Nareit Real estate working for you®

December 2022

2023 Outlook for the Economy, Commercial Real Estate, and REITs

What's Ahead for 2023 and Key Takeaways from 2022

Contents

John Worth, Nareit

John Worth, Executive Vice President, Research & Investor Outreach

Introduction

REITs 2023: Maintaining Solid Footing Amid Economic Uncertainty

As we look ahead to 2023 and cross the three-year mark from the onset of the pandemic, the effects of COVID-19 on our day-to-day lives will likely continue to wane, but we will still be living in an economy and commercial real estate environment shaped by the aftershocks of both the health crisis and the response to it.

The most obvious aftershock will be continued inflation in 2023. The causes of that inflation remain two-fold: COVID-created supply chain disruptions and the unintended consequences of the extraordinary monetary and fiscal policies enacted to prevent a health crisis from becoming an economic one.

Another aftershock is recession risk, which will remain high in 2023 as the economy slows. The Federal Reserve has a narrow target for a soft landing as it continues to raise and maintain higher rates in hopes of lowering the rate of inflation. While there are some encouraging signs that inflation rates are declining, higher short- and long-term interest rates and the resulting economic slowdown are likely to be the defining features of 2023.

The ongoing higher interest rate environment will continue to create challenges for commercial real estate (CRE). However, our review of REIT balance sheets and debt suggests that REITs are well-positioned for economic uncertainty in 2023 because of their strong balance sheets. They are entering the new year with leverage near historical lows, and well-termed, mostly fixed-rate debt and very low current interest expense.

2023 Outlook for the Economy, Commercial Real Estate, and REITs

John Worth, Nareit

The combination of aftershocks, higher interest rates, and the prospect of slower economic growth has resulted in a lower valuation for equities of all types. In 2022, stock performance reflected the dour economic outlook. Through November 2022, the Russell 1000 was down just over 14.1% while REITs were down 21%, trailing the broader stock market by about 700 basis points.

Our analysis of CRE and REITs notes that REITs had impressive operational results with record high earnings during 2022, despite their lower stock market valuations. It also discusses what industry stakeholders can expect in the REIT and CRE space in 2023 by highlighting the divergence between REIT and private real estate valuations. REITs have priced in higher interest rates and slower growth, and this gap will likely close because of changes in REIT and private market cap rates in 2023. Finally, the analysis looks at REIT performance across business cycles—including through previous recessions.

Our 2023 outlook wouldn't be complete without a deep dive into the institutional investor space. In 2023, we believe REITs will play an increasingly important role in institutional real estate portfolios. Institutional investors are recognizing that REITs not only have historically provided benefits in terms of higher total returns, but they also have provided access to new and emerging property sectors, global real estate, and leading ESG performance. Today, nearly two-thirds of the largest and most sophisticated institutional real estate investors in the United States and globally use REITs in their real estate strategies. We expect to see more institutional investors using REITs in 2023.

Though we will continue to feel the aftershocks and tremors of the pandemic next year, we feel confident that REITs are on solid ground.

John Worth
Executive Vice President,
Research & Investor Outreach
Nareit

2023: REITs, Recessions, and Economic Uncertainty

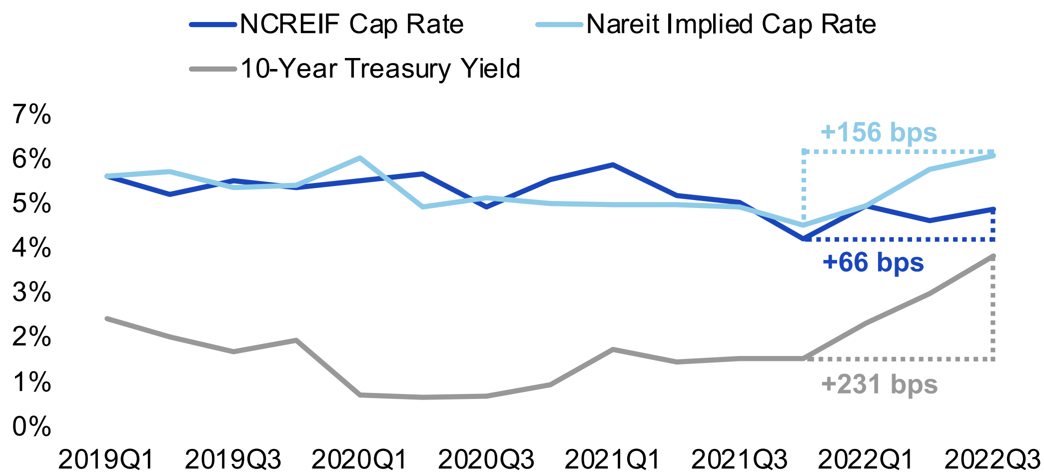
Key Takeaways

- REITs, on average, have outperformed both private real estate and the broader stock market during and after the last six recessions.
- REITs are entering this period of slower economic growth with strong operational performance and are well-positioned for economic uncertainty in 2023.
- REIT and private real estate valuations will continue to reflect higher interest rates and a slower growing economy in 2023.
- A wide valuation gap exists between REITs and private real estate. This gap will likely close through changes in REIT and private market cap rates in 2023. If this gap closes entirely through adjustments to private real estate cap rates, there could be a 20% decline in private real estate valuations.

In 2023, the U.S. economy will continue to be marked by mixed economic growth results, waning job gains, elevated inflation, and higher interest rates. The confluence of these factors has resulted in increased uncertainty surrounding the economic outlook. In November 2022, the Bloomberg consensus forecast survey placed the odds of a U.S. recession within the next 12 months at 62.5%; the likelihood was 15% at the start of the year.

While property fundamentals generally remained solid at the end of 2022, there has been some evidence of softening going into 2023. The industrial, retail, and apartment property types maintained elevated occupancy rates that were higher than their respective pre-pandemic levels. Office occupancy continued its downward trajectory, dropping nearly 3% from its 2019 average. Four-quarter rent growth rates remained healthy for the industrial, retail, and apartment sectors; office continued to work toward maintaining positive rent gains.

Real Estate Cap Rates & 10-Year Treasury Yields (1978Q1-2022Q3)



Sources: FRED, Federal Reserve Bank of St. Louis; Nareit; NCREIF.
Notes: Analysis uses NCREIF Transaction Cap Rate & Nareit T-Tracker® Implied Cap Rate.

Higher interest rates and debt costs are throttling commercial real estate transaction volume. The combination of high rates and weak valuations resulted in a dearth of REIT capital raising in the third quarter of 2022; it is at its lowest level since 2009.

Public and Private Real Estate Market Divergence

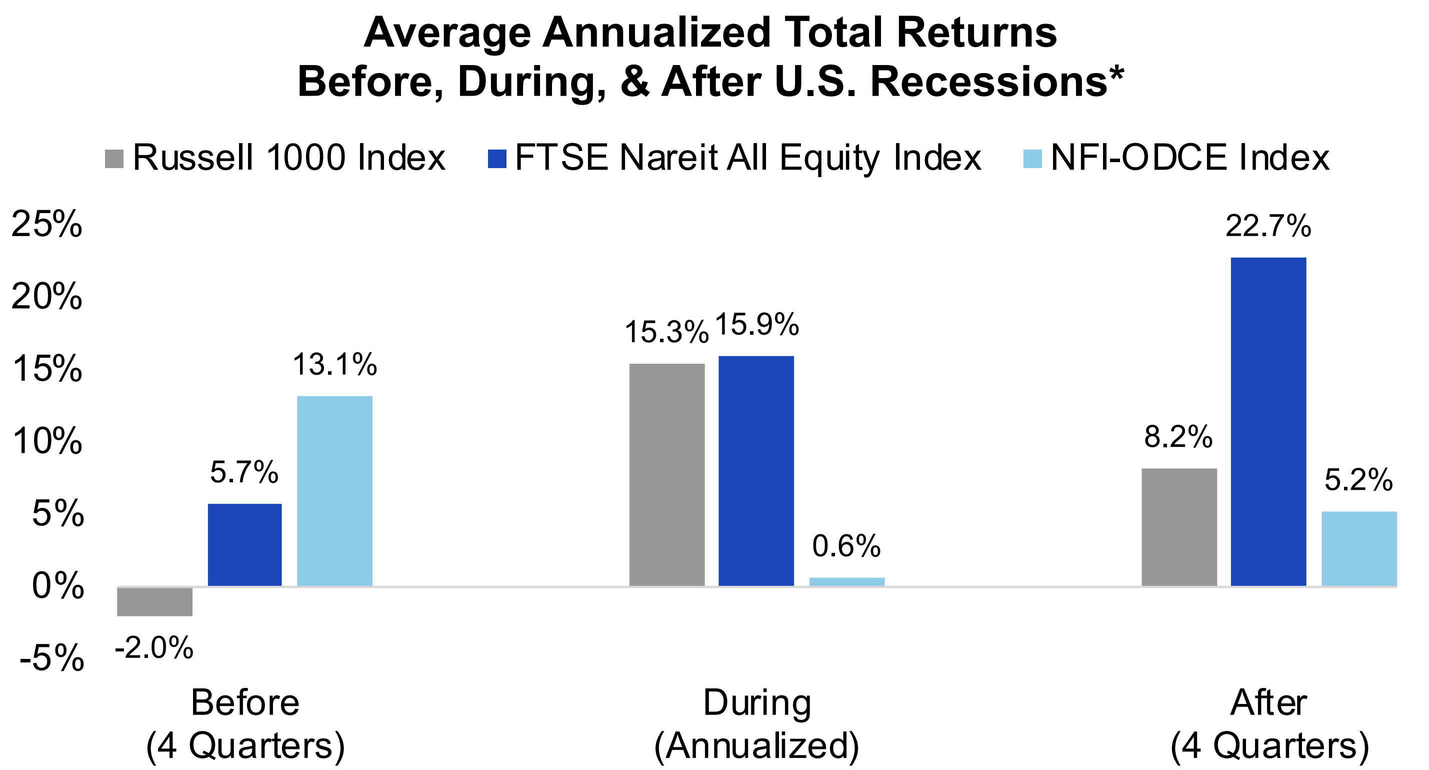
Public and private real estate performance diverged in 2022. Public real estate has priced in higher interest rates and slower growth, but the private market response has been sluggish. As of the third quarter, the FTSE Nareit All Equity Index and NCREIF Fund Index–Open End Diversified Core Equity posted year-to-date total returns of -28.2% and 13.1%, respectively; a difference of 41.3%. Note that REIT performance has typically led private real estate performance by six to 18 months. A similar divergence was evident with cap rates.

The chart above presents public and private real estate market cap rates, as well as 10-year Treasury yields. The 10-year Treasury yield surged in 2022. Though cap rates do not move in lock step with rising interest rates, the public real estate market had a meaningful reaction to the rise in the 10-year Treasury yield; the private market response was tepid. As of the third quarter of 2022, the REIT implied cap rate exceeded the private real estate cap rate by more than 100 basis points. All else equal, this disparity suggests the potential for a 20%, or larger, decline in private real estate market valuations, but typically, all else is not equal. There are a number of factors that can offset the potential decline, including operational performance, cap rate expectations, and time. In 2023, the gap between public and private cap rates is expected to close, most likely through changes in both REIT and private market valuations.

Real Estate and Equity Market Performance Before, During, and After Recessions

It is a well-known maxim that past performance may not be indicative of future results, but a review of historical public and private real estate total returns, as well as equity market total returns, before, during, and after recessions, may provide a look at what we may expect in 2023 and beyond.

Notably, recessions do not have to equate to negative real estate performance. Furthermore, REITs have traditionally been well-positioned to take advantage of economic recoveries.



Sources: NBER; Nareit; NCREIF; FactSet.
* Averages include the last six U.S. recessions between 1978Q4 and 2022Q3.

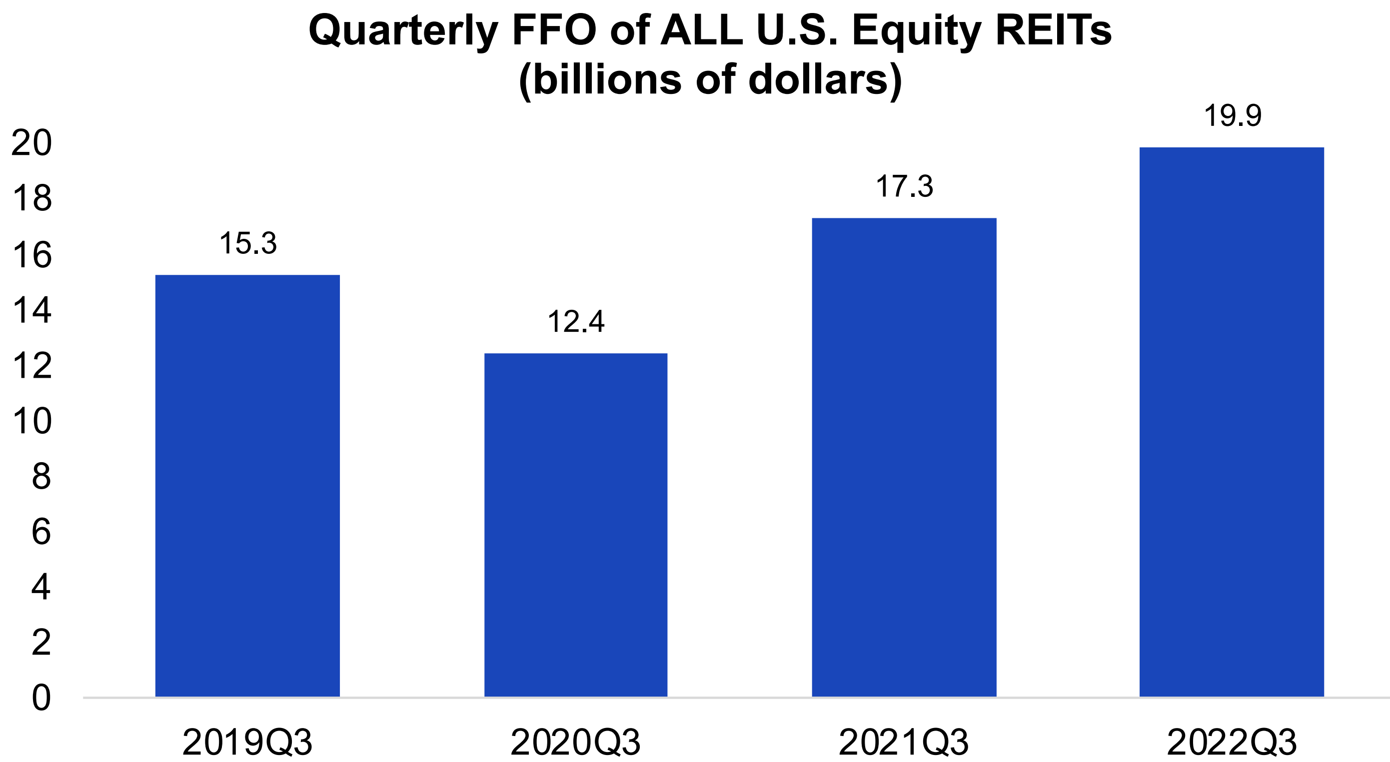
Note: The FTSE Nareit All Equity Index, the NCREIF Fund Index–Open End Diversified Core Equity (NFI–ODCE), and the Russell 1000 Index are used to measure REIT, private real estate, and stock market performances, respectively.

For example, the chart above displays the average annualized total returns for public and private real estate, as well as the equity market before, during, and after U.S. recessions. An analysis of the last six recessions reveals that, on average:

- REITs underperformed private real estate in the four quarters before a recession;
- REITs outperformed private real estate during a recession;
- REITs outperformed private real estate in the four quarters after a recession; and
- REITs outperformed their equity market counterpart before, during, and after recessions.

REITs Are Well-Positioned for Ongoing Economic Uncertainty

Despite economic headwinds and weakness in valuations, equity REITs have proven to be quite resilient from an operational perspective, and it is clear that REITs are well-positioned for ongoing economic uncertainty in 2023. Data from the Nareit T-Tracker® in the third quarter of 2022 highlighted solid year-over-year growth in funds from operations (FFO), net operating income (NOI), and same-store NOI. With strong operational performance and balance sheets, REITs are well-positioned to navigate economic and market uncertainty in 2023.



Sources: S&P Capital IQ Pro, Nareit T-Tracker®. Data as of 2022Q3.

The chart above shows aggregate quarterly FFOs of all U.S. equity REITs in billions of dollars for the third quarters of years 2019 through 2022. The pandemic clearly took a toll on the operational performance of equity REITs, but it has recovered and surpassed pre-pandemic levels. T-Tracker® data for the third quarter of 2022 show that quarterly FFO increased to $19.9 billion—a 14.9% increase from a year ago and an all-time high.

Notably, NOI increased by 8.1% over the past four quarters; and same-store NOI grew by 7.1% from a year ago, which underscores that REIT operational performance is keeping pace with inflation.

2023: REITs Likely to Remain Resilient to Higher Interest Rates

Key Takeaways

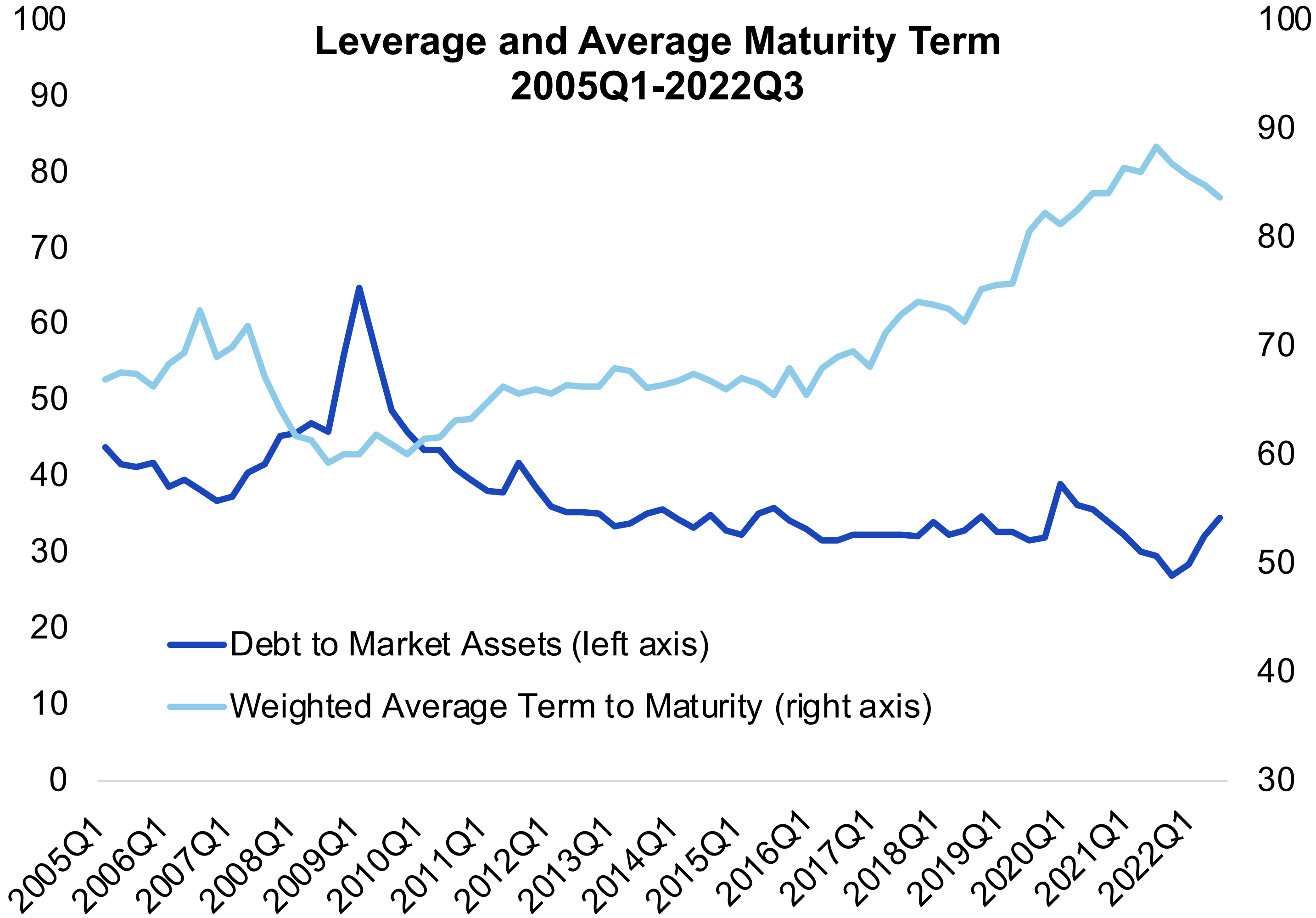
- REITs are well-positioned for economic uncertainty in 2023 because of their strong balance sheets.
- Leverage is near historical lows and REITs have well-termed, well-structured debt.
- Lower leverage has led to lower expenses as a share of net operating income (NOI).
- REIT balance sheets put them in a strong position in 2023 to compete against more highly levered market participants for property purchases.

2023 will continue to bring economic uncertainty as the Federal Reserve continues to increase short term rates to lower inflation. Though a higher interest rate environment can create a difficult operating environment for real estate generally, REITs have positioned their balance sheets to be resilient in 2023. Since the end of the Global Financial Crisis (GFC), REITs have lowered their exposure to higher interest rates by reducing leverage and interest expense, using fixed rate debt, and increasing the term of the debt they hold.

REITs Have Historically Low Leverage

Leverage, as measured as debt-to-market assets, has stayed below 40% since 2011, and has stabilized in the low to mid 30% range since 2016. For example, as of the third quarter of 2022, leverage is at 34.5% with a weighted average term to maturity of 83.5 months, or more than seven years.

Nareit Real estate working for you®



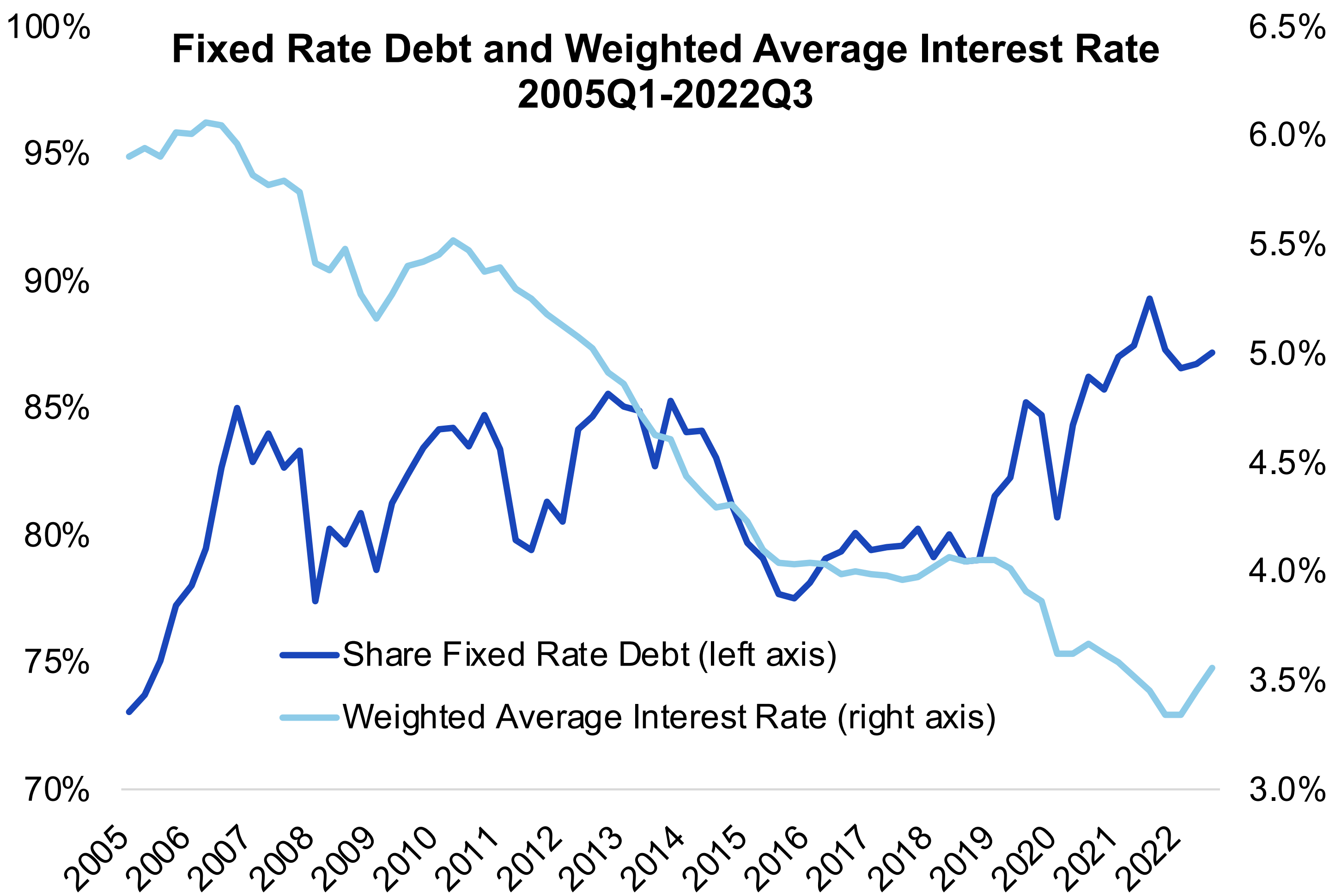
Source: Nareit T-Tracker(R)

The chart above tracks these two measures since 2005. Leverage was increasing through the run up to the GFC and briefly spiked in 2009 at 64.7% when market values fell.

REITs Have Well-Termed, Well-Structured Debt

REITs have a long runway to manage leverage in the higher interest rate environment because they have used fixed rate debt to lock in low interest rates for long terms.

For example, during the same time frame illustrated in the above chart, the weighted average term to maturity increased significantly. The term of debt was just more than 59 months (almost five years) in 2005 and rose to its peak in 2021 of 89 months (almost seven and a half years). The term of debt has shortened slightly in 2022, as new debt issuance has been well below historic levels, but remains near all-time highs.



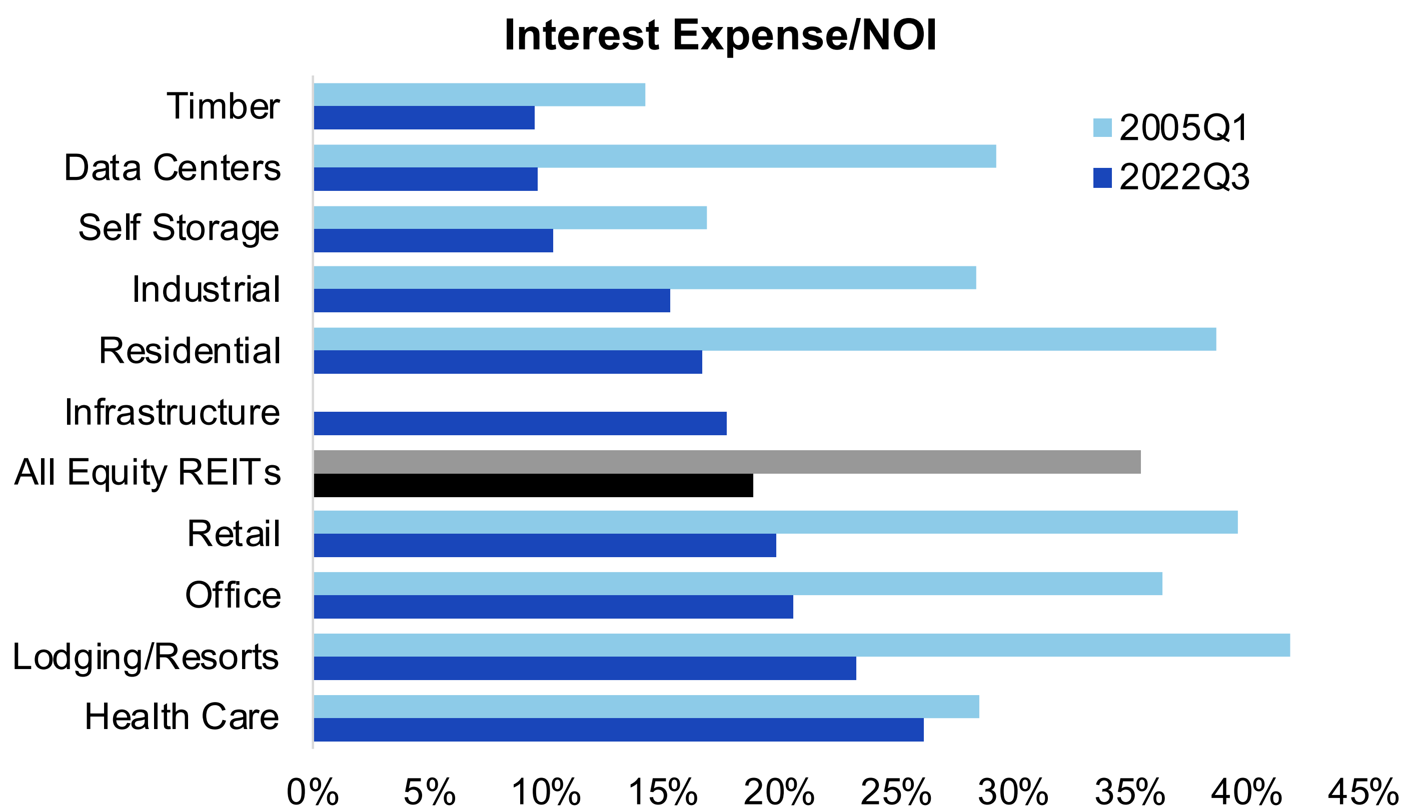
Source: Nareit T-Tracker(R)

The chart above shows the fixed rate share of total debt since 2005 and the weighted average interest rate on the total debt outstanding. The share of fixed rate debt has increased from 73% in 2005 to more than 85% in 2021 and 2022. At the same time as REITs have moved to fixed rate debt, the average interest rate on their debt has fallen. REITs have been able to decrease their weighted average interest rates from 5.9% in 2005 down to 3.6% in the third quarter of 2022.

With less exposure to variable rate debt, and as previously shown, long average terms to maturity, REITs locked in debt at low rates limiting their exposure to higher rates in 2023.

Interest Expense as Share of NOI Is Lower

One result of lowering leverage over the past several years for the industry has been lower interest expenses as a share of NOI. Interest expense as a share of NOI had been at 37% in 2009. Since that time, it has experienced a precipitous drop as REITs have reduced leverage and financed their debt with low interest rate debt. As of the third quarter of 2022, it was at 18.9%. As noted above, REITs also have most of their debt at fixed rates, with 87.2% of total debt at fixed rates.



Source: Nareit T-Tracker(R)

The chart above tracks interest expense as a share of NOI for the 10 pure-play property sectors comparing the beginning of 2005 to the third quarter of 2022 (infrastructure was not separated into its own property sector until 2012). All sectors have reduced interest expense as a share of NOI from 2005 levels. Notably, even the sectors with the highest ratios of interest expense to NOI today have levels below the industry average for 2005 of 35.4%.

Residential has experienced the largest reduction in interest expense to NOI since 2005, down 22 basis points, followed by data centers and retail, both down 20 basis points. Timber and data centers are both far below the industry average for interest expense, below 10%, and have tended to keep interest expense lower than the industry average. Lodging/resorts and health care are above average at 23.2% and 26.1% respectively. Health care has had the smallest reduction in interest expense share, down only 2 basis points.

In 2023, a higher interest rate environment will translate to higher rates on both variable debt and new debt, resulting in higher interest expenses and a larger debt services burden. REITs are in a strong position to weather higher rates and compete against more highly levered market participants for property purchases because they effectively managed their balance sheets.

Nareit Real estate working for you®

2023: Institutional Investors Will Increasingly Use REITs in Portfolio Completion Strategies

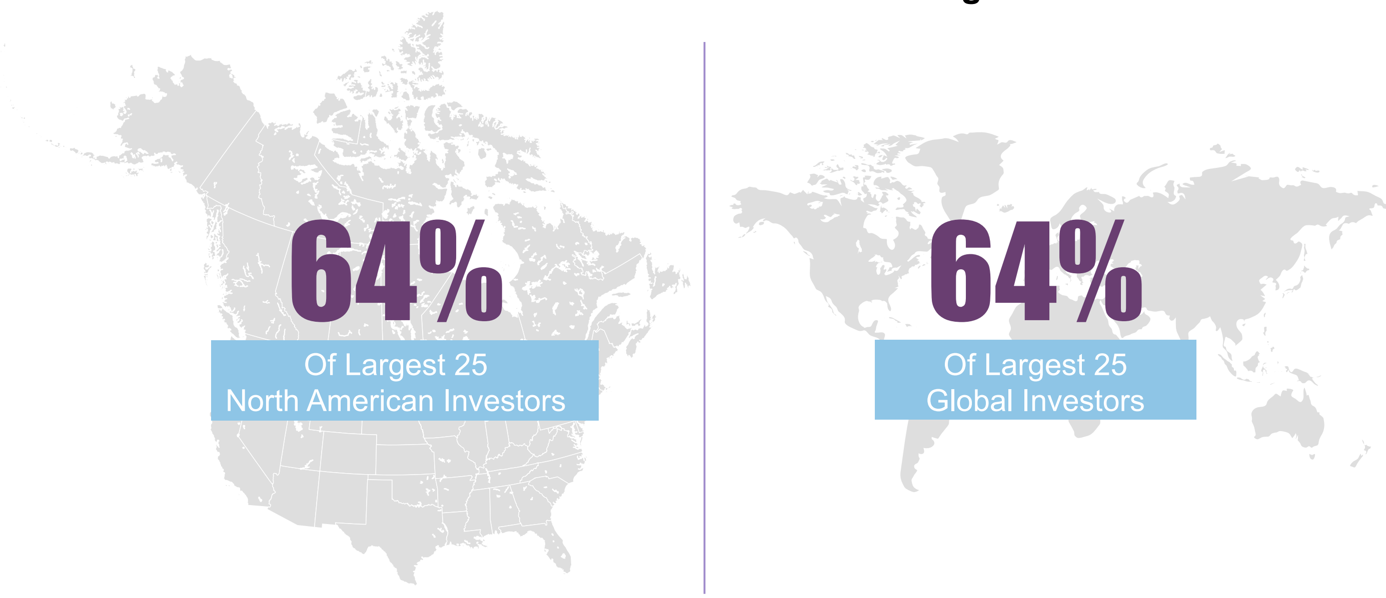
Key Takeaways

- In 2023, more institutional investors will likely consider REITs as part of portfolio completion strategies to gain geographic diversification or sector diversification, or to enhance their portfolios' ESG attributes.
- REITs offer sector diversification by giving investors better access to property sectors that house the modern economy, such as cell towers, data centers, self-storage, health care, industrial, and logistics.
- REITs offer geographic diversification; there are a total of 865 listed REITs in more than 40 countries and regions, with a combined equity market capitalization of $2.5 trillion.
- REITs enhance portfolios' ESG attributes because they provide access to best-in-class performers in environmental stewardship, social responsibility, and good governance.

Nearly Two-Thirds of Top North American and Global Plans Use REITs in Their Real Estate Allocation

REITs are widely used in the real estate strategies of nearly two-thirds of the largest and most sophisticated institutional real estate investors in the United States and globally. Approximately 64% of the top 25 largest defined benefit and sovereign plans in both North America and the world as a whole use REITs to optimize their real estate investment portfolios. Taken together, these top U.S. and global plans have, on average, $430 billion in total assets under management with an average real estate portfolio of more than $30 billion.

Institutional Investors REIT Usage



Note: Figures represent public plans and sovereign wealth funds that invest at least 1% of their total AUM in real estate and invest in REITs as part of their Real Estate allocation. This does not include investors who use REITs as part of their equity allocation. Not shown: 68% of non-U.S. public plans use REITs in their real estate allocation.

REITs have long been recognized as playing a key role in helping institutional investors meet their real estate allocation objectives by taking advantage of relative valuation opportunities and improving their portfolios' overall risk/return profile. Research by Nareit and CEM Benchmarking, Inc. shows that REIT returns have consistently outperformed private real estate by around 2% per year and, because of the timing differences between public and private real estate, provide "temporal" diversification.

Institutional investors also increasingly understand that investing with REITs allows allocators to be nimbler and more targeted in overweighting or underweighting specific sectors or geographic regions.

In 2023, we expect to see more institutional investors considering REITs as part of portfolio completion strategies. The term "portfolio completion" is used to indicate that REITs are being used in a key investment role to optimize, or complete, an aspect of a real estate portfolio.

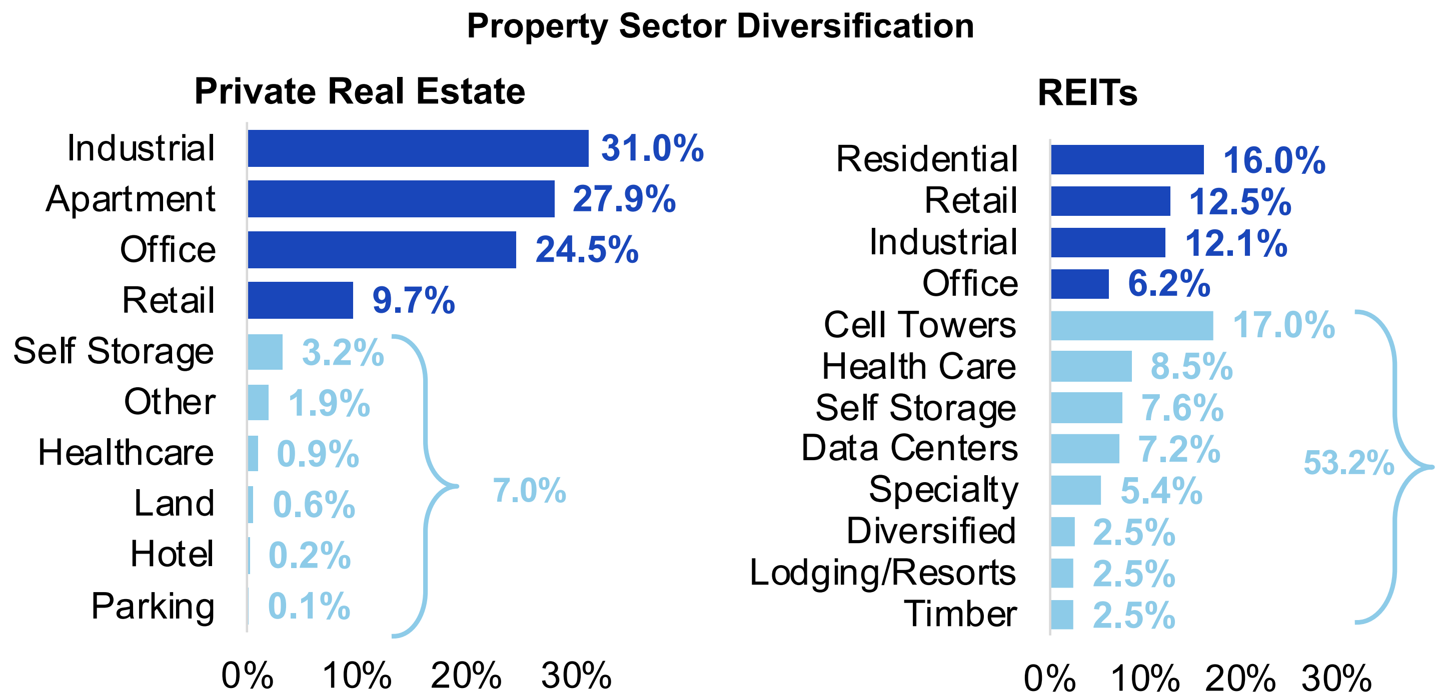
This could encompass: geographic diversification, by using non-U.S. REITs and listed real estate; sector diversification, to get access to modern economy sectors that tend to be better covered by REITs than private real estate; and ESG enhancement, by increasing a portfolio's ESG attributes.

REITs Offer Geographic Diversification

As of December 2021, there are 865 listed REITs with a combined equity market capitalization of approximately $2.5 trillion in more than 40 countries and regions around the world. Investors can easily diversify the geographic footprint of their real estate portfolio using REITs and listed real estate without the need to build out dedicated international teams or an on-the-ground presence.

REITs Offer Property Sector Diversification

Many legacy institutional real estate portfolios are currently overweight office and retail, and correspondingly underweight in modern economy sectors. REITs can be very attractive to those investors looking to increase their exposure to newer, alternative economy sectors, including cell towers, health care, data centers, self-storage, and others.



Source: NCREIF Open End Diversified Core Equity ending market value as of Q2 2022 via NCREIF; FTSE Nareit All Equity Index, equity market capitalization as of June 30, 2022 via Factset.

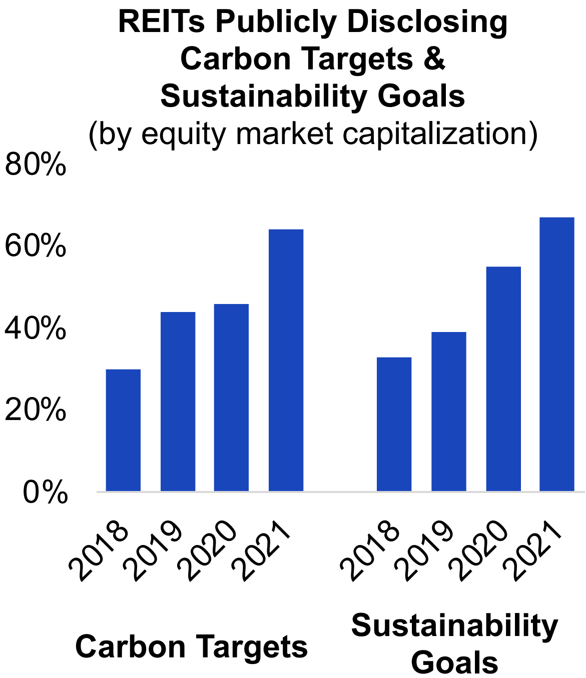
The chart above demonstrates how REITs provide better access to these newer and alternative real estate sectors.

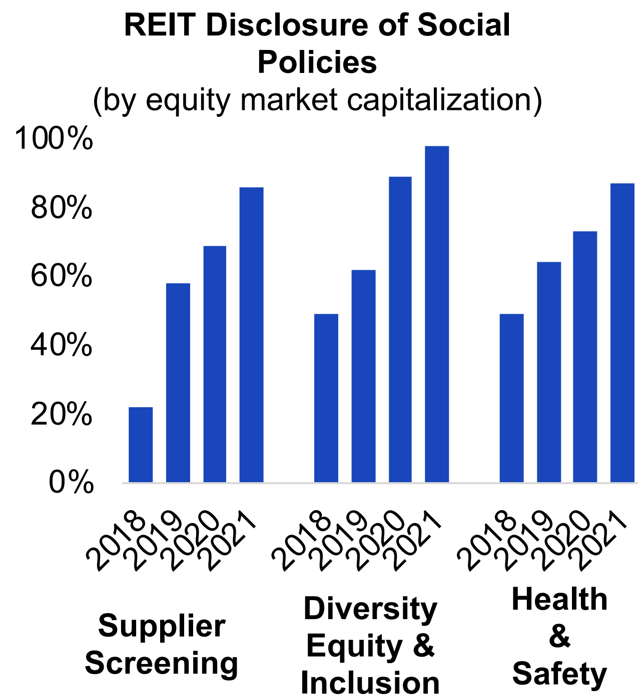
This diversification is a key factor as to why REITs are appealing to so many institutional investors that are looking to diversify the sectors and geographies of their real estate holdings.

REITs Enhance ESG Attributes

Over the past decade, institutional investors have become increasingly concerned with the ESG profile of their investment portfolio. For these investors, REITs provide access to some of the best-in-class performers in each dimension of E, S, and G.

REITs Expand ESG Disclosures





Source: Nareit ESG Dashboard.

As the chart above indicates, REITs are setting targets to address sustainability and climate change and are increasing disclosure around key social issues.

REITs provide geographic diversification, sector diversification, and can enhance a portfolio's ESG attributes. In 2023, more institutional investors will likely consider REITs as part of portfolio completion strategies because of these benefits.