Q3 2023 Market Overview

In Heitman's view, investors became more optimistic during the quarter that the United States and other major economies around the world would be able to avoid a recession, with a few notable exceptions.

During the third quarter of 2023, the United States economy was able to maintain positive employment growth and decelerating consumer price inflation growth.[1] [2] The nonfarm payrolls during the quarter averaged a little more than 265,000 per month. We believe that these payroll numbers, coupled with year-over-year CPI ex-food and energy declining from 5.3% for May 2023 to 4.3% for August 2023, helped increase the odds that Federal Open Market Committee ("FOMC") may be able to engineer a "soft landing" of the US economy while bringing inflation under control. Other releases supporting a "soft landing" include retail sales month-over-month growth remaining positive[3] and GDP growth of 2.1% reported for the second quarter of 2023.[4] On the concerning side, in Heitman's view, tighter bank lending standards (as measured by the Senior Loan Officer Opinion Survey) and FOMC rate hikes can lead unemployment by roughly two years.[5]

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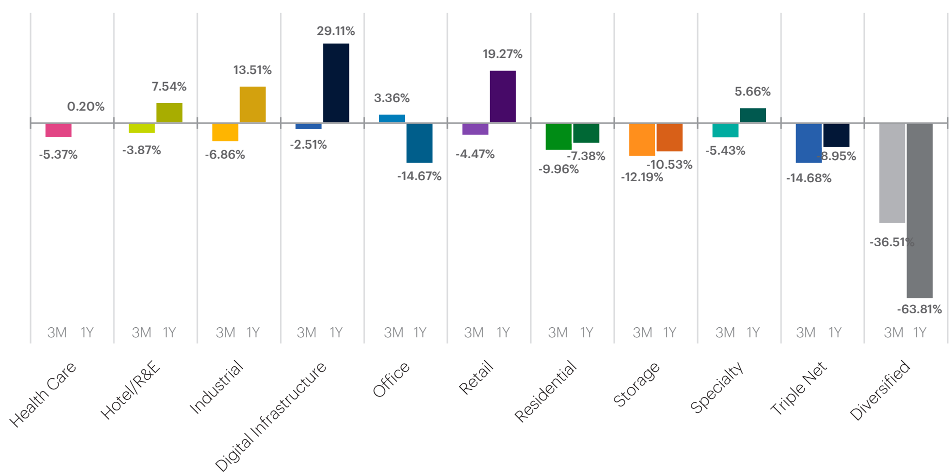
The FOMC left the Fed Funds rate unchanged at its latest meeting in September of 2023.[6] In its statement, we believe they kept their hawkish bias by noting that they would determine the "extent of" additional policy firming that may be appropriate. They also noted that while the "banking system is sound and resilient," tighter credit conditions "are likely to weigh on economic activity, hiring, and inflation," though the extent of these effects "remains uncertain." In the projection materials that they provided, there was an indication that the committee now only expects 50 basis points ("bps") of cuts in 2024,[7] verse the 100 bps of cuts in the previously provided projections.[8]

REIT Market Review – Q3 2023

During the second quarter of 2023, the FTSE NAREIT Equity Index returned negative 7.13%.[9]

FTSE NAREIT EQUITY REITS PERFORMANCE AS OF 9/30/23



1 Bloomberg Inc. NonFarm Payroll data retrieved 9 October 2023
2 Bloomberg Inc. CPI XYOY data retrieved 9 October 2023
3 Bloomberg Inc. RS data retrieved 9 October 2023
4 Bloomberg Inc. GDP data retrieved 9 October 2023
5 PCS Marco 4 October 2023 Research Report
6 https://www.federalreserve.gov/newsevents/pressreleases/monetary20230920a.htm
7 https://www.federalreserve.gov/monetarypolicy/fomcprojtabl20230920.htm
8 https://www.federalreserve.gov/monetarypolicy/fomcprojtabl20230614.htm
9 All performance is quoted in US Dollars.

According to Bloomberg data, $9.2 billion of equity issuance was announced during Q2 2023, up from $7.1 billion in the prior quarter.[10] Digital Realty Trust, Inc. and Physicians Realty Trust led the equity issuances at $1.5 billion and $600 million, respectively. We believe REIT balance sheets remain attractive relative to private real estate market norms, as evidenced by Heitman's estimate of 28.9% debt to estimated asset value, which along with access to corporate bond and equity market may put REITs in the position to play offense amid a deteriorating macro-economic environment.

M&A remains active in the retail sector with Kimco Realty Corp. announcing the acquisition of RPT Realty for a total valuation of $2 billion. Kimco views the deal as strategic given the 70% overlap with their current markets and expands the target markets of Miami, Tampa, and Boston. Furthermore, Kimco stated that RPT's in-place rents are at 20% below market and is immediately accretive to earnings.[11] The hotel sector also saw M&A with private equity firm KSL Capital Partners taking Hersha Hospitality Trust private in an all-cash transaction valued at $1.4 billion, a 60% premium to Hersha's trading price.[12]

Within the REITs, the best-performing subsectors for the September 2023 quarter included office (up 3.36%), followed by digital infrasture (down 2.51%), and hotels (down 3.87%). The triple-net sector lagged the most, down 14.69%, followed by storage, which was down 12.19%.

The office sector return was likely a result of the increased return to office announcements and mandates from large companies, including Amazon, Meta, and JP Morgan, in our view. The sector outperformance was also likely furthered by SL Green Realty Corp. selling a minority interest in 245 Park Avenue at a valuation well beyond market expectations.[13] While these events are incrementally positive, we believe more is required for the office sector to stage a full rebound.

Digital Realty drove the performance in digital infrastructure. While AI demand holds much promise for future demand, the persistent demand and increasingly limited supply on power availability constraints is driving current rent growth, in our view. This strong current and future demand is reflected in the forward-looking commentary of the three largest hyperscale technology companies. As an example, during the Q2 2023 earnings call, Facebook/Meta stated the following: "We expect both data center spend to grow in '24 as we ramp-up construction on sites with the new data center architecture that we announced late last year. And then we certainly also expect to invest more in servers in 2024 for both AI workloads to support all of the AI work that we've talked about across the core AI ranking recommendation work along with the next gen AI efforts."[14] Regarding the hotel performance, as previously mentioned, the sector return benefited from the news of Hersha Hospitality being taken private by KSL in an all-cash transaction valued at $1.4 billion, a 60% premium to Hersha's trading price.[15]

Regarding the underperforming sectors, the triple-net REITs sector is bearing the brunt of higher interest rates, given the lower internal profile and long lease terms resulting in a more "bond-like" valuation construct by the market, in our opinion. This sector's negative return was concentrated in the Agree Realty Corporation and Netsreit Corporation positions and detracted three bps versus the benchmark. The negative storage performance is attributed to lower demand and market rent growth as life needs normalize post-COVID and a continued

10 Bloomberg, Inc. data retrieved 9 October, 2023
11 Kimco company presentation https://s1.q4cdn.com/944058265/files/doc_presentations/2023/08/Kimco-Realty-to-Acquire-RPT-Realty-Joint-Presentation.pdf
12 Costar report 28 August, 2023 https://www.costar.com/article/1578584691/ksl-capital-to-acquire-hersha-hospitality-trust-for-14-billion
13 SL Green 26 June, 2023 press release https://slgreen.gcs-web.com/news-releases/news-release-details/sl-green-announces-sale-499-interest-245-park-avenue
14 Bloomberg 26 July 2023
15 Costar report 28 August, 2023 https://www.costar.com/article/1578584691/ksl-capital-to-acquire-hersha-hospitality-trust-for-14-billion

sluggish home sales environment, in our view. The continued weakness is most apparent in the Public Storage Inc. August 2023 investor update that cited move-in rents down 17.1% as of Q3 2023 to date over the prior year period.[16] The storage sector's negative performance lies in the Extra Space Storage Inc. and Public Storage positions.

Outlook

In line with previous months, the outlook for REITs remains mixed, in our view. While valuations remain attractive compared to private real estate and broad equities and are seemingly pricing in negative macro-economic outcomes, in Heitman's opinion, the potential for a "hard landing" or even higher interest rates present risk more broadly.

US REITs have strong operational performance and balance sheets and are well-positioned to navigate economic and market uncertainty.[17] Q2 2023 earnings season served as a reminder of the positive fundamentals within public REITs[18] by posting 4.1% earnings growth[19] over the prior year period. Additionally, 65% of public REITs exceeded expectations and 66% increased full year guidance.[20] Looking beyond the quarterly results, analyst consensus estimates indicate earnings growth of 6.6% and 5.6% in 2023 and 2024, respectively.[21]

US REITs have strong operational performance and balance sheets and are well-positioned to navigate economic and market uncertainty

In our view, much of this resilient growth is the result of the various secular and needs-based demand drivers, which include ageing demographics, on and near-shoring supply chain reconfiguration, continued growth in data potentially further by AI, and omni-channel (in-store and curb side retail pick-up/drop-off), which stand to benefit the senior housing/single family rental, industrial, data center, and open-air retail sectors, respectively. However, we are watching the apartment, retail, and industrial sectors closely for the risk of declining consumer sentiment on economic concerns as the monetary tightening takes effect. The office sector outlook remains generally negative in our opinion, but the tenant flight to quality assets and landlords with strong balance sheet, presents a compelling case for Prime REITs.

Overall, Heitman remains focused on the opportunities presented in these volatile markets by focusing on stocks with identifiable catalysts and strong secular trends that are underappreciated by the market. We continue to focus on higher-quality assets and strong balance sheets while taking risks where lower-quality opportunities arise.

16 Public Storage company update https://s1.q4cdn.com/588671402/files/doc_presentations/2023/09/Company-Update-Sept-23-vF.pdf
17 REIT Market Outlook 2023 | Nareit
18 Public REITs are defined as the FTSE NAREIT Equity Index.
19 Earnings is defined as Funds from operations. Source is Bloomberg data and company press releases.
20 Bank of American equity research US REITs August 11, 2023
21 Bloomberg data of sell-side earnings estimates.

Disclosures

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