REITs: why now?

January 2023

For professional investors only. In Switzerland for Qualified Investors only. Not for use by retail investors.

Creating more for clients and for society

Following strong inflation in 2022 and several rate hikes, 2023 is likely to see the Federal Reserve (Fed) change strategy to avoid a deep recession. History shows that listed real estate investment trusts (REITs) perform well after a hiking cycle. With a 25% decline in the global REITs index in 2022, values have adjusted ahead of the direct real estate market. We believe current values now offer an attractive entry point for long-term investors. Not all REITs are equal, though, and we would suggest an active approach to investment given the significant dispersion of returns.

REITs perform well after a hiking cycle

Inflation during 2022 ended up being less transitory than first thought, which prompted the Fed to raise rates at a much faster pace than initially expected. The sharp increase in interest rates throughout the year had a negative impact on bond and equity market valuations. The abrdn Research Institute expects inflation to continue to decelerate during 2023, allowing the Federal Open Market Committee (FOMC) to reach the terminal Fed funds rate in the first quarter of 2023 and possibly cut rates in the second half of 2023.

Real estate tends to perform well following the end of a rate hiking cycle because of the correlation between bond yields and real estate valuations. The two asset classes share similar characteristics, such as long duration and predictable cashflows.

On a relative basis, REITs also tend to outperform other listed equities after a rate hiking cycle. For instance, after the 1973 bear market (which shared many similarities with the 2022 bear market) and a pivot from the Fed in December 1974, the listed real estate sector returned 59% in the following 12 months, compared with 36% for the wider equity market. Similarly in the 12 months after the global financial crisis, the listed real estate sector returned 74%, compared with 49% for the wider equity market (see chart one).

Chart one

Global real estate versus global equity performance pre/post Fed 1974 pivot and pre/post the global financial crisis (GFC) in 2008

Mar-09	-12m	-3m	+3m	+12m
Real estate	-51.2%	-19.6%	26.7%	73.5%
Market	-44.0%	-12.5%	19.7%	49.1%

Dec-74	-12m	-3m	+3m	+12m
Real estate	-39.0%	-42.8%	45.1%	59.0%
Market	-26.3%	-4.5%	23.8%	36.0%

Source: Exane BNPP, Bloomberg, abrdn.

REITs perform relatively well in a low-growth environment

According to forecasts from the World Bank, the global economy should experience a mild recession in 2023 and possibly 2024. Due to the long leases of the underlying assets, REITs are generally less sensitive to the economic environment and income tends to be resilient in economic downturns. Some sub-sectors (such as flexible offices or hotels) are more cyclical than others (residential), though, and overall demand will be affected by a slowdown in growth.

Positioning our clients to benefit from a fast-changing world

abrdn.com

But sectors that benefit from demographic changes, such as nursing homes, should continue to see healthy activity. We expect this sector to generate solid earnings growth and value, which should outperform the broader market. Similarly, we expect the reshoring of capital expenditure to remain strong, even in a recession, supported by the US/China decoupling and de-globalisation. This should support the right logistics portfolios.

REITs valuations have been faster to adjust than direct real estate

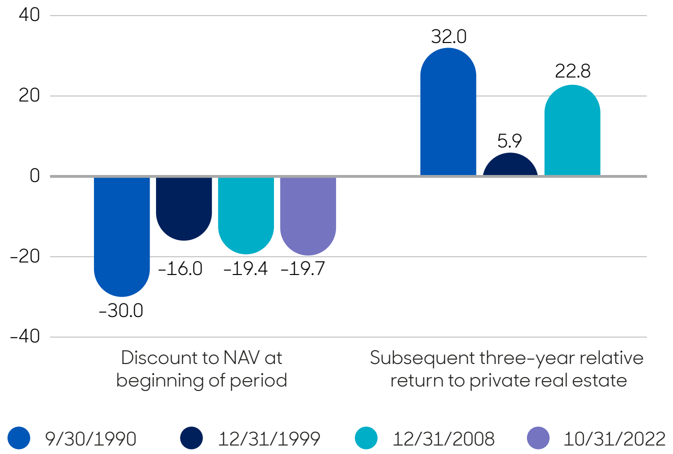
Listed REITs are more liquid vehicles than direct real estate and tend to anticipate moves in the direct market. Our research suggests that listed real estate leads performance of the direct market by between six and nine months. In 2022, share prices for UK REITs started to decline in the first half of the year, while the CBRE UK real estate index only started to show declines in September 2022. Similarly, it is likely that REITs will anticipate the turning point in direct real estate valuations and move ahead of the rebound in the direct market. This creates a potential arbitrage opportunity for investors (see chart two).

Chart two

Significant discounts to NAV for REITs have preceded outperformance relative to direct real estate.

Relative returns for US REITs compared with direct real estate

%



Sources: UBS, FTSE Nareit, MSIM, as at October 31, 2022.

REITs offer an attractive relative and absolute entry point

Over the course of 2022, the listed real estate sector underperformed the wider equity market in most countries. For example, UK listed REITs performed in line with the FTSE 250 over the last five years until April 2022, but underperformed by 23% for the remainder of the year (see chart three).

Chart three

UK REITs versus the UK equity market

UK REIT versus FTSE 250

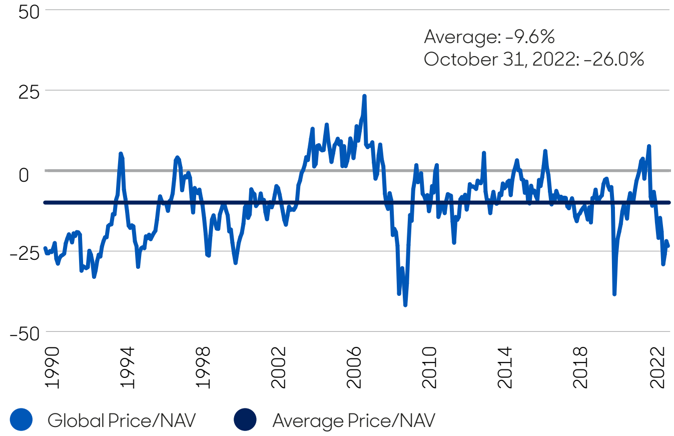
Source: Bloomberg, abrdn, Dec 2017 to Dec 2022.

Currently, market pricing for the listed real estate market implies an asset value correction of 15-20%. In Europe, the sector has derated significantly and is now trading at large discounts to spot net asset values (NAVs) (see chart four). The largest discounts can be found on the continent, with German residential names trading at historically wide discounts. Current valuations also reflect several other factors, such as the weakness of some corporate balance sheets or investor sentiment. The listed REITs sector tends to exaggerate direct valuation moves on the way up and on the way down. We believe that this provides mispricing opportunities for selected sub-sectors/stocks that have been sold-off indiscriminately.

Chart four

Global REITs currently trading at significant discounts to NAVs – an interesting arbitrage opportunity compared with direct real estate

%



Source: UBS, 1990-2022.

Not all REITs are equal

While we believe that the REITs sector offers a good entry point, we acknowledge that opportunities vary significantly by region, sub-sector and even by company. For instance, we believe that onshoring and sustainability will play a major part in driving performance over the next decade. While demand slows within the economy, supply may slow even more in some sub-sectors. Developers are likely to have a harder time underwriting new projects, given the spike in construction costs combined with the more difficult financing environment. Some other sectors, such as retail, may need to adjust rents even lower as consumption slows.

Investors need to be selective and factor-in the long-term trends currently reshaping the real estate universe. Structural market disruptors, such as ecommerce, are expected to further polarise sector performance. The significant dispersion in performance, at both a regional and sub-sector level, is likely to create a wealth of opportunities for active investors.

More opportunity. More potential. More impact. Forward-thinking solutions to meet your needs and deliver more sustainable outcomes.

Important Information

This communication constitutes marketing, and is available in the following countries/regions and issued by the respective abrdn group members detailed below. abrdn group comprises abrdn plc and its subsidiaries:
(entities as at 28 November 2022)

United Kingdom (UK)

abrdn Investment Management Limited registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL. Authorised and regulated in the UK by the Financial Conduct Authority.

Europe[1], Middle East and Africa

[1] In EU/EEA for Professional Investors, in Switzerland for Qualified Investors - not authorised for distribution to retail investors in these regions

Belgium, Cyprus, Denmark, Finland, France, Gibraltar, Greece, Iceland, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain, and Sweden: Produced by abrdn Investment Management Limited which is registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL and authorised and regulated by the Financial Conduct Authority in the UK. Unless otherwise indicated, this content refers only to the market views, analysis and investment capabilities of the foregoing entity as at the date of publication. Issued by abrdn Investments Ireland Limited. Registered in Republic of Ireland (Company No.621721) at 2-4 Merrion Row, Dublin D02 WP23. Regulated by the Central Bank of Ireland. **Austria, Germany**: abrdn Investment Management Limited registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL. Authorised and regulated by the Financial Conduct Authority in the UK. **Switzerland**: abrdn Investments Switzerland AG. Registered in Switzerland (CHE-114.943.983) at Schweizergasse 14, 8001 Zürich. **Abu Dhabi Global Market ("ADGM")**: Aberdeen Asset Middle East Limited, 6th floor, Al Khatem Tower, Abu Dhabi Global Market Square, Al Maryah Island, P.O. Box 764605, Abu Dhabi, United Arab Emirates. Regulated by the ADGM Financial Services Regulatory Authority. For Professional Clients and Market Counterparties only. **South Africa**: abrdn Investments Limited ("abrdnIL"). Registered in Scotland (SC108419) at 10 Queen's Terrace, Aberdeen AB10 1XL. abrdnIL is not a registered Financial Service Provider and is exempt from the Financial Advisory And Intermediary Services Act, 2002. abrdnIL operates in South Africa under an exemption granted by the Financial Sector Conduct Authority (FSCA FAIS Notice 3 of 2022) and can render financial services to the classes of clients specified therein.

Asia-Pacific

Australia and New Zealand: abrdn Australia Limited ABN 59 002 123 364, AFSL No. 240263. In New Zealand to wholesale investors only as defined in the Financial Markets Conduct Act 2013 (New Zealand). **Hong Kong**: abrdn Hong Kong Limited. This document has not been reviewed by the Securities and Futures Commission. **Malaysia**: abrdn Malaysia Sdn Bhd, Company Number: 200501013266 (690313-D). This document has not been reviewed by the Securities Commission of Malaysia. **Thailand**: Aberdeen Asset Management (Thailand) Limited. **Singapore**: abrdn Asia Limited, Registration Number 199105448E.

For more information visit abrdn.com

GB-230223-188420-2