Kennedy Capital Management®

Beyond the Storm:
Opportunities in the U.S. REIT Market

The real estate investment trust (REIT) market had an exceptionally good year in 2021. The broad-based REIT exchange-traded fund, iShares U.S. Real Estate ETF (IYR), for example, saw a total return of 38.7% in 2021. By the beginning of 2022, however, concerns over Federal Reserve (the Fed) efforts to curb rising inflation were growing. By March 2022, the Fed began its tightening cycle—raising the federal funds rate from near zero to a target range of 5.25% - 5.50% by July 2023.

This aggressive rate hike program—one of the most significant in history—had a negative influence on interest-rate-sensitive assets like real estate. Anticipating this impact, investors initiated a substantial sell-off of REITs in early 2022. This ultimately eroded not only the gains achieved in 2021 but also resulted in further value depreciation. As of October 20, 2023, the IYR ETF experienced a maximum drawdown of -32.4%.

iShares U.S. Real Estate ETF (IYR)
Total Return: December 31, 2020 – December 31, 2021

iShares U.S. Real Estate ETF (IYR)
Total Return: December 31, 2021 – October 20, 2023

Source: Fed Prime Rate, 2024

Specific REIT sectors faced additional challenges in 2022. Many of these challenges stemmed from COVID-related issues and rising interest rates.

Storage REITs:
Unwinding Excess COVID Demand

After benefitting from a robust housing market throughout a substantial portion of 2021, storage REITs encountered a reversal of these favorable conditions. The storage sector traditionally benefits from a strong housing market, as frequent relocations generate demand for temporary storage solutions. However, the significant increase in mortgage rates, a consequence of the broader interest rate rise, led to a dramatic decline in housing market transaction volume by 2022.

Office REITs:
COVID Shows Work-from-Home Is a Real Alternative to Office Attendance

The mandated work-from-home policies implemented during COVID closures caused REIT investors to assess the potential for a permanent reduction in demand for office space. Following the lifting of these restrictions, office REITs experienced a rapid decline in occupancy rates as tenants re-evaluated their space requirements.

Combined with rising interest rates, the decrease in demand for leasable square footage resulted in a significant sell-off of office REIT stocks. While many real estate sub-sectors have begun to address the uncertainties arising from COVID closures, investors are still assessing the long-term implications of remote work. This ongoing evaluation contributed to the continued decline of office REIT stock prices to multi-year lows.

Retail REITs:
Suffering from the Amazon Effect and COVID Closures

The rise of online shopping had already presented a significant challenge for many retail REIT landlords as the traditional brick-and-mortar retail experience became less essential for consumers. The COVID pandemic further exacerbated this trend, as closures of most physical retail stores led to a precipitous decline in retailer demand for space. Retail occupancy rates experienced a rapid downturn, with mall REITs being particularly affected. These factors resulted in a significant decline in the share prices of many retail REITs.

Industrial and Multifamily REITs:
Steepest Declines Early On

Industrial and multifamily REITs experienced some of the biggest initial declines in share price when the Fed started raising interest rates—mainly because these subsectors had enjoyed historically low capitalization rates (cap rates) compared to the broader REIT market. Due to their tight linkage to Treasury rates, both subsectors experienced immediate sensitivity to the rising cost of capital as interest rates increased rapidly.

Industrial REITs saw accelerating market value adjustments on new and renewal leases, leading to robust growth exceeding 10% for a majority of these companies. As a result, implied cap rates had compressed to the 3-3.5% range, previously supported by exceptionally low Treasury yields and projected growth. Similarly, multifamily REITs exhibited implied cap rates close to 4%, again underpinned by robust growth expectations and historically low interest rates.

Interest rates still have an impact

While many of the COVID issues are resolving, investors are still struggling with a volatile interest rate environment. History has shown that unstable interest rates tend to paralyze real estate capital markets, as REIT investors have a hard time determining true underlying value with uncertainty about rates and therefore true cost of capital and required rates of return.

The REIT Investment Opportunities Ahead

REITs performed well in the fourth quarter of 2023, following indications from the Fed of a potentially more dovish approach to future rate adjustments. However, there's still a lot of uncertainty about the Fed's monetary policy actions in 2024.

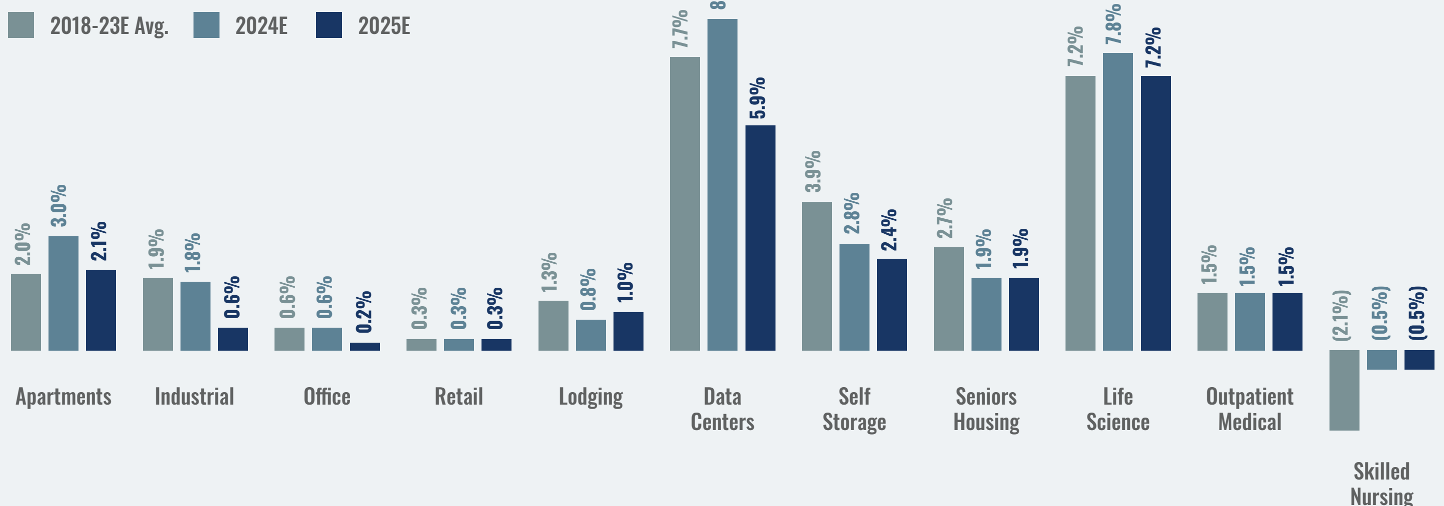
Arguments can be made for both maintaining current interest rates and potentially reducing them. While a downward trend in inflation observed in the latter half of 2023 strengthens the case for a rate cut, overall price levels remain elevated compared to pre-2022 levels—potentially hindering consumer spending. Additionally, although the job market remains robust with an unemployment rate below 4% as of this writing, an increase in layoff announcements in January 2024 potentially bolsters the argument for a modest rate decrease.

Despite these considerations, we anticipate that near-term market activity—particularly within the REIT sector—will continue to be influenced by ongoing uncertainties surrounding interest rates. In the long term, opportunities are emerging from the significant decline in new construction deliveries across various property types, coupled with the continued robust demand for space in most of these categories. Furthermore, REITs exhibiting the ability to increase per-share cash flow [as measured by non-GAAP metrics such as funds from operations (FFO) and, more importantly, cash available for distribution (CAD)], over the next four years are likely to generate strong absolute and relative returns.

New Construction Starts and Deliveries Slowing Dramatically, Bullish for REITs

- New supply impact across real estate asset classes is generally decreasing through 2025, benefitting next year's fundamentals more so than this year's, though some sectors are facing a wall of new deliveries (Data Centers, Life Sciences and Apartments).
- While data centers' supply growth is daunting – low vacancy, lack of power availability, and robust AI-driven demand should drive lease-up activity.

New Supply Growth as % of Existing Stock



Source: Raymond James & Associates, 2024

The banking industry bore the brunt of stress caused by rapidly rising interest rates. As rates increased, the value of banks' loans and investments declined, leaving many in precarious liquidity positions. This resulted in several bank receiverships in March 2023 and a related wave of deposit runs.

Making matters worse, banks' existing portfolios were already heavily weighted towards commercial real estate loans, particularly in the local construction sector. Their reluctance to sell off investments and loans at a loss has significantly restricted the availability of new debt. This will make it increasingly difficult to secure financing for new real estate projects across many sectors, which should prove to be a bullish development for most publicly traded REITs. Throughout real estate cycles, surges in new construction have consistently acted as a disruptive force, impacting market dynamics.

Over the next five years, we may witness a significant slowdown in new development across most property types within the REIT landscape. This potential scenario could allow existing landlords and property owners to capitalize on tenant demand for additional space by raising rents—ultimately leading to higher cash flow growth.

Hotels

Over the next three to five years, the hotel sector has the potential to exhibit the most favorable supply and demand dynamics. Industry forecasts anticipate net demand exceeding 1%, with urban portfolios particularly relevant for publicly traded hotel REITs due to their historical focus on these locations. In urban centers, net demand growth is projected to be exceptionally strong, reaching over 2.7%—presenting a compelling opportunity for existing urban hotel owners.

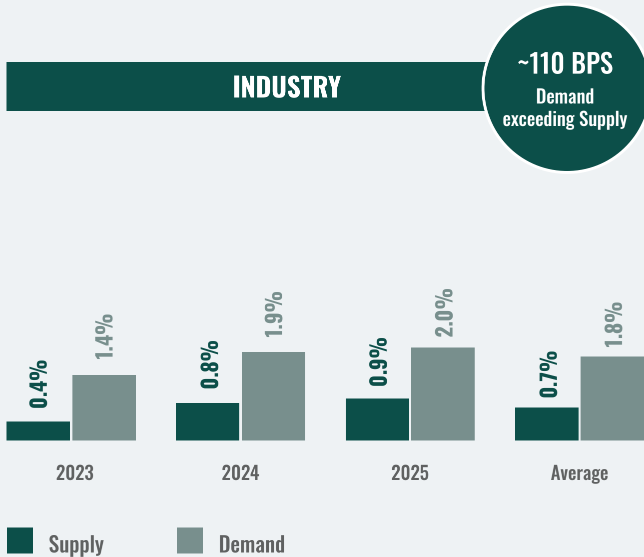
Furthermore, we anticipate that supply growth may be even lower beyond 2025. This, coupled with a renewed sense of wanderlust among U.S. consumers (evidenced by a shift in spending from goods to services post-pandemic), suggests that current demand projections may even be conservative.

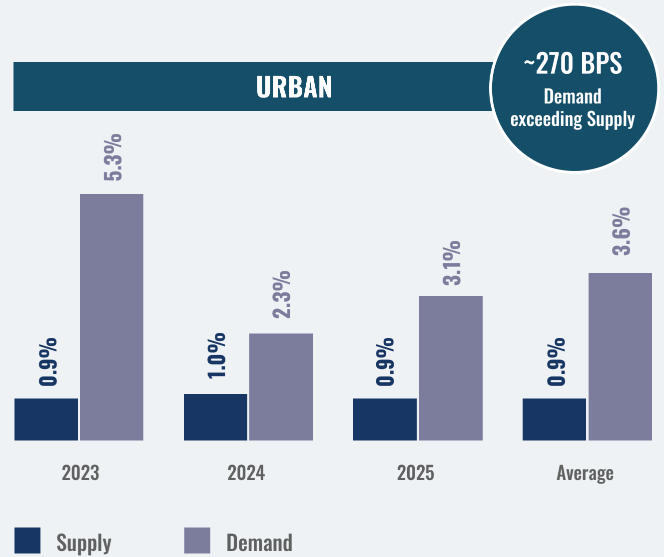
Considering these favorable supply/demand fundamentals, strong balance sheets with low leverage, the potential for occupancy rates to rise from a currently low base, and an inflationary environment likely to drive nominal growth in average daily rate (ADR), we believe hotels stand out as one of the most attractive investment opportunities within the REIT sector.

"We believe hotels stand out as one of the most attractive investment opportunities within the REIT sector."

Organic Growth

- Urban demand growth expected to significantly outpace new supply
- New supply in Urban markets projected to remain low for multiple years



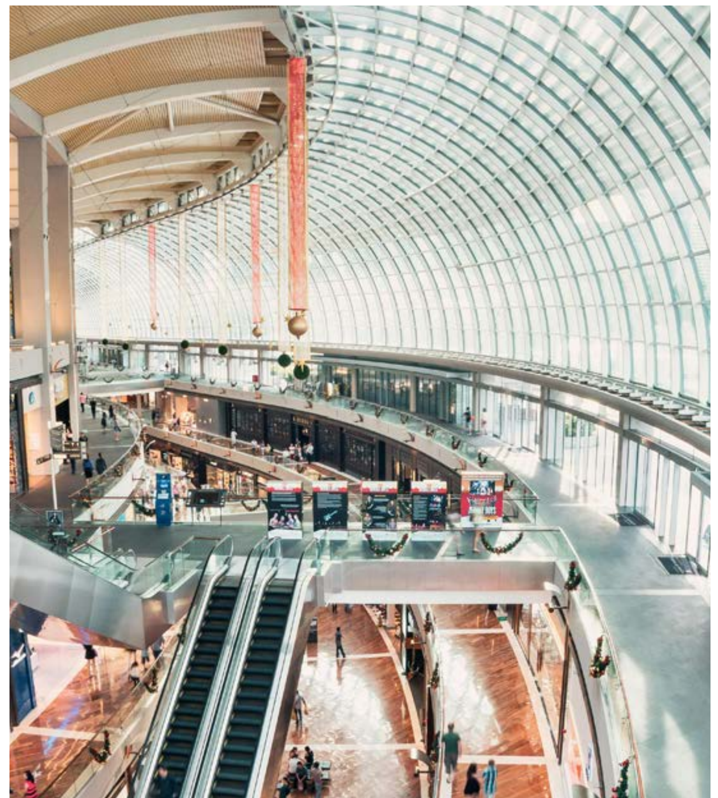


Source: RLJ Lodging Trust, 2023

Retail

New development in retail formats has been moribund since the global financial crisis—and there are no immediate signs of a revival. This stagnation coincides with the decline of older, outdated retail properties as they struggle to compete with higher-quality, better-positioned alternatives.

Publicly traded retail REITs hold many of the best-located, highest-quality, and most productive centers within their portfolios. This favorable positioning allows most retail REITs to strategically increase occupancy rates and raise rental rates. We believe that retail REITs will benefit from a landlord's market in the next three to five years, which should positively influence their stock performance during this period.



Skilled Nursing

Skilled nursing facilities (SNFs) witnessed significant contraction in new supply over the past five years. This trend is expected to continue at least through 2025 and potentially beyond as the industry grapples with low occupancy rates in the post-pandemic environment. Operators must also contend with declining operating margins due to a combination of rising operating costs and stagnant or decreasing reimbursement rates.

While these factors suggest a bearish outlook, we anticipate that the impending "silver wave" of aging Baby Boomers will drive substantial growth in demand for SNFs in the coming years. Advancements in medicine may improve health and reduce doctor visits, but they can't prevent the natural aging process.

Meanwhile, most SNF REITs can acquire existing facilities at attractive spreads to their cost of capital, presenting external growth as a viable path to increasing per-share CAD—even if internal growth remains challenging. We maintain a bullish long-term outlook on the SNF sector.

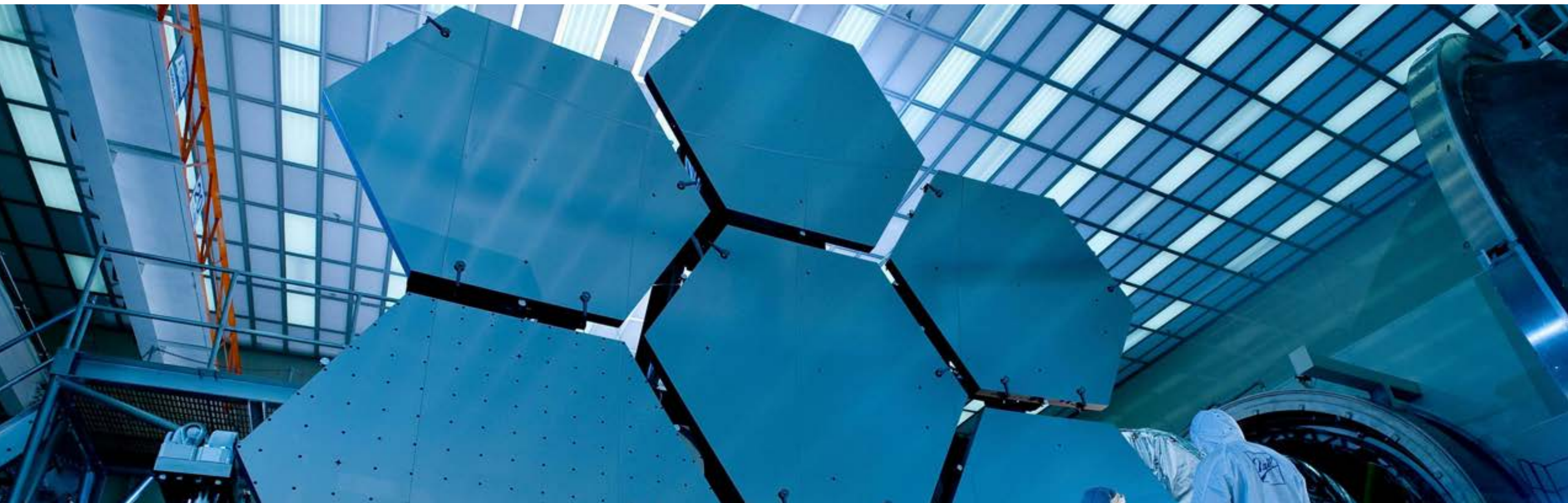
Overcoming Debt Maturities in the Next Four Years: REITs That Can Grow

One of the most significant headwinds to per-share CAD growth in the REIT universe is refinancing maturing debt at materially higher interest rates. Currently, the average interest rate on the aggregate debt across REIT balance sheets is believed to be 4% or lower. While most REITs have successfully laddered debt maturities to avoid periods of outsized debt expirations, a significant portion of their debt will require refinancing within the next five years.

Based on the current Treasury yield curve, we anticipate that refinancing rates will be 200-300 basis points higher than existing interest rates over time—significantly impacting REITs' bottom-line FFO and CAD metrics. Nevertheless, some REITs can overcome this challenge through robust internal growth strategies or more aggressive deleveraging maneuvers, such as selling assets at cap rates lower than the higher refinancing rates on maturing debt.

Stronger sectors within the REIT market may have the opportunity to sell properties in the 5-6% cap rate range and use the proceeds to pay down variable-rate debt with current coupon rates of 6.5% to 8%, particularly revolving credit lines. Using lower-cost financing to replace higher-rate debt is accretive to cash flow.

We are currently identifying REITs capable of overcoming the headwind of higher financing rates and maintaining per-share CAD growth through 2027. We believe that selecting the appropriate REITs, particularly those with lower leverage profiles and well-structured debt maturities, can generate strong returns.



Industrial

Industrial REITs are projected to experience significant growth over the next five years, driven primarily by three key factors:

1

Continued strong market rent growth and mark-to-markets in the 20-50% range:

This is expected to facilitate robust internal growth within the sector.

2

Low vacancy rates in major industrial markets, coupled with very limited anticipated new supply:

This favorable supply-demand dynamic is likely to persist for the next five years.

3

Exceedingly low leverage profiles:

This will minimize the impact on per-share CAD over the next five years. Notably, the leverage ratios of most industrial REITs are considerably lower than the average across the REIT universe, which will help to mute the impact of maturing debt on per-share CAD growth.

The industrial REIT market continues to witness exceptionally strong demand for space, translating into robust re-leasing spreads on both expiring and new lease agreements. We believe that industrial rent growth should be considerably stronger than other REIT sectors prospectively, even with a moderation of its mark-to-market profile, which may potentially lead to robust outperformance in both relative and absolute terms for industrial REITs. Our outlook on this subsector remains highly bullish.

Contrarian Deep Value: Office REITs

Perhaps the most out-of-favor subsector in real estate is office REITs—for many reasons. Rising demand for work-from-home flexibility has been further amplified by the migration of companies and individuals out of major office markets (e.g., New York, Los Angeles, San Francisco) towards sunbelt locations with smaller office footprints. Combined with persistently declining occupancy rates and historically low office utilization figures, this contributed to a significant deterioration in the fundamentals of the office REIT sector since 2020.

Despite these challenges, we believe there may be a turning point in sentiment surrounding office REITs, potentially presenting attractive investment opportunities. While hybrid work models are currently prevalent, a significant portion of businesses still prioritize centralized work locations, believing it fosters collaboration and innovation. Additionally, recent trends within sectors like Big Tech, despite initial 2024 layoffs, suggest a potential shift towards requiring employees to be present in physical offices.

Based on these observations, we believe the office sector has the potential to regain some of its past prominence within the real estate market over the next three to five years. With valuations currently hovering near all-time lows, office REITs are well-positioned for a mean-reverting rally once occupancy rates stabilize and start rising. We maintain a bullish outlook on the office REIT subsector over the next five years.

Concluding Thoughts

The publicly traded REIT sector faces several near-term challenges. These include uncertainty surrounding interest rates, the potential for excessive new supply in certain sectors, and the unwinding of inflated demand generated by the COVID pandemic in certain areas. These factors could constrain REIT share prices in the short run.

However, we believe strategic selection within the REIT universe can lead to exceptional returns over the next five years. This approach hinges on identifying REITs capable of achieving per-share cash flow growth organically, without an overreliance on acquisitions.

Notably, current REIT dividend yields are comparable to short-term Treasury yields. This presents an opportunity for investors to establish positions in the near term and receive income while awaiting a potential correction in stock prices that reflects the company-specific and industry-wide fundamentals outlined in this report. We believe the REIT sector is on the cusp of its next growth cycle—and that REITs remain a robust component of a well-diversified investment portfolio.

> **"We believe the REIT sector is on the cusp of its next growth cycle—and that REITs remain a robust component of a well-diversified investment portfolio."**

ABOUT KENNEDY CAPITAL MANAGEMENT LLC

Founded in 1980, St. Louis-based Kennedy Capital Management LLC (KCM) delivers investment strategies to corporate and public pension funds, endowments, foundations, multi-employer plans and high-net-worth individuals. As a registered investment adviser, KCM specializes in the management of micro, small and mid-cap strategies across the growth-value spectrum and as of March 31, 2024, managed $5.05 billion in assets. KCM integrates environmental, social and governance (ESG) considerations into its research process and has over 20 years' experience managing socially responsible client accounts. For more information, visit **www.kennedycapital.com**.

Advisory services are offered through KCM, an SEC Registered Investment Adviser. All investing involves risk. The value of an investment may increase or decrease over time. **Past performance is not a guarantee of future results.** Future returns are not guaranteed, and a loss of principal may occur. The material and information contained within this presentation are not meant as investment advice and should not be construed as a recommendation; or an offer to buy or sell; or the solicitation of an offer to buy or sell any security, financial product, or instrument; or to participate in any particular trading strategy. All opinions expressed herein constitute KCM's judgment as of the date of the article and are subject to change without notice. Statements made are not facts, including statements regarding trends, market conditions and the experience or expertise of KCM. All statements are based on current expectations, estimates, opinions and/or beliefs of KCM. There can be no assurance that any KCM strategy or investment will achieve its objectives or avoid substantial losses.

Certain information contained in this document constitutes a "forward-looking statement;' which can be identified by the use of forward-looking terminology, such as "may;' "will;' "seek;' "should;' "expect;' "anticipate;' "estimate;' "intend;' "continue;' "believe;' or the negatives thereof or other variations thereof or comparable terminology. Due to various risks and uncertainties, actual events or results or the actual performance may differ materially from those reflected or contemplated in such forward-looking statements, including a complete loss of investment.

Diversification does not guarantee a profit or protect against loss in declining markets. 2024040022

Kennedy Capital Management®