

Buying the REIT Recovery in a Dislocated Market

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Overview

The global health crisis and recession have turned property markets upside down in dramatic fashion, as shelter-in-place orders have given certain tenants the economic and political cover to avoid or delay rent payments.

With governments shutting down entire sectors of the economy, global REITs lost more than 40% of their value from mid-February to mid-March, before recovering half their losses following policymakers' unprecedented response to provide liquidity to credit markets and financial support to businesses and households.

Year to date, global REITs have declined 23% through April, underperforming global equities by a surprising 11%. As a result, publicly listed real estate is trading at meaningful discounts to our view of private-market values. It appears the next few months will be challenging for many landlords. However, most public real estate companies have ample liquidity to withstand impaired cash flows through the crisis, in our view.

We believe the current dislocation is creating opportunities to take advantage of rare discounts for high-quality listed real estate franchises that we believe will be among the first to recover as activity resumes.

Highlights

- 1. Discounts like these don't happen very often.** REIT discounts to our private-market estimates are toward the low end of their historical range at -6.7% globally. Given REITs' strong balance sheets, access to capital and attractive valuations, we have confidence that investors will look back at 2020 as an attractive vintage year and a buying opportunity.
- 2. The advantages of liquidity.** The lag in private-market values, together with challenges in closing property transactions in a socially distanced environment, present roadblocks for private investors to effectively capitalize on valuation opportunities, whereas listed REITs allow investors to take advantage of distress immediately. We are seeing increased interest in opportunistic allocations to REITs as investors seek to take advantage of discounts to marked-down asset values.
- 3. Recessions have been fertile ground for outsized return opportunities.** Just as the REIT recapitalizations in 2009 led to substantial returns in the ensuing years, we expect similar opportunities will emerge to provide capital infusions—whether to help healthy companies pursue acquisitions, or to assist high-quality but cyclically challenged businesses. We continue to position portfolios in property types experiencing resilient demand in the crisis (digital infrastructure, housing, self storage) and in undervalued and well-capitalized companies operating in challenged sectors, which we expect to emerge stronger from the crisis.

Discounts Like These Don't Happen Very Often

The wide range of possible outcomes as the virus cycle ripples through the economy presents unique challenges to establishing a view of value. In addition to our normal investment routines, we have implemented special research task forces focused on the virus's trajectory, progress on testing and treatment, and how the crisis could change long-term consumer behaviors, government policies and business operations. As our views evolve, each team continuously reassesses their base-case and bear-case forecasts, synthesizing our top-down macro roadmap with valuation regimes to guide portfolio decisions.

This process leads to several observations:

The next three to six months are likely to be very challenging for many landlords. Even as new virus cases have flattened in many cities, COVID-19 will likely continue to circulate, with periodic flareups for the foreseeable future. It will take time before people feel safe going back to offices, factories, restaurants, malls, sporting events and other crowded gathering spaces, translating into a slow recovery in consumption and employment.

However, unlike in the financial crisis, credit markets are functioning. Central banks have injected unprecedented liquidity into the financial system. Banks are well capitalized and have been supportive in providing liquidity through lines of credit, term loans and, in some cases, relaxed covenants. There have also been unsecured REIT bond issues—a market that was completely closed in the financial crisis—at reasonable all-in rates. Even considering the disruptions in cash flow, we believe REITs have two to three years of

liquidity on average, though some of the higher-leveraged or more cyclical companies may require equity infusions.

REIT earnings should be far more resilient than those of the broader market. Despite rent impairments in some sectors, most leases remain in force, providing resilience to REIT earnings. We estimate global REIT earnings will decline about 4% in 2020—a historically bad outcome for real estate, but far better than the 25% earnings decline expected for companies in the MSCI World Index. Net asset values (NAVs) are somewhat of a moving target in this market, but we expect private-market declines of 5–15% on average, with certain hotels down 30% or more on the low end, and cell towers, data centers and warehouses possibly holding steady or moving higher.⁽¹⁾

Global REITs are trading at attractive values. Though REIT asset valuations are up from their March lows, they remain toward the low end of their 5-year range across most major regions and property sectors, trading at a 6.7% average discount to NAV globally (Exhibit 2). REITs also appear attractive versus stocks, trading at nearly a 6X earnings multiple discount to the global equity market (Exhibit 3).

As an income alternative, REITs should continue to provide a significant yield advantage to fixed income, in our view, with government bond rates at historic lows. Exhibit 4 shows REIT dividend yields (adjusted for estimated distribution cuts of 10–20% in 2020) relative to 10-year government bonds.

While we can't predict how markets will perform, attractive valuations and ample liquidity give us confidence that in the next several years, investors will likely look back on 2020 as an attractive vintage year—especially relative to private real estate.

Exhibit 1: Historic REIT Correction Has Created Dislocations

Cumulative Returns (%) for Global REITs in Bear Markets



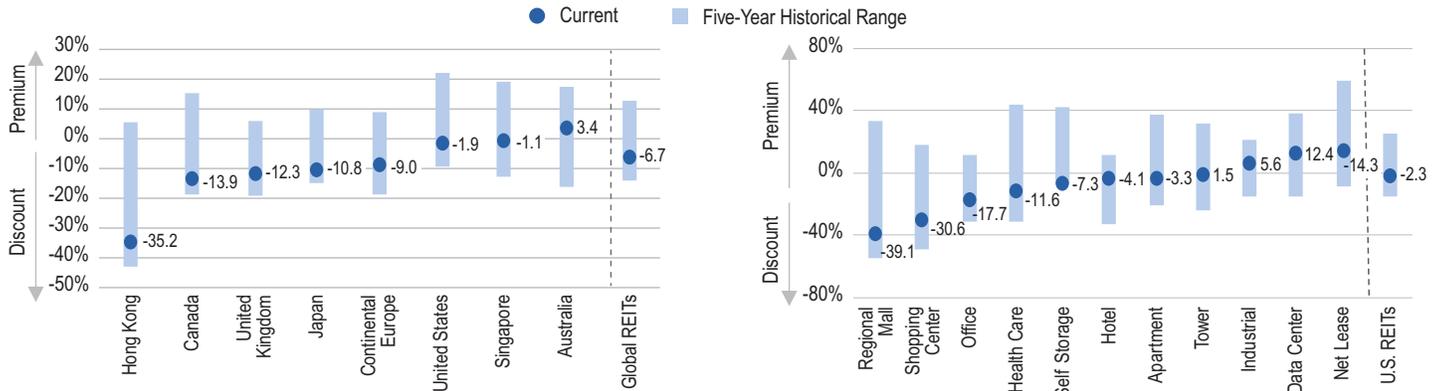
At April 30, 2020. Source: Bloomberg, Cohen & Steers.

Data represents past performance, which is no guarantee of future results. The chart above is for illustrative purposes only and does not reflect information about any fund or other account managed or serviced by Cohen & Steers. There is no guarantee that any historical trend illustrated above will be repeated in the future, and there is no way to predict precisely when such a trend will begin. An investor cannot invest directly in an index and index performance does not reflect the deduction of any fees, expenses or taxes. Index comparisons have limitations as volatility and other characteristics may differ from a particular investment. Data based on the S&P Global REIT Index, which offers a longer return history than the FTSE EPRA Nareit Developed Index. See page 9 for index definitions and additional disclosures.

(1) Net asset value is the net market value of a company's assets minus liabilities.

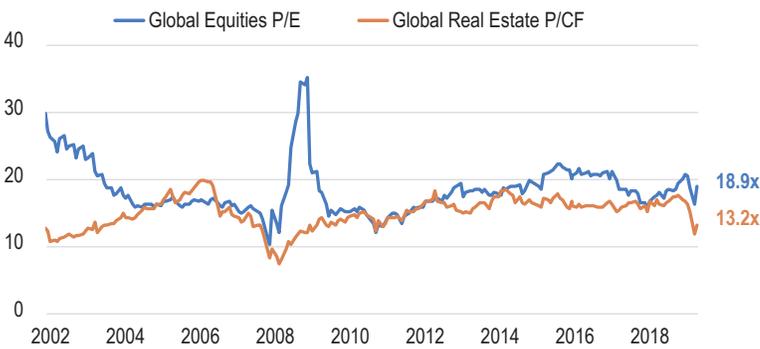
Exhibit 2: REITs Priced at Significant Discounts to Value of Property Holdings^(a)

Premium/Discount to NAV, by Region and U.S. Property Sector



At April 30, 2020. Source: Cohen & Steers estimates.

Exhibit 3: REITs Trading at Low Earnings Multiples Relative to Broad Equities^(b)

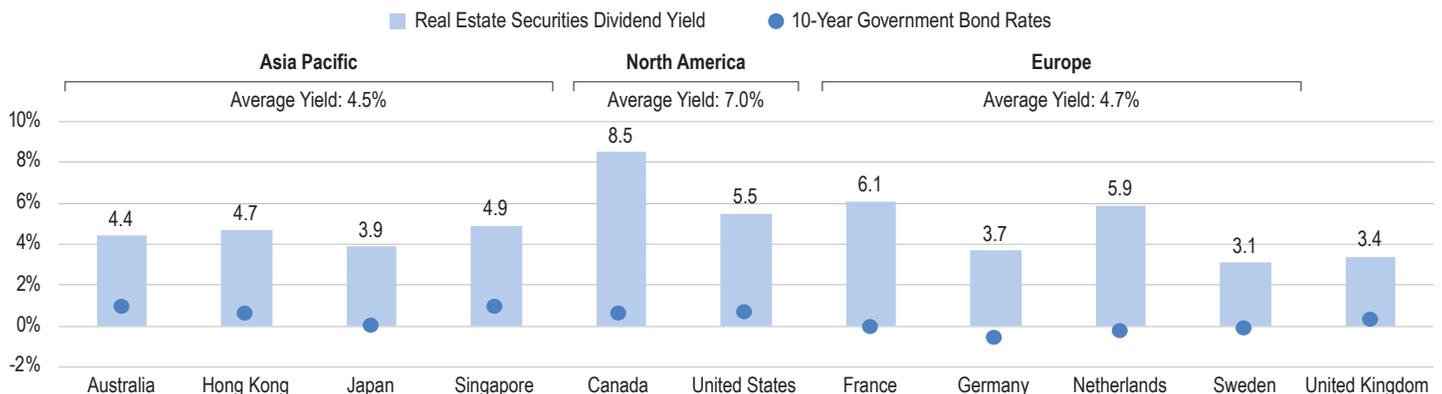


REITs are trading at attractive levels relative to private real estate (above), stocks (left) and bonds (below)

At April 30, 2020. Source: Morningstar, Cohen & Steers estimates based on proprietary metrics.

Exhibit 4: REITs Offer a Significant Yield Advantage^(c)

REIT Dividend Yields Shown After Estimated Distribution Cuts



At April 30, 2020. Source: Cohen & Steers (REIT dividend yields), UBS (government bond rates).

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The Advantages of Liquidity

The current crisis is yet another occasion to highlight the long and growing list of private property comingled funds—both institutional and retail—that have gated withdrawals because appraised valuations are stale and uncertain. These roadblocks to redemptions are an important reminder of the value of liquidity offered by listed real assets.

A larger issue for many private real estate investors, in our view, is how to capitalize on opportunities.

Deal volumes are effectively going to zero in the near term due to uncertain values, difficulties in performing due diligence and canceled networking events for buyers, brokers and lenders. At this point, most of what is left in private markets are distressed assets that are going back to special servicers in commercial mortgage-backed securities (CMBS) pools, which have a different risk profile than the types of assets owned by listed REITs.

Opportunities in the private market will eventually emerge, but this is often a long, drawn-out, predictable process. By contrast, billions of dollars of REIT shares are traded on stock exchanges daily, allowing investors to take advantage of distress in a liquid, immediate way.

An arbitrage opportunity for private real estate investors

Historically, listed and private real estate markets tend to track each other over time, with REITs outperforming core private real estate over full market cycles (Exhibit 5). However, the two markets often diverge in the short run due to the lag in private real estate appraisals. As Exhibit 6 shows, listed and private real estate correlations are higher over longer holding periods (1-year vs. 3-year rolling periods), and lagging private returns increases correlations further, indicating that private real estate is typically behind listed real estate by three to four quarters.

Prolonged dislocations between listed and private real estate tend to be unsustainable because real estate companies and other investors may take advantage of the opportunity for arbitrage. This dynamic means that REIT NAV premiums or discounts have historically been a good indicator of private-market performance over the following year. Exhibit 7 on the following page illustrates the close correlation between listed NAV premiums and the forward one-year return of private global core property funds (left chart), with deeper listed-market discounts typically followed by greater REIT outperformance on average (right chart).

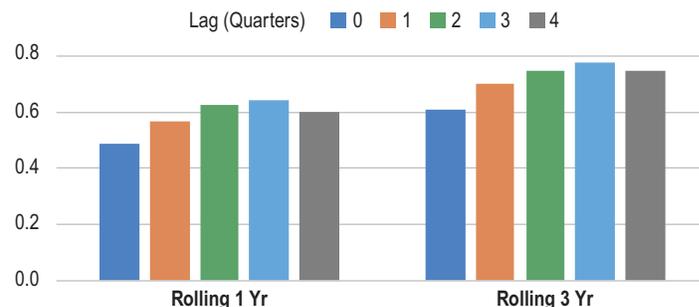
We expect private-market values to decline over the next several quarters, whereas investors can buy real estate through the listed market at discounted prices to marked-down asset values. As a result, we are seeing investors who participate in both private and public markets take advantage of attractive relative valuations with opportunistic allocations to REITs.

Exhibit 5: REITs Have Outperformed Private Real Estate Over Time
Annualized Returns Through 2019 (%)

	1 Year	3 Years	5 Years	10 Years	15 Years
Global REITs	21.9	8.3	5.6	8.4	6.0
Core Private Real Estate Funds	5.1	8.2	6.8	6.1	4.8
Difference	+16.8	+0.1	-1.2	+2.2	+1.2

At December 31, 2019. Source: NCREIF, Morningstar, Cohen & Steers.

Exhibit 6: Private Real Estate Lags Listed by 3 to 4 Quarters
Correlations of Listed and Private Global Real Estate Real Estate



At December 31, 2019. Source: NCREIF, Morningstar, Cohen & Steers.

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Targeting potential cyclical and secular winners

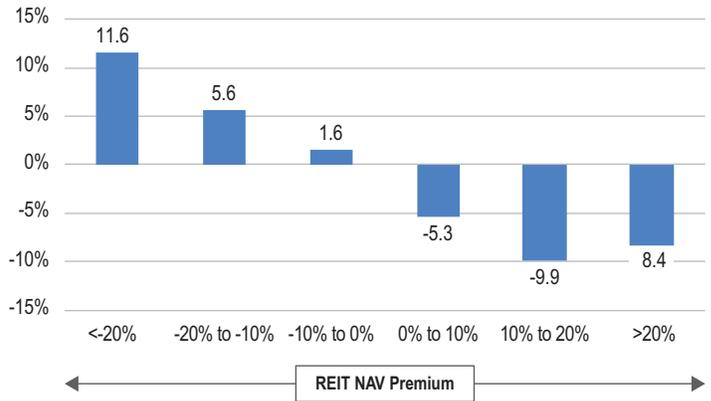
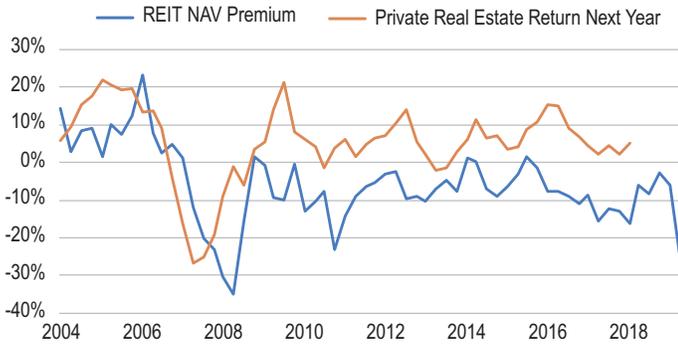
We believe some non-traditional sectors—such as data centers, cell towers, self storage and certain types of health care—are better positioned to manage through the current recession (Exhibit 8). These property types are well represented in the listed REIT market, where as private-market investors tend to have greater exposure to more impacted sectors, including retail and offices.

However, REIT benchmarks do have exposure to sectors facing both cyclical and secular challenges, which passive REIT strategies are unable to sidestep. Active REIT managers concentrate assets in areas of the market they believe offer the greatest upside potential relative to risk. Currently, that may be sectors that can defend well in the current environment. But eventually, the more vulnerable sectors could become more attractive as markets recover, and some companies will be in a much stronger position to capitalize on opportunities than others. This process of shifting dynamics underscores the importance of fundamental research—the cornerstone of the active management process.

Exhibit 7: NAV Discounts and Relative Performance of REITs vs. Private Real Estate Since 2004

NAV premiums (or discounts) are closely correlated to private real estate performance the following year

12-month forward relative performance of REITs vs. private real estate, by intervals of REIT NAV premiums (discounts)

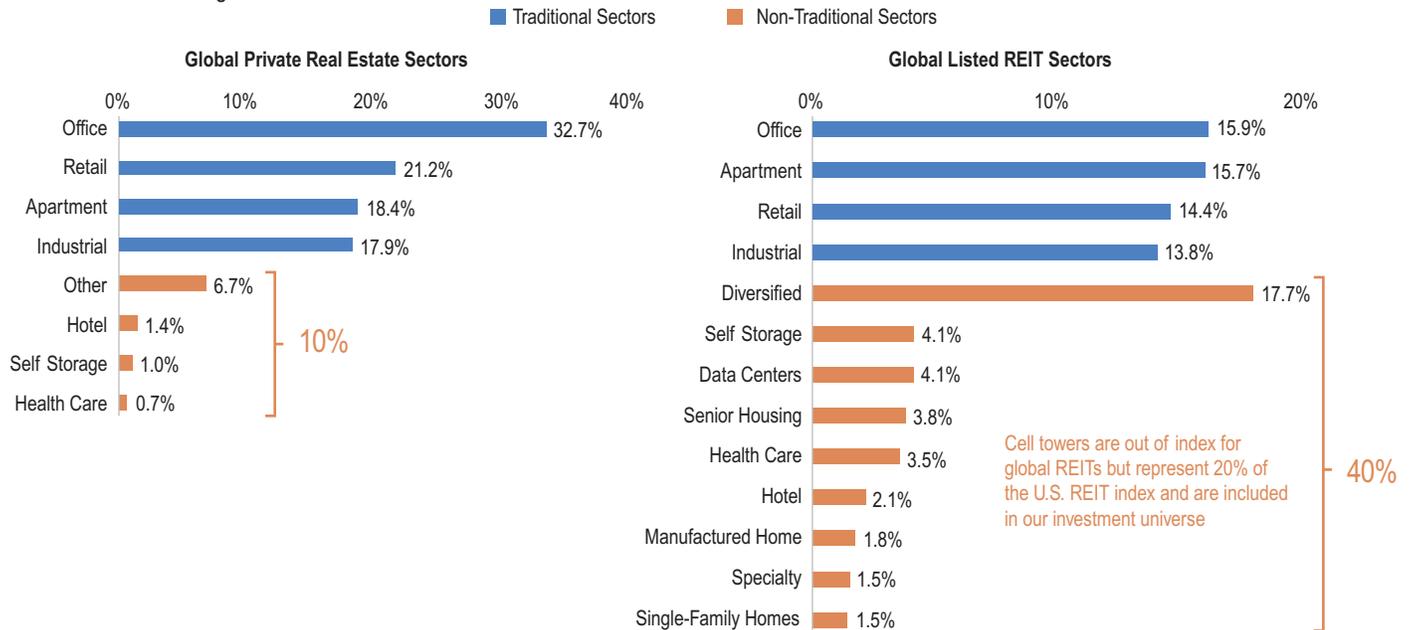


At December 31, 2019. Source: NCREIF, Morningstar, Cohen & Steers.

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Exhibit 8: Non-traditional Sectors Make Up 40% of the Global REIT Market

Global Index Sector Weights



At April 30, 2020. Source: NCREIF, Cohen & Steers.

Diversification does not assure a profit nor protection against loss. The mention of specific sectors is not a recommendation or solicitation to buy, sell or hold any particular security and should not be relied upon as investment advice. Sector allocations may vary over time. The views and opinions are as of the date of publication and are subject to change without notice. An investor cannot invest directly in an index and index performance does not reflect the deduction of any fees, expenses or taxes. Index comparisons have limitations as volatility and other characteristics may differ from a particular investment. Sector weights for private real estate based on ANREV, INREV and NCREIF classifications, using latest available data as of 12/31/2019; "Other" includes mixed-use, aged care, student housing, leisure, parking, land, senior living, cash and non-reported sectors. Global listed REIT sector weights based on FTSE EPRA Nareit Developed Index sector classifications. See page 9 for index definitions and additional disclosures.

Recessions Have Been Fertile Ground for Outsized Return Opportunities

After each bear market in our 34 years as a REIT manager, we have found major investment opportunities—from riding the wave of real estate securitization that began the Modern REIT Era in the early 1990s, to providing private placement growth capital in 1998. In the aftermath of the global financial crisis, motivated by our conviction in the asset class, we led the recapitalization of U.S. REITs, providing cornerstone equity and financing strategies for many of the top property companies. This defining moment for the REIT market helped restore investor confidence in the sector's liquidity and set the stage for substantial returns in the ensuing years.

Though every bear market is different, we believe opportunities will emerge to support companies in need of capital. For example, we recently provided equity to an already well-capitalized net lease REIT that needed additional ammunition to pursue acquisitions. We are

monitoring the market for additional opportunities to provide capital infusions to REITs in a variety of ways, including:

- Helping healthy companies take advantage of opportunistic acquisitions
- Improving strained capital structures of otherwise sound businesses
- Assisting high-quality but cyclically challenged businesses in avoiding distress

These special situations allow us to take mutually beneficial equity stakes in strong real estate franchises that we believe offer meaningful upside potential for our clients.

We continue to position portfolios in property types experiencing resilient demand in the crisis, as well as in undervalued, well-capitalized companies that we expect will emerge stronger from the crisis. Below is a summary of our current views on key opportunities and risks.⁽¹⁾

Digital Infrastructure

Data Centers



Everything online: A growing reliance on digital platforms to manage our work, education and social lives is driving the need for secure exchanges where service providers can connect on neutral territory—something data center REITs are uniquely positioned to provide. The pandemic has prompted many companies to increase investments in remote IT infrastructure, which should drive stronger data center leasing activity.

Company example:
Equinix

California-based firm with 210 properties in 26 countries, representing the largest market share in colocation data centers globally.

Cell Towers



5G infrastructure: We believe towers are at an inflection point for increasing demand amid a multi-year investment cycle in wireless infrastructure. Despite a temporary decline in wireless data usage (users are accessing more data over their home WiFi), network providers are ramping up spending for the 5G rollout and usage should rebound quickly as people emerge from quarantine. The sector is also benefiting from the Sprint/T-Mobile merger clearing its last hurdle in February, paving the way for Dish to become the fourth nationwide carrier.

Company example:
SBA Communications

Owns over 32,000 communications sites, including towers, distributed antenna systems, rooftop installations and small cells across North and South America and South Africa.

Industrial



E-commerce logistics: Industrial companies have seen a significant increase in demand from e-commerce-related tenants in recent months. Prologis reported that 40% of its leasing is now e-commerce based, compared with 23% pre-COVID, and Amazon announced in March that it would hire 100,000 new warehouse and delivery workers to meet the surge in online orders. Lower consumption could negatively impact demand through the third quarter, but requests for rent relief have so far been relatively minimal.

Company example:
Prologis

The world's largest industrial/ logistics property owner, with 965 million sq. ft. in 19 countries, serving 5,500 tenants; has over \$4.6B in liquidity.

(1) Company examples based on most recent company reports and Cohen & Steers analysis.

Defensive Growth

Apartments / Single-Family Rentals



Home base: Job losses will have an uneven impact on apartments depending on region, with higher-income markets such as Seattle and San Francisco seeing only modest deceleration. At the other end, Houston faces both recession and the collapse in oil prices, while Orlando's tourism industry has been decimated. German apartments feature especially strong fundamentals, with demand far outpacing residential supply, resulting in healthy and defensive rent growth. Overall, housing tends to be economically resilient due to its necessity, which could limit the recession's impact on revenues.

Company example:
UDR

Owns 51,000 apartment units in the U.S. at an average rent of \$2,200 a month, located primarily on the West and East Coasts.

Health Care



Critical care services: Medical office buildings and life sciences should see strong demand through the crisis, while also featuring long lease terms that reduce economic sensitivity. However, hospitals have had to cut back on profitable elective procedures during the crisis, and some senior housing centers have been disproportionately impacted by the virus, prompting companies to take aggressive (and costly) steps to contain the threat to residents and employees. We expect senior housing occupancy will face pressure from reduced move-ins.

Company example:
Welltower

Owns assisted living centers in the U.S., Canada and the U.K. that have been severely impacted by the virus, but has ~\$3.5B of near-term liquidity with no major upcoming debt maturities, and focuses on high-quality assets in premier markets.

Self Storage



Freeing up living space: Self storage companies in the U.S. and the U.K. have reported a significant rise in inquiries to their websites and call centers, due in part to quarantined dwellers anticipating the need to create usable living space. While actual move-in activity has slowed, move-outs have slowed as well, and demand from college students vacating their dorms early has pulled forward demand that usually waits until the summer.

Company example:
Safestore

The U.K.'s largest self storage provider, with 163 locations across Britain and Continental Europe.

Selective Value Amid Risk

Retail



Focused on the "essentials": Retail landlords, already facing the threat from e-commerce, are now having to work with tenants to offer rent deferrals or outright relief. We expect roughly half of U.S. department stores could close, and tenant bankruptcies will likely accelerate in an extended shutdown. However, we believe near-term challenges have been largely priced in following severe share price declines year to date. We are targeting opportunities in companies with the strongest balance sheets, a high proportion of nondiscretionary retail tenants (grocery, pharmacy, discount) and little exposure to vulnerable tenants such as dining and fitness.

Company example:
Agree Realty

Pronounced AY'-gree, owns 868 free standing (single-tenant) retail properties in 46 U.S. states, leasing primarily to investment-grade essential-service companies such as Walmart and Home Depot, which should keep rent losses low compared with peers.

Hotels



Inhospitable conditions for hospitality: The hotel industry has been upended by virus concerns more than any other property sector, with revenues trending toward zero in the near term. Whereas the larger companies tend to have better balance sheets and access to capital, we expect smaller, irrelevant brands with limited liquidity will face severe cash flow issues. As such, we are finding value in large companies we believe have the financial strength to weather the difficult months ahead.

Company example:
Hilton Worldwide Holdings

A global hospitality company, managing 18 brands totaling 972,000 rooms in 6,110 properties across 119 countries; no debt maturities until 2024 and \$3.6B in cash.

Offices



Shifting workplace paradigms: The work-from-home experiment of the COVID quarantine has shown many companies they can operate with little or no impact on productivity, causing some managements to openly speculate about needing less office space in the future. The co-working business model—packing many employees into open, shared working spaces—may be finished. The trend of cramming more workers per square foot will reverse as employers remove workstations to provide greater physical distance between workers. On balance, we believe these trends, along with cyclical factors, mean the risks for offices are on the downside.

Company example:
Kilroy Realty

Acquires and develops offices on the West Coast, serving technology, life sciences and media markets that have seen strong demand; has relatively low leverage compared with its office peers.

Conclusion

The past 20 years have offered investors few chances to own high-quality real estate at the values we are seeing today. While these are uncertain times, current share prices already reflect a lot of pain for landlords. With a focus on companies with strong balance sheets and opportunities to provide capital infusions to high-quality businesses, we believe 2020 could be one of the great vintages for investors with the right investment time horizon.



About the Authors

Tom Bohjalian, CFA, Executive Vice President, is Head of U.S. Real Estate and a senior portfolio manager for the firm's real estate securities portfolios, overseeing the research process for U.S. real estate securities. He has 29 years of experience. Prior to joining Cohen & Steers in 2002, Tom was a vice president and REIT analyst for five years at AEW Capital Management. He holds both a BS and an MBA from Northeastern University and is based in New York.

Jon Cheigh, Executive Vice President, Chief Investment Officer and Head of Global Real Estate, leads the investment department and oversees the global real estate team, serving as senior portfolio manager for all global real estate strategies. Prior to joining the firm in 2005, Jon was a vice president and senior REIT analyst at Security Capital Research & Management. Prior to that, he was a vice president of real estate acquisitions at InterPark and an acquisitions associate at Urban Growth Property Trust, two privately held real estate companies incubated by Security Capital Group. Jon holds a BA cum laude from Williams College and an MBA from the University of Chicago.

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Global REITs: FTSE EPRA Nareit Developed Index is an unmanaged market-capitalization-weighted total-return index, which consists of publicly traded equity REITs and listed property companies from developed markets. The S&P Global REIT Index is composed of global real estate equities in developed and emerging markets.

Global stocks: The MSCI World Index is a free-float-adjusted index that measures performance of large- and mid-capitalization companies representing developed market countries and is net of dividend withholding taxes.

Global core private real estate: The Global Real Estate Fund Index – Core (GREFI Core) is an index showing the performance of core non-listed real estate funds on a global scale and is created by leading non-profit association of investors in non-listed real estate: ANREV (Asia), INREV (Europe) and NCREIF (U.S.).

U.S. REITs: The FTSE NAREIT All Equity REITs Index contains all tax-qualified REITs with more than 50% of total assets in qualifying real estate assets other than mortgages secured by real property that also meet minimum size and liquidity criteria.

U.S. stocks: The S&P 500 Index is an unmanaged index of 500 large-capitalization stocks that is frequently used as a general measure of U.S. stock market performance.

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Cohen & Steers is a global investment manager specializing in liquid real assets, including real estate securities, listed infrastructure and natural resource equities, as well as preferred securities and other income solutions. Founded in 1986, the firm is headquartered in New York City, with offices in London, Hong Kong and Tokyo.

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