Real Estate Investing in a Post COVID-19 World

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- The COVID-19 Pandemic of 2020 has significantly impacted the global economy as the 'Black Swan' of large scale economic shutdowns spread throughout the developed world.
- While the S&P 500 has had a positive return thus far for 2020, many individual sectors tell a different story.
- The sudden global shutdown of the economy has split the Real Estate sector into clear winners (Data Centers, Towers, Industrials, and Self-Storage) and losers (Retail, Lodging and Office). For the most part, the pandemic accelerated trends that were already in place.
- So what is occurring here? If we consider Real Estate broadly as a homogenous sector, are we in danger of missing out on attractive returns and cash flows benefitting from secular growth tailwinds?
- If the dispersion of returns is so wide in a COVID-19 driven market, what does this tell us about the future of real estate investing?

AN EVOLVING SECTOR

It is said that 'Real Estate houses the economy' and as the economy has evolved, so has the composition of the Real Estate sector. Over the years, the REIT universe has expanded beyond the traditional property sectors institutional investors typically owned in the past; Office, Retail, Residential and Industrial. In 2000, these sectors comprised over 75% of the market capitalization of equity REITs. However, as new property types (Data Centers, Cell Towers etc.) have entered the space, the traditional property types now account for 50% of total market capitalization. The newer sectors of the REIT universe, only 5% of industry market cap 20 years ago, has expanded to 33%.

2019 saw a strong 25.8% return for the MSCI US REIT index and the rising tide lifted almost all boats as there was great breadth across the industry. While the Industrials (+48.7%) and Data Centers (+44.2%) sectors led the way, several more traditional areas held their own like Office (+31.4%) and Lodging (+15.6%). Malls (-9.1%) were alone in posting a negative return for the year as brick and mortar retail has been challenged for several years. We were already on the path towards this point in our embrace of technology, it just wasn't supposed to happen this quickly.

MILLENNIALS FINALLY COME HOME

One of the biggest trends to emerge in real estate in 2020 has been the increased demand for suburban housing. Millennials had stubbornly resisted suburbia as they approached middle age, prioritizing the convenience and experiences of urban settings over the white picket fence. The long months of enforced lockdown finally broke that resistance. While it remains quite challenging for many to ascend the property ladder due to high prices, tighter lending standards and high levels of personal debt, the flight to the suburbs is definitely in motion.

Rental property operators have experienced significant effects due to the pandemic and this suburban flight. For example, scaled operators like Single Family Rental REITs* have been able to raise rents at impressive levels (+7.5% year over year in October alone) over the past few months. Occupancy is at record highs and late payments have shown no signs of increasing. These trends are quite remarkable given the steep recession experienced in 2020 and they highlight the uneven recovery we are witnessing. While unemployment rates are currently very high across the whole economy, many Americans are working from home, continuing to earn and pursuing more living space, particularly space to work, and outdoor space. Even when this pandemic subsides, there is an expectation that millennials will continue to desire suburban space and quality schools while being unable to buy due to high levels of student debt.

While single family rental operators experience success with high occupancy and low late rent payments, multifamily operators are facing increased pressure. Initially renewal rates were higher than normal as many occupants were reluctant to move during the shutdown, but job losses and the decline in demand for living in high-density cities have created considerable uncertainty going forward. There is much more optimism surrounding those residential REITs with exposure to the Southeast and Southwest Sunbelt areas as the dense, gateway cities continue to experience exodus.

ACCELERATION OF PRE-COVID TRENDS

Data Center and Tower REITs (also known as Infrastructure REITs) were already the growth areas in the REIT industry before COVID-19 hit. The demand profile for Data Center REITs had been very solid for many years as cloud adoption and outsourcing gathered pace and drove robust growth. The pandemic has only reinforced the importance of these initiatives as robust and flexible digital architectures are paramount. Global demand from large companies like Microsoft, Google, Apple, Facebook and Salesforce remains strong. With people around the globe under stay-at-home orders, data centers play a central role in enabling the virtual world; individuals working from home through their business VPN, companies shifting to equip a newly remote workforce, students pivoting to online education systems, and families accessing entertainment over the internet.

Similarly, the Tower REIT sector continues to enjoy a long runway of strong U.S. leasing and low interest rates. The sector has held up well during the recent challenges due to its nature of long-term contracts, significant barriers to entry and leasing volumes tied to Data Growth. The 5G upgrade cycle has been delayed somewhat during the shutdowns but remains a tailwind

Single Family Rental REITs are a relatively new group, having assembled their portfolios in the aftermath of the Financial Crisis mainly through foreclosures or buying non-performing loans.

as the REITS benefit from the greater spending and equipment requirements of the new networks. Larger, heavier antennas and other equipment will generally drive higher rents for this group over the longer term.

Industrial REITs are another beneficiary of the change in behavior precipitated by this crisis. Demand for warehousing has increased due to increased adoption of E-commerce. The E-commerce share of all U.S. retail sales rose to 16.1% in the second quarter of 2020, up from 10.8% a year earlier. Traditional brick and mortar retailers like Macy's now sell 43% online, up from 25% prior to the pandemic. They partner with Google to improve search engine results instead of sourcing new mall locations. The first half of 2020 has seen a record number of retail store closings. According to BDO USA LLP., 29 retailers have filed for bankruptcy protection in 2020 as of mid-August. 2020 could surpass the record of 48 bankruptcies in 2010 which came on the heels of the Global Financial Crisis.

SO WHERE DO WE GO FROM HERE?

What does all of this mean as investors look towards Real Estate in a post pandemic world? Increasingly observers expect a K-shaped recovery whereby certain business models thrive and grow while others continue to struggle. The emphasis on data and connectivity is unlikely to reverse, and we do not see a reason to think that the global demand for Data Centers and Cell Tower locations will decrease going forward. The E-commerce adoption rate has clearly accelerated, but this adoption is not expected to reverse when the pandemic recedes. McKinsey recently conducted a study, which found that 3 out of 4 participants tried a new method of online shopping during the year, with 70% intending to continue buying online into the future. The conclusion of the study is that 10 years of adoption was compressed into a 3 month period of time. The trend was already there, it just accelerated dramatically out of necessity.

The Industrial REITs focused on E-commerce warehousing appear likely to consolidate their strong position into the future. Further M&A among industrial warehousing REITs is likely as the smaller competitors find it more challenging to provide dominant retailers, like Amazon and Walmart, the bespoke warehousing they require.

Similarly, the millennial move to suburbia is likely a long term effect. Families rarely pursue less space and more congestion as they grow. It is difficult to imagine the reassessment of priorities that city dwellers have experienced in 2020 dissipating once the lockdowns are all behind us.

THE OUTLOOK FOR THE TRADITIONAL REIT SECTORS

The future of the more traditional Real Estate sectors is a mixed bag. It is reasonable to expect demand to return to the Hotel and Resort space over time. There is likely a lot of pent up demand to travel and explore the world. We expect some level of business travel to return, as relationships are harder to build over a Zoom screen than face to face. The lodging companies able to navigate these nearer term challenges ought to benefit from a longer term return to normalcy.

Office REITs have a similarly mixed outlook. While rumors of the death of the office have been greatly exaggerated, one can reasonably expect the growth prospects in the space to remain muted for a while. The large Office REITs have experienced resilient rent collection throughout the summer, but companies across many industries must reassess how much office space they will need in the future as attitudes to or toward the centralized workplace evolve. Most office leases range from five to fifteen years, so the main concern is the longer term impact. Some expect companies to reduce their office footprint and increase work from home on a permanent basis, while others suggest more office space will ultimately be needed as spacing out workers becomes a priority.

The Real Estate sector enjoys favorable tailwinds as we head into 2021. Overall, the industry balance sheet is in solid shape, capital markets have been consistently open and REIT's cost of capital is at historic lows. The current low interest rate environment looks likely to be with us for a while yet and with the 10 year US Treasury note yielding well below 1%, the approximately 3% yield offered by the overall REIT sector remains quite desirable to income starved investors. At the time of writing, control of the US Senate is uncertain, but If Republicans lose control, new tax legislation is quite likely, potentially changing the 2017 Tax Cuts and Jobs Act, which currently allows individuals to deduct up to 20% of ordinary REIT dividends.

Many investors allocate to the Real Estate sector using broadly exposed funds or passive Exchange Traded Funds (ETFs) which track the appropriate index. While news of vaccines and potential reopening has led to significant rallies in the most challenged sectors, long term exposure to businesses that are in secular decline can weigh on investment results. The experience of 2020 in the financial markets has made a very strong argument for

active management. As the economy evolves, the Real Estate sector in particular looks likely to reward a highly selective approach to allocation over the long term.

In contemplating an allocation to Real Estate, it is worth considering that the same themes driving the broader market are also driving the Real Estate sector. Landlords exposed to technology and innovation are best positioned. Value has underperformed Growth in the equity markets for more than the past decade and the same is true in REITs. Some of the struggling areas of Real Estate may look attractive based on traditional metrics like Price to Net Asset Value (P/NAV) or Price to Funds from Operations (P/FFO) but it is very challenging to underwrite assets when the plates are shifting beneath us and it certainly feels like there are tectonic shifts occurring in the global economy. The K- shaped recovery idea leaves us with many real estate losers and it is important for investors to make every effort to avoid them. The 1919 REIT Strategy is cognizant of these realities and is positioned to take advantage of the more technology oriented, growth sectors of Real Estate while maintaining a modest exposure in the more traditional sectors as the strategy strives to identify the best, long-term growth opportunities in the Real Estate sector.

1919 REIT CAPABILITY

1919 Investment Counsel provides two main avenues to offer our clients' exposure to Real Estate outside of a traditional balanced account allocation: Third-Party Private Real Estate Investments, and the 1919 REIT Strategy.

- Private Real Estate Investments managed by Third Party entities are reviewed and recommended by the 1919 Private Investments Committee
- The 1919 REIT Strategy is a separately managed account strategy which focuses on mid and large cap publicly traded Real Estate Investment Trusts
- The 1919 REIT Strategy invests in between 20 and 25 different companies and seeks to identify companies with leading competitive positions within their subsectors, quality corporate governance practice with demonstrated ability to generate strong, sustainable cash flows and are beneficiaries of secular industry tailwinds
- The 1919 REIT Strategy is managed by Portfolio Managers and supported by a team of 5 additional 1919 Investment Counsel Professionals. AUM is $7.49 million as of 9/30/20.

About 1919 Investment Counsel

1919 Investment Counsel, LLC is a registered investment advisor. Its mission for more than 100 years has been to provide counsel and insight that helps families, individuals, and institutions achieve their financial goals. The firm is headquartered in Baltimore and has regional offices across the country in Birmingham, Cincinnati, Houston, New York, Philadelphia, San Francisco and Vero Beach. 1919 Investment Counsel seeks to consistently deliver an extraordinary client experience through its independent thinking, expertise and personalized service. To learn more, please visit our website at 1919ic.com.

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Mel is a Portfolio Manager with 1919 Investment Counsel, LLC. He has more than 15 years of experience in the financial services industry, focused on equity analysis and portfolio construction for individuals, families, foundations and institutional clients.

Prior to joining 1919 Investment Counsel, Mel was a Vice President in Equity Sales and Trading for both Compass Point Research in Washington, DC and Keefe, Bruyette & Woods in New York.

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