The Real Interest in Real Estate

Funds in focus: Brompton Global Real Assets Dividend ETF (BREA), Brompton Global Dividend Growth ETF (BDIV), Global Dividend Growth Split Corp (GDV)

On the back of solid re-opening fund flows, the REIT sector posted outsized gains so far this year. The U.S. REIT sector returned 28.8% year to date, outperforming the S&P 500 by 11.1%; the Canadian REIT sector also posted strong returns, gaining 26.2% year to date versus the S&P TSX Composite Index, which gained 17.8%[1]. Some readers may find this surprising since the U.S. 10-year treasury rate followed an upward trajectory throughout the first quarter and REITs are traditionally considered to be negatively correlated with the U.S. 10-year due to their bond proxy nature. Others may wonder if the REIT sector has run too hot. REITs are also tied to the economy and the rising 10-year yield indicates a strengthening economy. In our view, the sector should continue to benefit from the reopening trade and improving fundamentals.

As the chart below demonstrates, over the past two decades, REITs have generally outperformed the S&P 500 regardless of the direction of the 10-year treasury rate. REITs have outperformed the S&P 500, 56% of the time when interest rates were rising, and 62% of the time when interest rates were declining.

Exhibit 1: Number of years when REITs outperformed or underperformed the S&P 500 when the 10-year Treasury rate increased or decreased

2000-2021 YTD		Outperformed the S&P 500	Underperformed the S&P 500	Outperformed the S&P 500	Underperformed the S&P 500
		Number of Years		Percentage of Years	
REITs	Rates ↑	5	4	56%	44%
	Rates ↓	8	5	62%	38%

Source: Goldman Sachs (July 8, 2021)

A deeper dive within the REIT complex paints a more accurate picture of each subsector's performance. Over the past 6 months, the strength of the sector is mainly driven by retail, apartments, and offices. Hotels, retail and offices were most heavily impacted by COVID-19 in 2020, but have recovered off their troughs stronger than other subsectors in 2021. As seen below, those sectors have all seen meaningful FFO multiple expansions (Funds From Operations) in excess of 25% (Exhibit 2). On the other hand, Data centers, Towers and Industrial REITs benefited the least from the reopening trade. Although their fundamentals remain strong and have all outperformed the S&P 500, their respective performance were eclipsed by their more cyclical peers.

Exhibit 2: Consensus 2021 FFO per share estimate revisions, share price performance, and multiple expansion/contraction by property type since the beginning of 2021

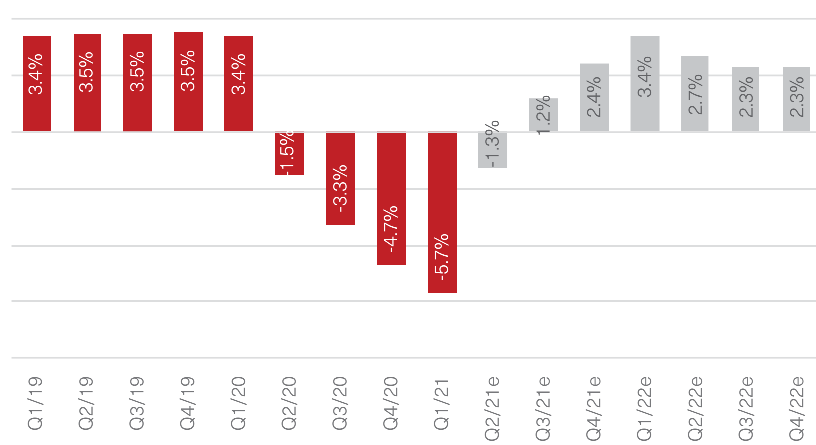
Subsector	Total Market Cap ($mn)	Estimate Change	Price Change	2021E FFO Multiple 1/1/21	2021E FFO Multiple 7/6/21	Multiple Expansion
Malls	$48,382	1.2%	52.3%	8.5x	12.7x	51.6%
Apartments	$126,167	-4.9%	33.4%	19.1x	26.8x	40.4%
Strip Center	$15,859	0.5%	37.2%	11.0x	15.0x	36.6%
Office	$57,054	-3.1%	22.4%	13.3x	16.8x	26.5%
Storage	$75,283	9.2%	37.5%	21.2x	26.7x	25.9%
SFR	$34,689	4.8%	31.7%	22.8x	28.6x	25.7%
Student Housing	$6,578	-8.1%	13.5%	20.5x	25.3x	23.5%
Industrial	$118,746	4.0%	22.4%	25.9x	30.5x	17.7%
Data Centers & Towers	$378,353	1.1%	19.0%	24.3x	28.6x	17.6%
Net Lease	$49,700	-0.5%	13.4%	16.5x	18.7x	14.0%
Hotels	$24,829	64.1%	14.0%	35.5x	-23.8x	-3.6%
REITs Mkt Cap Wtd Avg		**2.7%**	**25.1%**	**21.7x**	**24.8x**	**23.6%**
S&P 500		**14.7%**	**15.6%**	**22.8x**	**22.9x**	**0.8%**

Source: Goldman Sachs (July 8, 2021)

Each subsector was found to behave differently in different interest rate regimes. According to Goldman Sachs, when interest rates rise, subsectors with shorter lease terms, such as hotels, storage and apartments, tend to benefit, as landlords can more readily adjust to market rates as economic conditions change. Office REITs are found to be more sensitive to interest rates, where they tend to outperform the REIT index when interest rates are rising and underperform when interest rate decline. This is due to its ties with the labor market. Employment growth is a major driver for office demand; when interest rate rise, economic activities, along with employment growth tend to pick up. Industrial REITs have generally outperformed REITs during both rising and declining rate environments. This can be attributed to the strong secular tailwinds the sector has faced, especially during COVID where e-commerce activities saw a permanent boost.

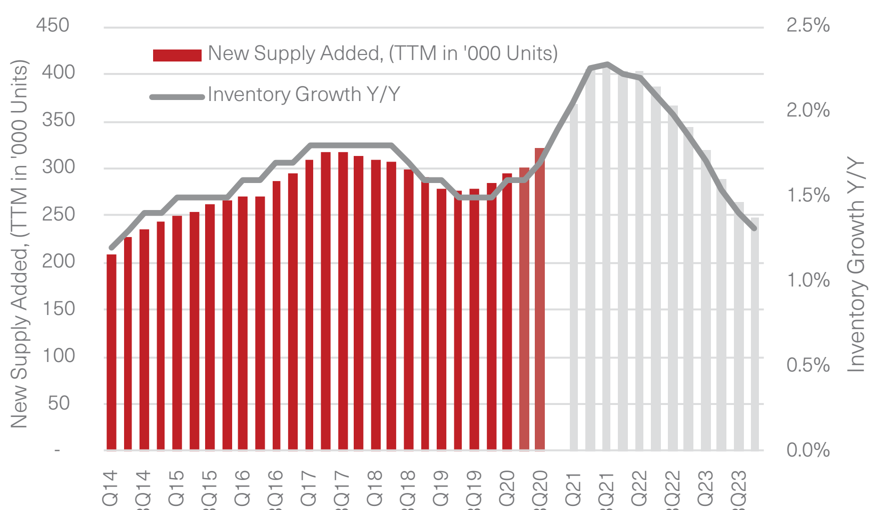
We are more confident about the REIT sector's performance looking out to the rest of the year, where we expect the U.S 10 year to continue to gyrate between 1.2% and 1.8%. We currently have a bullish view on REITs in general, particularly on residential, retail (shopping centers) and industrial REITs. The multifamily subsector, despite trading at a Price-to-FFO per share premium to the REIT sector, should continue to be robust. Same store revenue growth for the sector is expected to reach an inflection point from negative to positive in Q3 of this year (Exhibit 3), and new supply build has slowed down or paused across many major REIT markets (Exhibit 4). The sunbelt region in particular will benefit disproportionately more from the reopening trade, especially when interest rate rises, as suburban markets face an influx of renters from coastal cities.

Exhibit 3: Multifamily REIT actual and projected same store revenue growth



Source: Scotiabank (June 24, 2021). Forecast as of January 2021.

Exhibit 4: Multifamily inventory growth to peak out in 2021



Source: Scotiabank (June 24, 2021). Forecast as of January 2021.

Shopping centers are currently trading at their 3-year average as measured by P/FFO per share spread to the REIT sector. The sector was dominated by rent deferrals and high vacancy rates in 2020, but since then, vacancy rates have troughed and occupancy rates have stabilized. This sets up the sector for easy comparables in the second and third quarter this year. As economies get back to normal, leasing momentum and acquisition opportunities should be plentiful. Alongside growing funds from operations, we see industry constituents raising their dividends later this year. Lastly, sectors that are tethered to the digital economy theme like industrial properties, data centers and towers should continue to see robust demand even as the pandemic wanes.

Brompton's Approach

Brompton Global Real Assets Dividend ETF ("BREA") has material exposure to real estate and has broad exposure across the REIT complex, such as residential, industrial, retail and tower. We prefer to invest in players that have market leading positions, management expertise and above average FFO growth. Several of our global dividend growth funds including Brompton Global Dividend Growth ETF ("BDIV") and Global Dividend Growth Split Corp ("GDV") also have exposure to the themes discussed in the piece. The REIT sector has many constituent parts and different economic factors and backdrops affect the positioning of those sub-sectors. We believe that active management allows the best opportunity to adjust portfolio positioning as this attractive sector continues to recover.

[1] Source: Bloomberg, as of July 12, 2021.

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