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A REIT Defense for the Late Cycle

Real estate has a history of helping investors protect their downside in challenging market environments

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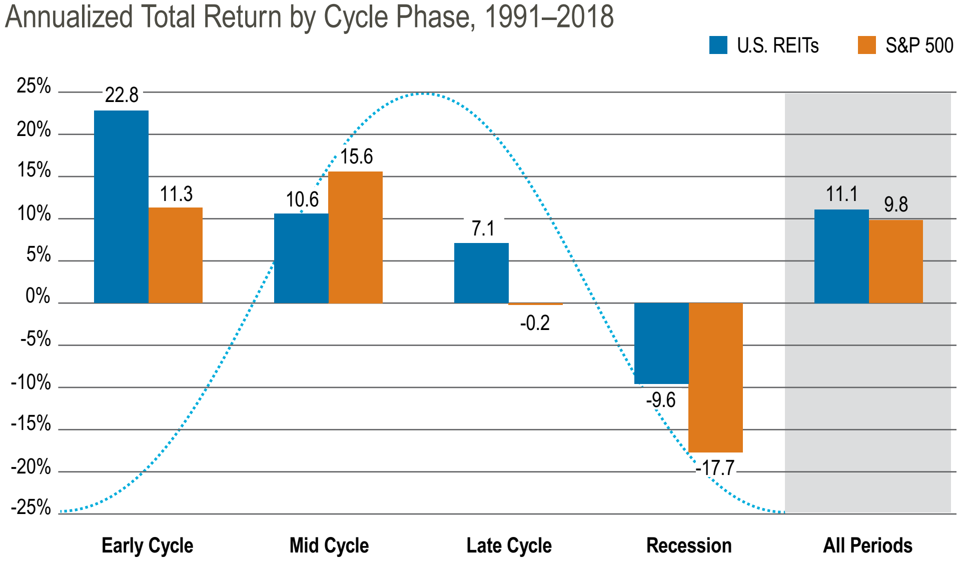
Executive Summary

- U.S. REITs have outperformed the S&P 500 by more than 7% annually in late-cycle periods since 1991 and have offered meaningful downside protection in recessions, underscoring the potential value of defensive, lease-based revenues and high dividend yields in an environment of heightened uncertainty (see chart below).
- We expect the backdrop for REITs to remain positive in 2019: supply/demand fundamentals are healthy, balance sheets are stronger than ever, equity correlations are low (0.52 at 1/31/19; Ex. 2), and earnings multiples are at discounts to broad equities.
- Amid tremendous demand for real estate from private investors, managers of private real estate funds are sitting on a record $300 billion of capital looking to buy the types of assets REITs own, potentially providing a floor of support for REIT valuations.

REITs Have Been Resilient in Late Cycle and Recessions

Annualized Total Return by Cycle Phase, 1991–2018



At December 31, 2018. Source: The Conference Board, National Bureau of Economic Research (NBER), Thomson Reuters, Cohen & Steers.

Data quoted represents past performance, which is no guarantee of future results. Average of annualized monthly returns grouped by phase. Expansion subdivisions determined by Cohen & Steers based on major trends in the Conference Board Coincident Index (CBCI): Early cycle—CBCI accelerating (104 of 336 months: 3/91–12/94, 11/01–12/04, 6/09–1/11); Mid cycle—CBCI stable (180 of 336 months: 1/95–4/00, 1/05–9/06, 2/11–12/18); Late cycle—CBCI decelerating (24 of 336 months: 5/00–2/01, 10/06–11/07). Recessions as reported by NBER (28 of 336 months: 1/91–2/91, 3/01–10/01, 12/07–5/09). Analysis focuses on post-1991 period—considered the "modern REIT era" due to evolution of the REIT structure, breadth and size of the market and overall liquidity—which we believe is representative of the current U.S. REIT investment universe and characteristics. See page 7 for index associations, definitions and additional disclosures.

A Shift in Market Leadership

Real estate investment trusts (REITs) have spent the last several years largely out of favor, with a strong economy benefiting property fundamentals but not so much their share prices. That began to change toward the end of 2018 as the prospect of slowing global growth and tighter liquidity battered financial markets around the world.

In the fourth quarter, U.S. REITs defended much better than broad equities, with a drawdown of –6.7% versus –13.5% for the S&P 500. Real estate securities in Europe and Asia were similarly resilient, and REITs continued to widely outperform in January's relief rally as money flowed into the space.

While REITs have seen other periods of relative strength in recent years, we believe this is just the beginning of a broader shift in market leadership as the U.S. economy transitions from mid- to late cycle.

We believe defensive characteristics, healthy fundamentals and private-market demand have the potential to drive attractive absolute and relative returns for REITs in the shift to late cycle.

Consider that:

1. REITs have historically outperformed broad equities in late-cycle periods (cover exhibit)—yet the clear majority of generalist fund managers continue to be structurally underweight real estate, creating the potential for a massive rotation of capital.
2. REIT property fundamentals remain healthy and balance sheets are the strongest they've ever been, in our view—yet REIT earnings multiples have contracted over the past six years under the weight of rising interest rates, whereas equity multiples have expanded.
3. Significant, sustained investment demand for real estate in the private market has created a bottleneck of capital, resulting in a $300 billion mountain of uninvested capital in private real estate funds looking to buy the types of assets REITs already own, providing potential support to valuations.

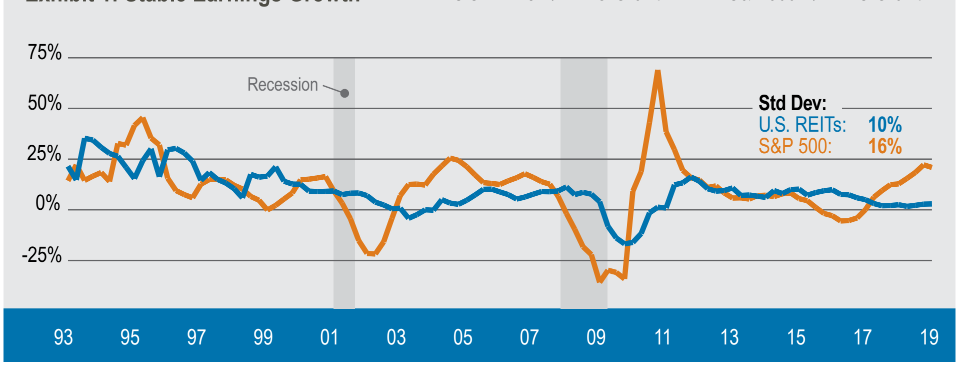
As investors look to protect their portfolios from what may be a more challenging and volatile environment, we believe a 10–15% allocation to REITs can be part of the solution.

Why REITs in Late Cycle

Since the start of the modern REIT era in 1991, U.S. REITs have outperformed the S&P 500 by more than 7% on average in late-cycle periods, and by even wider margins in recessions and early recoveries (cover exhibit). While REITs are not immune to changes in the business cycle, we believe there are several reasons why they may outperform in late-cycle environments.

First, **REITs tend to have predictable, lease-based revenues.** In tough times, you can always put off upgrading your smartphone or buying a new car. But if you're an office tenant with a 10-year lease, you're contractually obligated to pay your landlord regardless of economic conditions. As a result, REITs have historically generated more consistent earnings growth than most sectors in the stock market (Exhibit 1).

Exhibit 1: Stable Earnings Growth



At December 31, 2018. Source: UBS, Bloomberg, NBER, Cohen & Steers.

Data quoted represents past performance, which is no guarantee of future results. FFO: funds from operations, the REIT industry's key earnings metric, calculated as GAAP net income, less gains from asset sales, plus real estate depreciation and amortization. EPS: earnings per share. See page 7 for index associations, definitions and additional disclosures.

Impact of Sector Cyclicality

U.S. REIT Sector Performance Q4 2018

Hotels **-20.5%**
(cyclical / 1-day leases)

Cell Towers **+3.6%**
(secular / 5-year opt-outs)

At December 31, 2018. Source: Nareit.
Data quoted represents past performance, which is no guarantee of future results. See page 7 for index associations, definitions and additional disclosures.

It's important to note, however, that this can vary significantly depending on the property type. For example, hotels are highly cyclical due to their one-day leases and reliance on business and leisure spending. By contrast, cell tower leases are typically structured as 25–30 year leases, with 10-year non-cancellable terms and 5-year rolling opt-outs, providing stable, long-term cash flows. Furthermore, demand for tower space has little to do with the business cycle, driven instead by the ongoing expansion of wireless networks to satisfy customers' increasing data usage.

Second, **REITs have a history of paying attractive dividends, giving investors a potential head start on returns in a low-growth environment.** At the end of 2018, real estate was tied with energy as the top-yielding sector in the S&P 500.(1) This is typical for REITs, resulting from cash-flow-oriented business models focused on operating, acquiring and developing properties that generate recurring income streams. And, whereas distributions are optional for most other companies, the IRS requires U.S. REITs to pay out at least 90% of their taxable income to shareholders.

Lastly, **slower growth may ease the pressure from interest rates.** Though U.S. inflation has been rising, we believe a peak in economic growth and a more challenging global economic backdrop means that bond yields are unlikely to move much higher from current levels. Additionally, the Federal Reserve has already struck a more dovish tone and could soon put a hold on further rate hikes.

(1) **At December 31, 2018.** Source: Standard & Poor's, Nareit.

A Favorable Backdrop for Real Estate

Healthy fundamentals. Defensive characteristics alone are not enough to protect investors. Based on our outlook for more moderate but still healthy growth in 2019, we have adjusted our estimates for property values and cash flows, taking a more conservative view of capitalization rates (a valuation technique to derive property value).

Even factoring that in, we believe REITs continue to offer the potential for attractive absolute and relative returns amid a generally favorable backdrop for U.S. commercial real estate. We expect supply and demand to remain largely in balance and for landlords to maintain some level of pricing power, translating into healthy earnings and dividend growth in the mid-single digits.

As always, it is important to look not just at REIT fundamentals overall, but at individual sectors and companies, as supply and demand conditions can vary significantly. Below is our view of select opportunities.

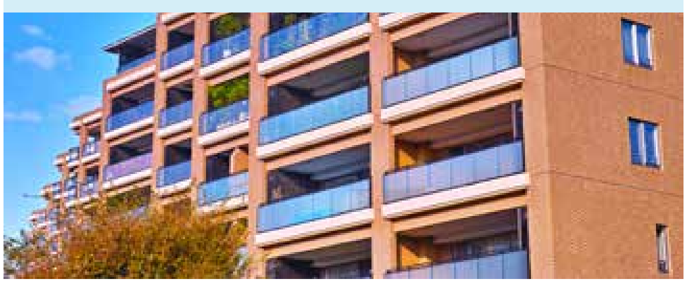
Cell Towers

Tower owners are seeing a long runway of growth, benefiting from spending on networks by wireless carriers to support exponential growth in data usage; 4G deployments continue to be robust, while the 5G rollout is in its early stages

Data Centers

Demand and development pipelines remain healthy amid continued growth of IT outsourcing and data-intensive web applications, though cloud-related spending may slow in the near term, creating potential divergence among REITs in the sector

Apartments



The sector is seeing significant inflows of institutional capital, while strong demographics and continued job growth are driving above-average household formation amid housing supply that remains significantly below the historical trend

Health Care

After being significantly underweight for a decade, we have turned more positive: defensive characteristics are well suited to the current environment, valuations have become more attractive and most tenant issues have been resolved

Strong balance sheets. Credit spreads may widen modestly, but we believe this should have a minimal impact on the REIT market. REIT balance sheets are stronger than they have ever been, in our view, as most companies have spent the past decade reducing leverage and extending maturity durations.

Low correlations. REITs have historically been effective diversifiers, illustrated by their low correlations with other asset classes. After spiking in the wake of the financial crisis, correlations with equities have since returned to previous long-term levels, at 0.52 as of January (Exhibit 2). We believe their diversification potential may be especially important heading into what could be a period of greater uncertainty.

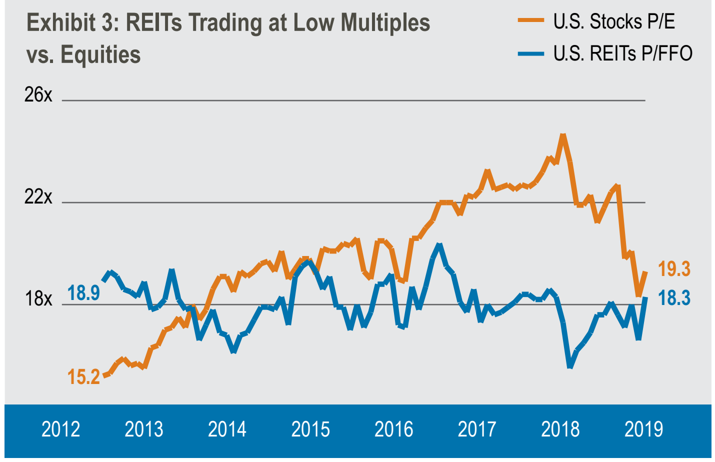
Attractive value relative to stocks. Despite strong fundamentals, REIT earnings multiples have contracted over the past six years, whereas multiples for the broad equity market have expanded, even accounting for the decline over the past year (Exhibit 3). Considering that REITs have historically traded at higher multiples than equities on average, we believe the current discount indicates potential value.

Exhibit 2: Equity Correlations at Pre-Crisis Levels
1Y Rolling Correlations, U.S. REITs vs. S&P 500

At January 31, 2019. Source: Morningstar, Cohen & Steers.

Data quoted represents past performance, which is no guarantee of future results. Correlation is a statistical measure of how two securities move in relation to each other. Volatility is a measure for variation of price of a financial instrument over time. See page 7 for index associations, definitions and additional disclosures.

Exhibit 3: REITs Trading at Low Multiples vs. Equities



At January 31, 2019. Source: Morningstar, Cohen & Steers estimates based on proprietary metrics.

Data quoted represents past performance, which is no guarantee of future results. REITs: P/FFO: ratio of share price to funds from operations; FFO is the REIT industry's key earnings metric, calculated as GAAP net income, less gains from asset sales, plus real estate depreciation and amortization. P/E: ratio of share price to earnings. See page 7 for index associations, definitions and additional disclosures.

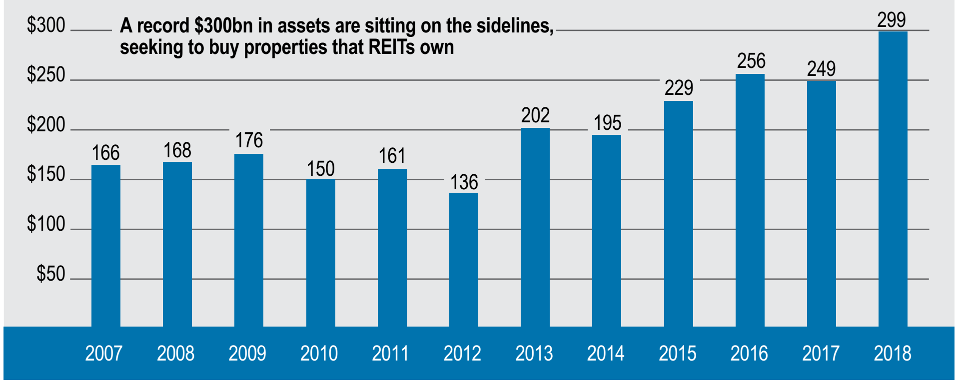
A healthy real estate backdrop, attractive values and low correlations may offer a strong defense against late-cycle volatility, in our view.

Support from private investment demand. Amid tremendous demand for real estate from private investors, real estate asset managers have been raising capital faster than they can put it to work. This backlog has led to a record $300 billion of dry powder in private real estate funds looking to buy the types of assets REITs own (Exhibit 4). We believe this could serve as a potential floor of support for REIT valuations, flowing through to the listed REIT market in several ways:

- Putting upward pressure on commercial real estate prices
- Purchasing assets from REITs at premium prices
- Acquiring REITs themselves at premium valuations

Exhibit 4: Dry Powder Targeting Real Estate

Uninvested Capital in Private Real Estate Funds, $ billions



At November 30, 2018. Source: Preqin, Cohen & Steers.

Data quoted represents past performance, which is no guarantee of future results. Dry powder measures total capital commitments to private real estate funds minus capital that has been called for investment by the general partner. See page 7 for additional disclosures.

Takeaways

REITs' strong relative performance since October highlights the potential benefits of having defensive, lease-based revenues and high dividend yields in an environment of heightened uncertainty.

Periods of volatility are often an opportunity for investors to reassess their asset mix and ensure their portfolio is well diversified.

We believe REITs provide a compelling way to diversify in today's market, offering attractive relative valuations, low correlations with equities and the backing of robust demand in the private market.

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Index Definitions. *An investor cannot invest directly in an index and index performance does not reflect the deduction of any fees, expenses or taxes.* U.S. REITs: FTSE Nareit Equity REIT Index contains all tax-qualified REITs except timber and infrastructure 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 (Exhibit 4): Russell 3000 Index, maintained by FTSE Russell, is a capitalization-weighted stock market index that seeks to be a benchmark of the entire U.S stock market, measuring the performance of the 3000 largest publicly held companies incorporated in the U.S. as measured by total market capitalization, representing approximately 98% of the U.S. public equity market. S&P 500 Index is an unmanaged index of 500 large-cap stocks that is frequently used as a general measure of stock market performance.

About Cohen & Steers

Cohen & Steers is a global investment manager specializing in liquid real assets, including real estate securities, listed infrastructure, commodities 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, Tokyo and Seattle.

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