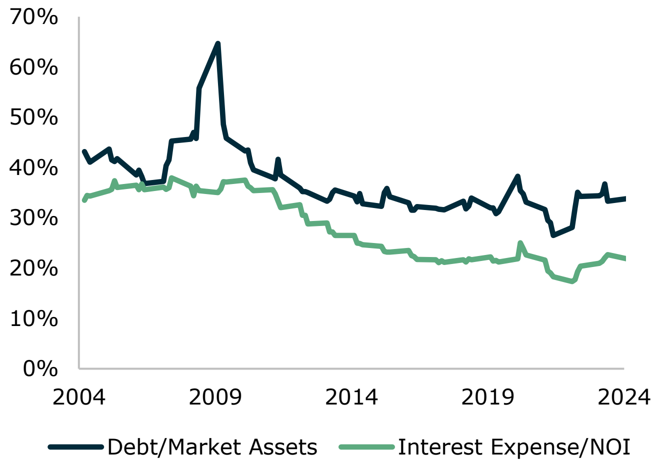
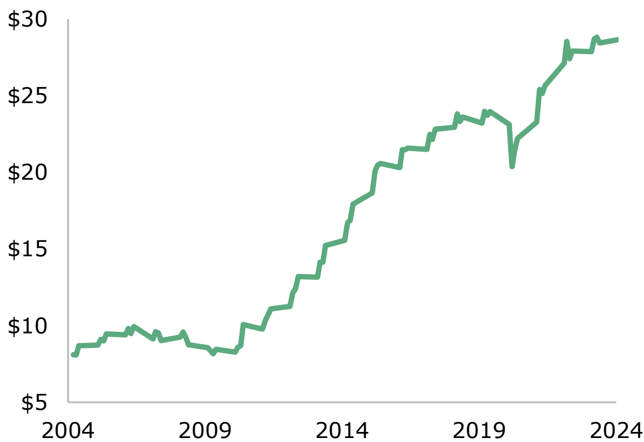


Figure 6 – U.S. REITs NOI in billions $USD– 20 YR



On the earnings front, robust operating fundamentals since the beginning of 2022 have resulted in cumulative earnings growth of over 15% for the global REIT industry. Despite forecasts of slower economic growth in 2024, we believe REIT earnings will remain resilient. This resilience is supported by annual contractual rent increases, positive re-leasing spreads upon lease expiration, and the lease-up of vacant space. According to UBS, global REIT earnings are forecasted to rise by 4.6% in 2024 and 6.9% in 2025[7].

Discounted Valuations

One of the most compelling reasons to consider REITs right now is the historically low valuation multiples at which they are currently trading compared to equities.

Since the start of 2022 to June 2024, REITs have experienced a contraction in their trading multiple of around 30%, surpassing declines observed in any other industry – see Figure 7 below[8].

Figure 7 - Change in Forward P/E Multiple since Dec 2021

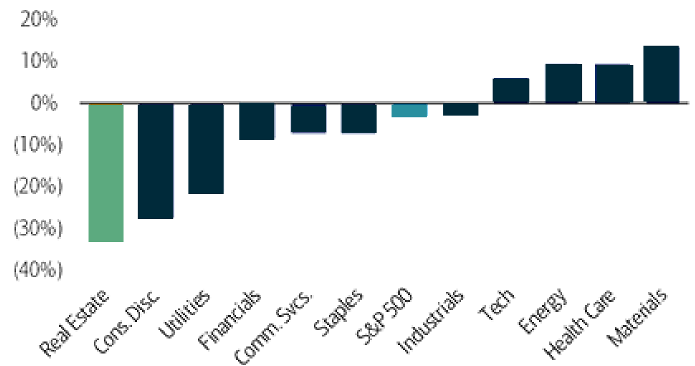
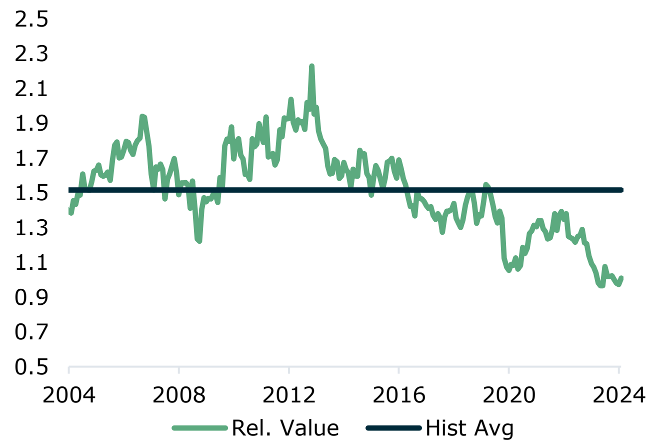


Figure 8 calculated by UBS, shows the relative value spread of price-to-cash flow of real estate versus global equities over the past 20 years[9]. This spread is determined by dividing the price-to-cash flow ratio of real estate by the price-to-cash flow ratio of equities. Over the past 20-years, the historical average spread has been 1.5. Currently, that spread has narrowed to just 1.0, illustrating that REITs are trading at their cheapest levels in the past two decades relative to equities on a cash flow-to-price basis.

Figure 8 – Real Estate v Global Equities Price to Cash Flow Ratio – 20 YR



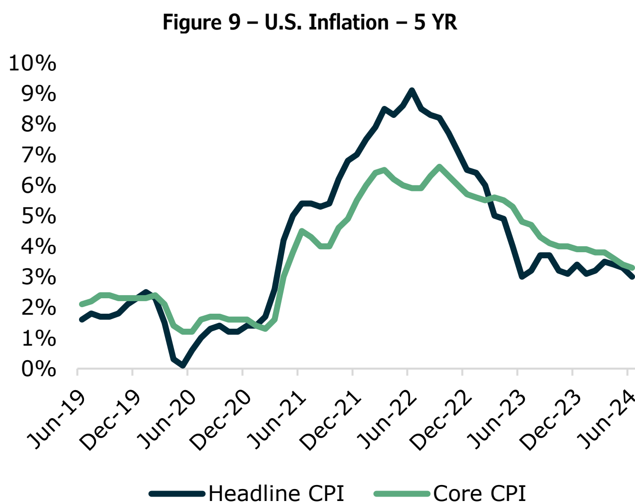
Considering that REITs have never been cheaper on a price-to-cash flow basis relative to equities over the past 20 years, this could signal a potentially lucrative entry point for investors. The current valuation discount offers the potential for significant upside as the market re-rates REITs to more normalized levels.

Macroeconomic Outlook

The macroeconomic environment is shifting, presenting another compelling reason to consider allocating to REITs. Major economies across the globe are already moving towards easing monetary policies. The European Central Bank cut rates for the first time in June, and the Bank of Canada has made two cuts, one in June and another in July. Both central banks have signaled the potential for more rate cuts before the end of the year. While the U.S. Federal Reserve has yet to cut rates, there are growing indications that the Fed may pivot soon, given encouraging inflation data.

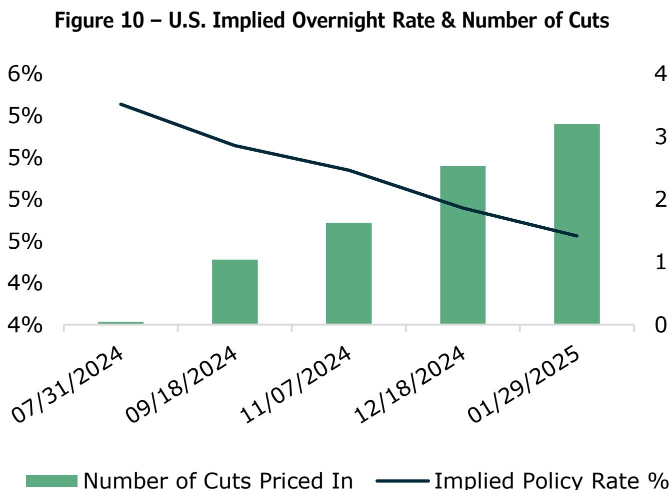
The recent U.S. core CPI print in June was the lowest since April 2021, and the overall trend has been declining since inflation peaked in the summer of 2022. Figure 9 below showcases the trend in U.S. inflation as measured by headline and core CPI[10].

Figure 9 – U.S. Inflation – 5 YR



With this encouraging disinflationary backdrop, the market is pricing in a high probability of the first U.S. rate cut by September, with potentially another cut before the end of the year. Figure 10 below shows expectations for U.S. interest rates into January 2025[11].

Figure 10 – U.S. Implied Overnight Rate & Number of Cuts



Early Signs of Rebound

We are beginning to see signs of a possible bottoming in REITs as investors anticipate a rebound and move back into the space ahead of the expected Fed rate cuts. Figure 11 and Figure 12 below show the returns for various S&P 500 sectors, highlighting that while real estate has lagged since 2022, it has led the pack for the month of July[12].

Figure 11 – S&P 500 Sector Returns - June 2022 to June 2024

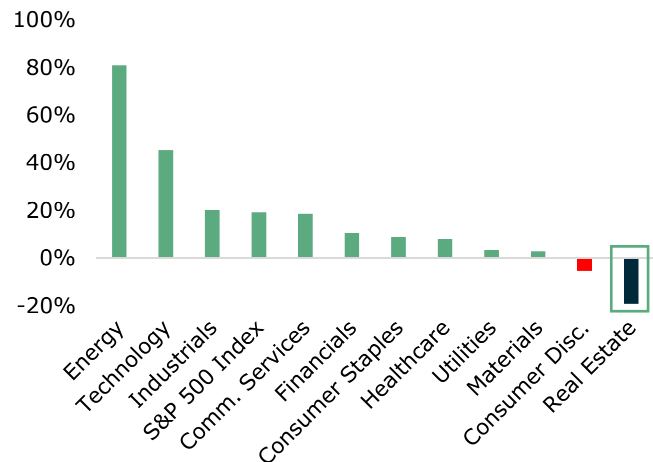
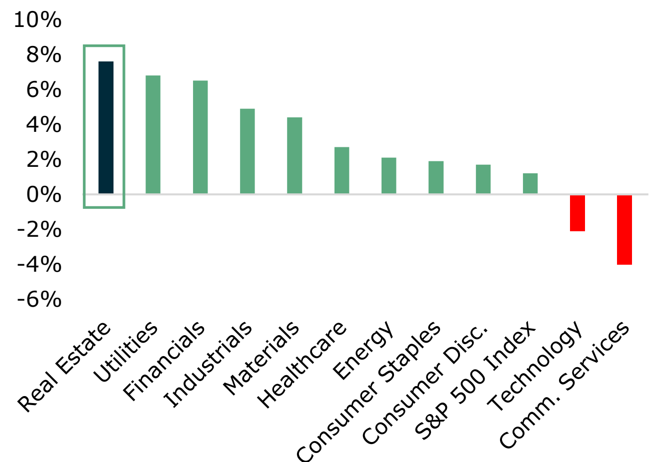


Figure 12 – S&P 500 Sector Returns – July 2024

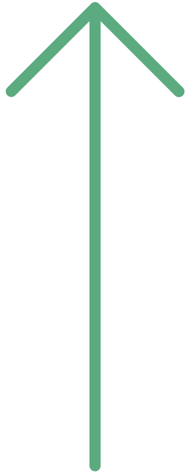


While there is always the potential that this may be another false dawn, it could also indicate the beginning of a reversal in investor sentiment towards REITs and a rotation back into the space. As the macroeconomic environment continues to evolve, the potential for an improvement in asset values from a moderation in interest rates is likely to boost the sector.

Recap →

Recap

While REITs have faced challenges over the past few years, healthy fundamentals, current low valuation multiples and a more favorable capital markets and macroeconomic outlook present a compelling case for investing in REITs right now. The overall tailwinds for real estate and recent activity we are seeing in the market may finally signal **an inflection point for REITs**. This combination of factors makes it an opportune moment for investors to consider allocating to this asset class.



Sources

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