REITs and Inflation

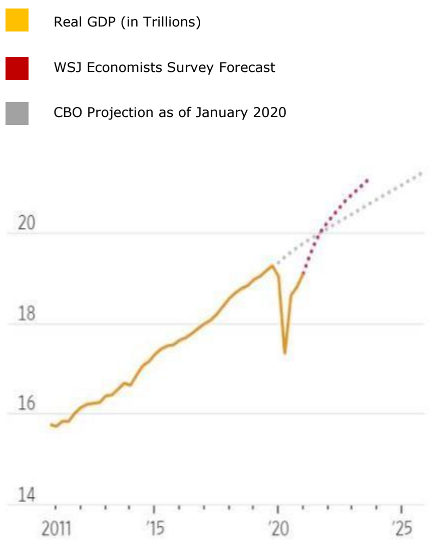
June 2021

The speed at which the U.S. recovery is accelerating has taken the market by surprise. Consumers have trillions of dollars of accumulated savings they want to spend and businesses are reopening faster than expected. Combined, these drivers have powered global equity markets past their 2020 pre-pandemic highs. While these positive data points are welcomed, there remains material disruption in the supply chain leading to supply/demand mismatches and the unintended consequence of inflation. **Our view is that inflation is a tailwind for the real estate industry that will positively influence future cash flows (higher), asset values (higher) and new supply (lower).** Investment in real estate and REITs create a potential solution to maintaining investor's purchasing power.

Demand, driven by higher private and public consumption, is compounded by the restart of corporate investment and exporting. But supply is not keeping up due to production delays, inventory problems and challenges with transportation. We think higher wages and prices will remain elevated for the next 12-24 months causing short term price volatility.

The recent Wall Street Journal Economists Survey demonstrated a much steeper Gross Domestic Product ("GDP") growth than last year's Congressional Budget Office expectation, as demonstrated in Figure 1. GDP is spiking and is about to overshoot with the implication that inflation can continue to be elevated a little longer than previously expected.

Figure 1: Recent projections of the economic recovery exceed initial forecasts.



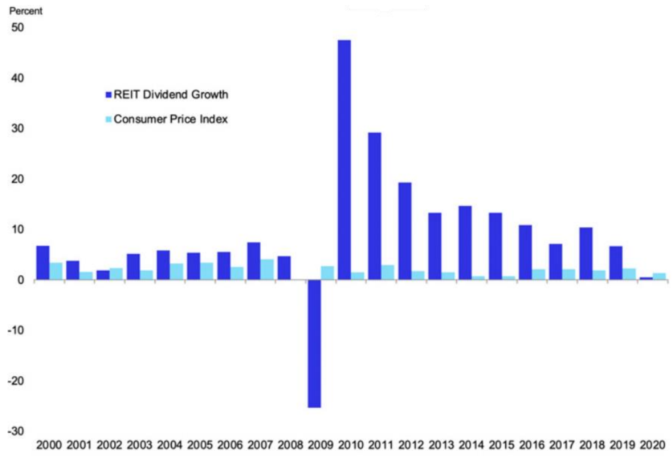
Source: The Wall Street Journal

The U.S. Bureau of Labor Statistics reported that the Consumer Price Index ("CPI") increased by 5.0% over the last 12 months, the largest increase since 2008. While inflation has exceeded its target, the Federal Reserve expects this level to be temporary and has restated its willingness to tolerate higher short-term inflation as recently as June 22nd.

What makes this economic backdrop different is that the expectation of inflation, whether transitory or more structural in nature, is coupled with the prospect of high growth. Investors should position themselves accordingly.

As you can see in Figure 2, REIT dividend increases alone have outperformed inflation in 18 of the last 20 years. Over the 20-year period, the average compounded annual dividend growth per share was 8.9% compared to 2.2% for CPI.

Figure 2: REIT Dividend Growth per Share vs. Consumer Price Index 2000-2020



Source: NAREIT, S&P Globe Market Intelligence 2021

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An investor's total return comes from two components, income and capital appreciation. In an inflationary environment, real estate stands ready to benefit from both, as it has done historically. And unlike other real assets, such as commodities and/or precious metals, real estate cash flows are underpinned by predictable and recurring contractual leases which contain inflation protection mechanisms.

Let's focus first on the income component. Rents reset upon renewal or the releasing of vacant space. In the current environment, where higher inflation is linked to stronger economic growth, rents benefit from and thus hedge past and expected inflation. Real estate sectors with short term leases (apartments, single family rentals, self-storage, hotels and seniors housing) have revenues that move up quickly as lease rates adjust to changes in inflation. Multi-year leases (office, retail, industrial and data centers) have embedded contractual annual rental rate increases tied to the previous year's rate of inflation as part of their lease structures. Finally, we believe that even if inflation does prove to be transitory, the market's expectation of future inflation can improve the negotiating power of landlords and result in higher rents.

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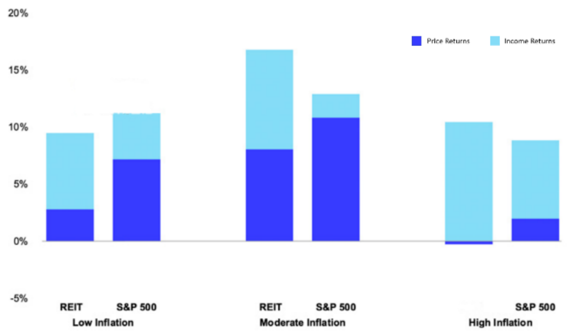
Turning to capital appreciation, increases in underlying cash flows will lead to growth in asset values resulting in higher "NAV" for the REITs themselves. As the economy fully re-opens and economic conditions continue to strengthen, capital that has accumulated during the pandemic will take seek to advantage of improving commercial and residential real estate fundamentals. The existing positive yield spread over government bonds offers investors a path to generating an attractive return on invested capital.

Combining both income and capital appreciation REITs outperform equities through all but low inflationary environments as demonstrated in Figure 3 below. Periods of high inflation see strong income return more than offsetting the temporary softening of prices. During periods moderate inflation, although the S&P 500 had stronger price returns, income returns for REITs lead to the outperformance over S&P 500.

Figure 3: REIT returns compared to S&P 500 returns during different inflation periods (1972-2020)

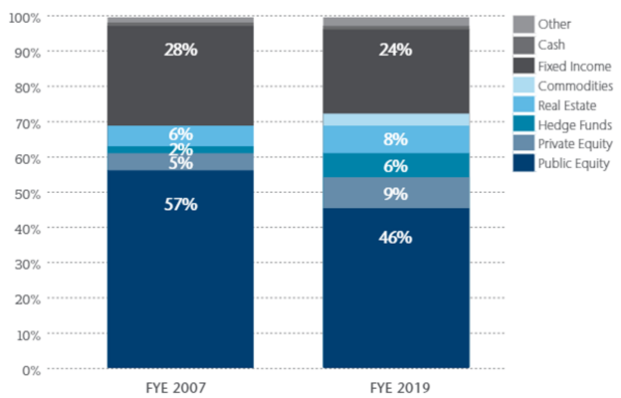


Source: NAREIT, FTSE Nareit All Equity REIT Index and S&P 500 Index

REITs also have a built-in financial advantage compared to other equities. Debt comes in the form of mortgages (i.e. debt secured by property) allowing REITs to borrow both long term and at exceptionally attractive fixed interest rates. As inflation grows, the largest component of the expense side stays flat while revenues expand.

Pension funds continue to source investments that deliver the highest expected risk-adjusted return to meet their growing liabilities and are lowering exposures to public equity and fixed income as seen in Figure 4. Fueled by greater longevity risk and as alternative investments become more institutionally acceptable, real estate is becoming an increasingly larger portion of asset allocations. This greater institutional demand ultimately leads to value increases for the underlying real estate.

Figure 4: Global Pension Asset Allocation



Source: AON

Regardless of the quantum of inflation, REITs outperform equities through various inflationary environments.

Furthermore, new supply is likely to be muted. Construction costs have risen at well above the rate of CPI, predominantly due to labor and raw material costs, pushing up replacement cost. Lumber and copper prices, two key building materials, have increased by ~228% and ~66%, respectively since the start of 2020. Higher replacement costs typically result in a diminishing rate of return on new development, making the development of new buildings less attractive. This should translate to lower levels of new supply, which in turn benefits existing landlords in terms of pricing power and further supports higher asset values on existing properties.

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Our 2021 global outlook published in January, remains unchanged: we are embracing the global recovery and 2021 is the beginning of the great "REIT-opening". REITs are up approximately 10% year-to-date. Our valuation models suggest that global REITs are still undervalued and priced at significant discounts to intrinsic value (a blend between NAV and discounted cash flow), by up to 30%. Assuming a two-year time period to reach intrinsic value and when combined with dividend payouts, this equates to an annualized total return of 15%-20%.

Investors, large and small, are seeking stable sources of return in an increasingly changing world. The underlying fundamentals and characteristics of real estate position it well regardless of whether inflation is here to stay or not, making it a critical ingredient in portfolio construction.

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