CenterSquare
REAL ASSET INVESTMENT LEADERSHIP

2023 Mid-Year REIT Outlook: Spring-Loading REIT Performance


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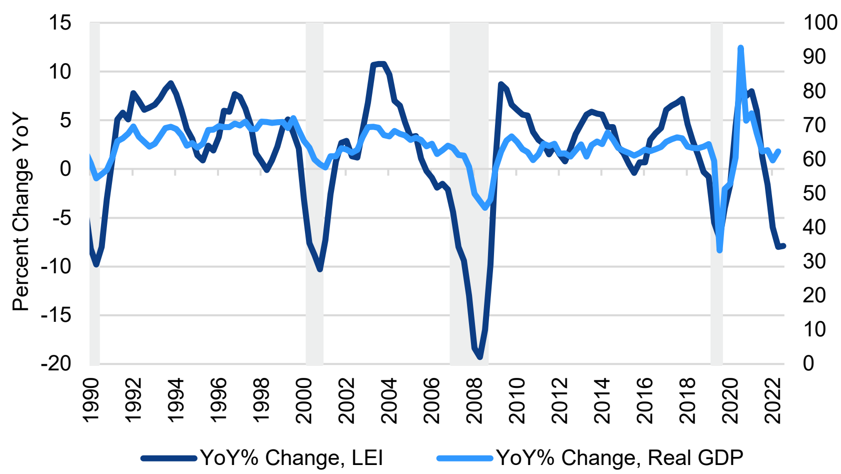
As we revisit our initial 2023 REIT outlook, the conditions we cited for REIT outperformance intensified in the first half of the year. Relative REIT valuations (versus equities and private real estate) have become stretched further, making an even stronger case for listed real estate investment once the Federal Reserve stops raising interest rates. Patience will be key, but as public and private real estate markets continue to move as we have predicted, a significant amount of energy is being stored, creating a spring-loaded dynamic and positioning REITs for a powerful trajectory in the coming months.

The End of Interest Rate Hikes

Inflation has been the key driver of the Federal Reserve's dramatic actions over the last year. Yet, the conversation dominating investor sentiment has recently shifted to the rolling recession occurring throughout the economy as the lagged effect of Fed policy is realized. The technology sector was among the first to experience an earnings recession in late 2022, with the housing market following soon after as a function of rapidly accelerating mortgage rates. Meanwhile, banking industry turmoil in the first half of 2023 resulted in a meaningful tightening of lending standards, restricting access to capital across the board. Leading economic indicators continue to signal weaking growth prospects for the economy (Figure 1) as we wait for what we still believe will be an economic recession. However, the surprising strength of the consumer has prevailed with the labor market remaining tight and spenders continuing to dig into excess pandemic savings to fuel consumption. Whether this strength leads to a "soft landing" remains to be seen. What we do know is that inflationary pressures are easing across the economy, and therefore, the end of the Fed's rate hiking cycle seems to be on the horizon.

Figure 1: Leading Economic Indicators vs. Real GDP Growth



Source: Bloomberg, July 7, 2023.

The Valuation Case for REITs

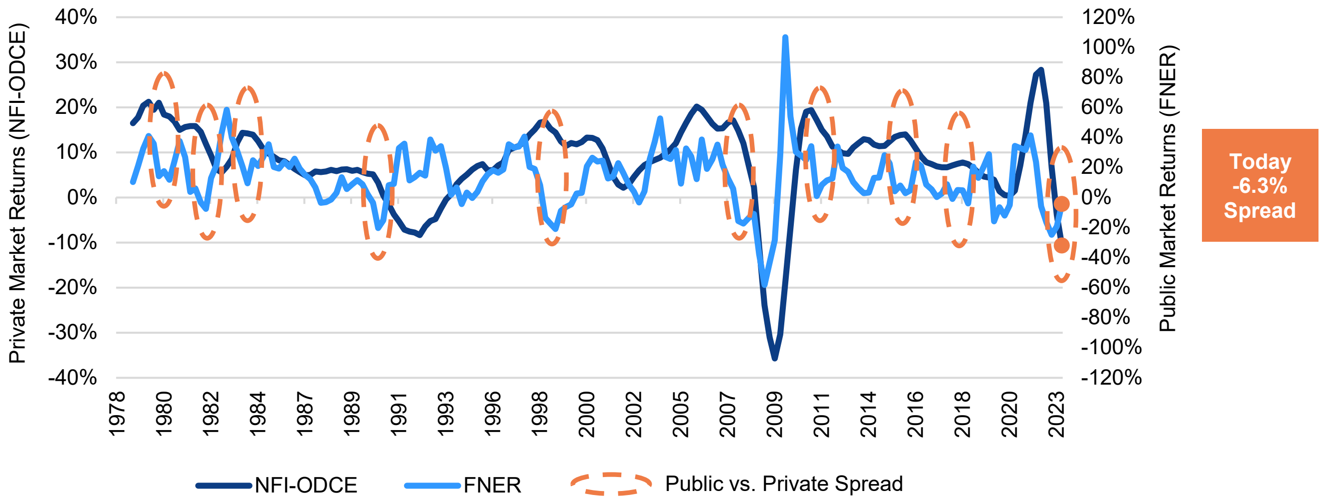
Despite the rate hiking cycle seemingly coming to an end, we should note some level of capitulation from the market about the interest rate environment over the long term. We believe the era of ultra low interest rates that investors had grown accustomed to following the GFC is over, and the 10-year treasury rate is likely to remain in the 3.5%-4.0% range for the foreseeable future. Such a scenario is already priced into REIT valuations, especially in comparison to private real estate.

In the private real estate market, we have finally started to see a more meaningful correction in valuations as a function of rising interest rates. While the REIT market reacted to rising debt costs in 2022, the private market lagged meaningfully, a trend supported by our historical data, which shows a repeating phenomenon whereby private markets peak at the same time public markets bottom. Our earlier prediction that this public/private inverse relationship would continue has already played out once again since the second half of 2022. Our follow up, data-based forecast would suggest further good news for REITs. Based on patterns we have tracked since 1978, REITs outperform the private market by an average of 42.8% in the year following a REIT market bottom. Even excluding the outsized impact seen during the GFC, the outperformance of REITs versus ODCE funds in the following year after a REIT market bottom has been 26.2% (Figure 2 on the following page).

> **"Our earlier prediction that this public/private inverse relationship would continue has already played out once again since the second half of 2022."**

As of 2Q23, we have seen trailing 12-month total returns supporting our expectation that while history may not repeat itself, it does tend to rhyme. As of June 30, 2023, REITs outperformed private real estate by approximately 6.3% in the trailing 12 months. While we have seen private market valuations beginning to correct given the new reality of debt costs, we believe there is still more pain to come here as most private valuation cap rates remain below borrowing costs. As REITs continue to trade at a meaningful discount to private market valuations, they provide investors with access to real estate at a much more attractive price.

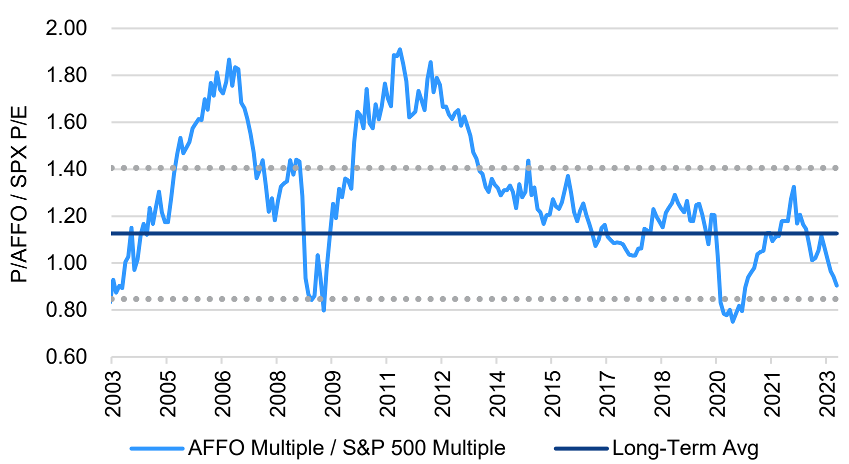
Figure 2: Public vs. Private Trailing 12-Month Returns



Source: Bloomberg, CenterSquare as of June 30, 2023. Private Real Estate represented by NFI-ODCE Index; REITs represented by FTSE Nareit All Equity REITs (FNER) Index.

Meanwhile, we have seen relatively strong equity market performance through the first half of this year, though much of this surge has been a function of multiple expansion. S&P 500 multiples have expanded from 17.0x at the end of 2022 to 20.2x at the end of the first half of 2023, even as earnings expectations have deteriorated. In comparison, REIT earnings have proven to be more resilient and multiple expansion has been negligible. Taken together, REITs are trading at a meaningful discount to equities on a relative basis, approaching levels we've only seen twice over the last two decades during major REIT market corrections (Figure 3).

Figure 3: 12-Month Forward REIT P/AFFO vs S&P P/E



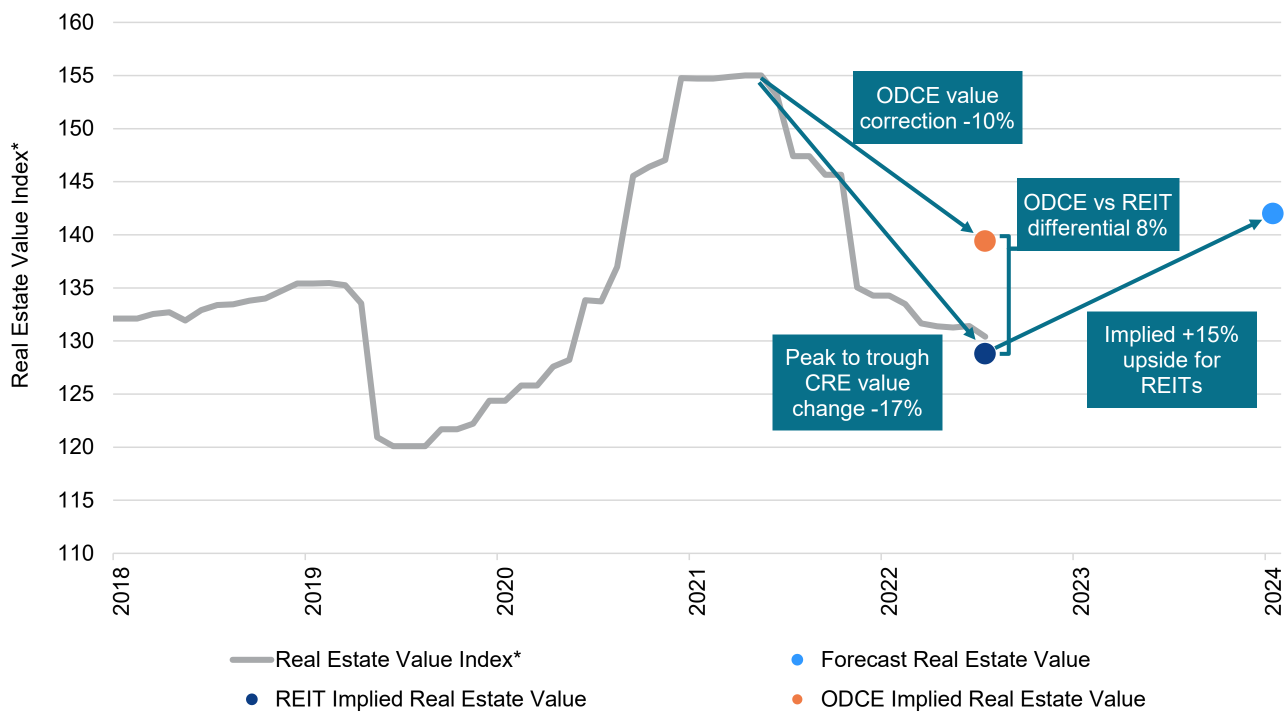
Source: Bloomberg, Evercore ISI, Bank of America, Nareit, CenterSquare Investment Management as of June 30, 2023.

Second Half Forecast

In anticipation of the Fed halting interest rate hikes, we examined history and found that REITs outperform equities and private real estate following the end of rate hiking cycles. Furthermore, we found the degree of REIT outperformance versus equities and private real estate was directly correlated with the relative discount at which REITs were priced against those respective asset classes. Since we conducted our analysis, REITs have become even cheaper when compared to broader equities and are still trading at a meaningful discount to private real estate, setting up for a favorable outlook for REITs in the second half of the year.

In reviewing Figure 4, private markets have repriced real estate values lower by approximately 10% compared to the peak, while REITs have priced real estate values down closer to 17%, creating an 8% differential. Given our expectation for continued net income growth across the real estate asset class coupled with cap rates stabilizing in the 5.5% range, we anticipate a 15% upside to REITs from here through the end of 2024.

Figure 4: Real Estate Value Index Comparison and Forecast



* Green Street CPPI
Source: CenterSquare and Green Street, June 30, 2023. The above data includes forward looking information; actual results may vary.
Note: NOI growth assumed to be 5.2% in 2023 and 4.2% in 2024, repriced valuation at applied 5.4% cap rate.

Conclusion

Good things come to those who wait, and it feels as if the REIT market has waited long enough. The fight against inflation is progressing in the right direction and the Fed is finally seeing data to support incremental policy tightening. These factors suggest the tension formed in the REIT market is poised for a release that will catalyze performance into 2024.

About the Authors

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Senior Investment Strategist and Global ESG Lead

Uma Moriarity is the Senior Investment Strategist and Global ESG Lead for CenterSquare Investment Management. She focuses on investment strategy and thought leadership across the Firm's public and private real estate platforms and is part of the listed real estate investment team. Uma leads the Firm's Environmental, Social, and Governance (ESG) strategy to incorporate ESG into the decision-making and management of listed and private real estate investments to create long-term value, reduce risk, and generate superior risk-adjusted investment returns. Prior to joining CenterSquare, she spent three years in corporate strategy and planning at ExxonMobil in Houston.

Uma graduated from The Pennsylvania State University with Interdisciplinary Honors and High Distinction and holds a B.S. in Finance with a minor in International Business, B.S. in Accounting, and Master of Accountancy. She is a CFA charterholder and member of the CFA Institute, a LEED Green Associate, and a member of the ULI San Francisco Young Leaders Group Steering Committee and Sustainability Committee. She currently serves on the Board of Directors for Green Building United and the Penn State Smeal Sustainability Advisory Board.

Scott Crowe
President, Chief Investment Strategist

Scott Crowe is the President and Chief Investment Strategist of CenterSquare Investment Management and, in that capacity, leads the strategic growth and innovation of the Firm. Scott joined the Firm in 2015 as Chief Investment Strategist and is responsible for CenterSquare's Private Equity Real Estate investment platform and Capital Markets group. He sits on the Firm's investment and product development committees and has oversight for Risk Management, ESG integration and thought leadership. Scott is also a member of CenterSquare's Board of Directors.

Prior to joining CenterSquare, Scott was CIO of Liquid Alternatives at Resource Real Estate where he built and led a global investment and distribution platform. Prior thereto, Scott was the lead Global Portfolio Manager for Cohen & Steers, where he was responsible for $10B in assets under management and led the investment and research team of over 20 portfolio managers and analysts. Prior to this, Scott held the position of Head of Global Real Estate for UBS Equities Research, where he built and managed the U.S. REIT division while leading a global team of more than 40 analysts. Scott began his career at Paladin Property Securities and holds an Honors Finance Degree from the University of Technology Sydney and a Bachelor of Commerce from the University of NSW/National University of Singapore.

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Any indication of past performance is not a guide to future performance. The value of investments can fall as well as rise, so investors may get back less than originally invested. Because the investment strategies concentrate their assets in the real estate industry, an investment is closely linked to the performance of the real estate markets. Investing in the equity securities of real estate companies entails certain risks and uncertainties. These companies experience the risks of investing in real estate directly. Real estate is a cyclical business, highly sensitive to general and local economic developments and characterized by intense competition and periodic overbuilding. Real estate income and values may also be greatly affected by demographic trends, such as population shifts or changing tastes and values. Companies in the real estate industry may be adversely affected by environmental conditions. Government actions, such as tax increases, zoning law changes or environmental regulations, may also have a major impact on real estate. Changing interest rates and credit quality requirements will also affect the cash flow of real estate companies and their ability to meet capital needs.

Definition of Indices

FTSE Nareit All Equity REITs Index (FNER)
The FTSE Nareit All Equity REITs Index is a free-float adjusted,market capitalization-weighted index of U.S. equity REITs. Constituents of the index include all tax-qualified REITs with more than 50 percent of total assets in qualifying real estate assets other than mortgages secured by real property.

FTSE Data disclosure: Source: FTSE International Limited (FTSE) © FTSE 2023.

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NCREIF Open End Diversified Core Equity Index
The ODCE, short for NCREIF Fund Index - Open End Diversified Core Equity (NFI-ODCE), is the first of the NFI-ODCE Fund Database products and is an index of investment returns reporting on both a historical and current basis the results of 36 open-end commingled funds pursuing a core investment strategy, some of which have performance histories dating back to the 1970s.

S&P 500® Index (S&P 500)
An unmanaged, market capitalization-weighted index of 500 stocks of leading large-cap U.S. companies in leading industries; gives a broad look at the U.S. equities market and those companies' stock price performance. Market index performance is provided by a third-party source CenterSquare deems to be reliable (Bloomberg). Indexes are unmanaged and have been provided for comparison purposes only. No fees or expenses have been reflected.

These benchmarks are broad-based indices which are used for illustrative purposes only. The investment activities and performance of an actual portfolio may be considerably more volatile than these indices and may have material differences from the performance of any of this index.

A direct investment in an index is not possible.

The CenterSquare Cap Rate Methodology

CenterSquare REIT Implied Cap Rates are based on a proprietary calculation that divides a company's reporting net operating income ("NOI") adjusted for non-recurring items by the value of its equity and debt less the value of non-income producing assets. The figures above are based on 2Q23 earnings reported in June 2023.

The universe of stocks used to aggregate the data presented is based on CenterSquare's coverage universe of approximately 200 U.S. listed real estate companies. Sector cap rates are market cap weighted. Sectors and market classifications are defined by the following:

Apartment: REITs that own and manage multifamily residential rental properties; Industrial: REITs that own and manage industrial facilities (i.e. warehouses, distribution centers); Office – REITs that own and manage commercial office properties; Retail – REITs that own and manage retail properties (i.e. malls, shopping centers); Hotel – REITs that own and manage lodging properties; Healthcare – REITs that own properties used by healthcare service tenants (i.e. hospitals, medical office buildings); Gateway – REITs with portfolios primarily in the Boston, Chicago, LA, NYC, SF, and DC markets; Non-Gateway – REITs without a presence in the gateway markets.

The REIT ODCE Proxy is a universe of REIT stocks built to resemble the NCREIF Fund Index – Open End Diversified Core Equity (NFI-ODCE). The NFI-ODCE, short for NCREIF Fund Index - Open End Diversified Core Equity, is the first of the NCREIF Fund Database products and is an index of investment returns reporting on both a historical and current basis the results of 36 open-end commingled funds pursuing a core investment strategy, some of which have performance histories dating back to the 1970s. The REIT ODCE Proxy is proprietary to CenterSquare and uses gateway/infill names in apartments, retail, industrial and office, and then weights them according to the ODCE index to create a proxy.

Private Market Cap Rates represent the cap rate achievable in the private market for the property portfolio owned by each company, and are based on estimates produced by CenterSquare's investment team informed by various market sources including broker estimates.

About CenterSquare

Founded in 1987, CenterSquare Investment Management is an independent, employee-owned real asset manager focused on listed real estate, private real estate equity and private real estate debt investments. As a trusted fiduciary, our success is firmly rooted in aligning our interests with those of our clients, partners and employees. CenterSquare is headquartered in suburban Philadelphia, with offices in New York, Los Angeles, London and Singapore. With approximately $13 billion in assets under management (June 30, 2023), our firm and subsidiaries are proud to manage investments on behalf of some of the world's most well-known institutional and private investors.

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