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U.S. Real Estate Investment Trust (REIT) Industry Analysis & COVID-19 Impact

FINANCIAL SERVICES SECTOR REPORT

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ANALYST(S)

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Companies mentioned in this report followed by Edward Jones:

- **American Tower** (AMT - Buy; $255.93)
- **Digital Realty** (DLR- Hold; $142.69)
- **Duke Realty** (DRE - Hold; $35.31)
- **Equinix** (EQIX - Buy; $701.12)
- **Equity Residential** (EQR - Buy; $57.02)
- **Prologis** (PLD - Buy; $93.57)
- **Public Storage** (PSA - Buy; $192.89)
- **Realty Income** (O - Buy; $56.83)
- **Simon Property Group** (SPG - Hold; $63.69)
- **Ventas** (VTR - Hold; $34.89)
- **Welltower** (WELL - Hold; $50.02)

Source: Reuters. Prices and opinions ratings are as of 7/14/20 and subject to change.

Investment Overview

At Edward Jones, we view real estate as a good way to help improve portfolio diversification while providing relatively steady income streams for investors. For long-term-oriented individual investors, in particular, real estate investment trusts (REITs) are a good way to add that real estate exposure, in our view. In this report, we provide a REIT investment overview and our outlook for a variety of property types. Notably, we think the coronavirus has elevated the risks for retail, leisure, health care and office properties, while accelerating growth opportunities for industrial warehouse, data-center, and wireless-communications tower properties.

Investing in REITs can provide several advantages:

- **Asset-Class Diversification**. Many clients hold a balanced portfolio of U.S. stocks and bonds. Real estate is one of several other asset types, including commodities, high-yield bonds, and international stocks and bonds, that can diversity a portfolio. Diversification can potentially reduce volatility and enhance long-term investment returns.

- **Small Investment Size**. Direct commercial real estate investments, such as a motel or apartment building, can require a sizable one-time investment. REITs, which trade like stocks, can be purchased in almost any dollar amount.

- **Industry Diversification**. The purchase of REITs across several subindustries (building types) can also provide better diversification than buying individual properties.

- **Liquidity.** Most U.S. REITs trade on public exchanges, offering good liquidity. There are currently almost 200 publicly traded REITs, and about 30 are included in the S&P 500 Index.

- **Regular Income**. REITs generally offer attractive yields, and most pay regular quarterly dividends.

When investing in REITs, we recommend that investors first consider the type of real estate the REIT owns, as different types of real estate have different risks and demand drivers.

Please see important disclosures and analyst certification on page 5 of the report.

Industry Background

REITs are unique companies because they do not pay U.S. corporate income taxes. They were created in 1960 by a change in the tax laws to give individuals a way to invest in a diversified portfolio of real estate. In exchange for not paying taxes, REITs must distribute at least 90% of their taxable income to investors in the form of dividends. These dividends are generally taxed at the investor's individual tax rate. However, REITs qualified as a pass-through entity under the Tax Reform Act that passed in December 2017, which allows individuals to lower their taxes paid on dividend income by 20%. For example, if the shareholder's marginal tax rate is at 35%, under the new law that individual would pay taxes of 28% (35%x80%) on the dividend income. If a REIT pays out more than 100% of its taxable income, then a portion of the dividend in excess of taxable income is considered a return of capital. The return-of-capital component is not taxed in the year it is received, but rather is taxed when the REIT shares are sold.

Please note that Edward Jones, its employees and financial advisors cannot provide tax advice. You should consult your qualified tax advisor regarding your specific situation.

Analyzing REITs

When analyzing individual REITs, we look for companies that can add value through the day-to-day operations of the properties. For instance, we look for REITs with strong tenant relationships. Location is always important for real estate, and large, coastal cities probably offer the best demographic trends for REIT properties. In addition, the scarcity of available land in big cities can provide a barrier to new competition.

REITs typically report funds from operations (FFO) in addition to traditional profit measures such as net income and earnings per share (EPS). FFO is essentially net income prior to noncash and nonrecurring items, such as depreciation expense and amortization, and gains and losses from property sales. Unlike buying a computer, which declines in value in a matter of months, well-maintained real estate tends to appreciate over time. As a result, REIT analysts look at net income prior to depreciation and other noncash and nonrecurring items to determine the amount of cash available for paying dividends. Most REIT investors and analysts use FFO as the primary earnings measure for REITs. In our opinion, FFO provides investors with a more accurate assessment of the recurring cash flows being generated by a REIT than EPS.

The economic cycle, both up and down, can also present challenges for REITs. During a downturn in the economy, job growth slows and so does overall demand for office space, retail stores, and other real estate. During economic expansion, competition can emerge from newly constructed buildings. Given REITs pay out most of their income in dividends, they typically need outside funding to grow and expand. As a result, REITs are frequent borrowers from banks, insurance companies, pension funds, and public bond investors. When looking at REIT investments, we would pay close attention to corporate credit ratings from agencies such as S&P and Moody's. While the goal of REITs is to increase the dividend over time, we also note that REIT common dividends can be reduced should earnings decline.

Major REIT Property Types

Below are some major REIT property types. They typically offer investors good current dividend yields, combined with the potential for growth in dividends over time.

1) Apartments

Apartment REITs are probably the easiest type of REIT for individual investors to identify with, since most of us have paid rent to a landlord at some time in our lives. Over the long term, we expect apartment REITs to benefit from changing demographics, particularly the maturing of the millennial generation, which tends to rent longer and should positively impact apartment demand. We view the overbuilding of apartments in local markets as the biggest risk of investing in apartment REITs. We think high unemployment rates due to the health crisis are a risk that is currently being offset by steady white-collar employment and fiscal stimulus. We recommend large and geographically diversified apartment REITs to help reduce the risk of weakness in any particular market.

2) Retail

Some retail property types, such as shopping centers, have historically been among the most stable due to their long-term leases. However, high-profile tenant bankruptcies and struggling department stores, combined with inroads by e-commerce, have resulted in retail REITs falling out of favor. Additionally, the coronavirus-driven lockdowns have led to increased pressure on already struggling retailers with weak balance sheets, and will likely accelerate bankruptcies. While the environment has grown more challenging for retailers, and in conjunction, retail real estate owners, we believe high-quality retail REITs remain viable investments for long-term investors. We recommend REITs that are geographically diverse and have tenants across different industries (especially those resilient to e-commerce risks).

3) Industrial Properties

Industrial REITs have historically tended to be fairly sensitive to the economy. However, with an accelerated shift towards e-commerce due to the virus, we believe demand will only increase for warehouse properties. When looking for REITs in this sector, we focus on companies that have strong financial positions and facilities in high-barrier-to-entry markets such as coastal cities. We believe the long-term tailwind of e-commerce will continue to drive strong pricing power for distribution facilities.

4) Self-Storage

The self-storage industry benefits from increased consumer spending and relocation. Self-storage properties tend to generate high operating margins relative to other real estate sectors because operating costs and real estate taxes are often lower. In addition, capital-expenditure requirements and maintenance costs for self-storage properties are modest versus other real estate sectors. In our view, the biggest risk with respect to self-storage is the entry of unsophisticated competitors, given the relatively modest cost to develop and maintain a self-storage facility. This risk is mitigated to a degree by local zoning and entitlement requirements that often make the development of self-storage difficult.

5) Health Care

Health care REITs typically lease properties to health care providers under long-term contracts. For most health care real estate, demographic factors, rather than economic forces, tend to drive demand. Although an aging population is expected to drive demand for health care real estate over time, we believe there has been an oversupply in senior housing the past few years. Unfortunately, with elderly residents being particularly vulnerable and lockdowns limiting visits to medical facilities, the health care REIT sector has been among the most exposed to the virus. We believe this headwind could last for a couple years until effective treatments and a vaccine are developed.

6) Wireless Communication Towers

Infrastructure is a relatively new category of REIT, pioneered by companies operating wireless and broadcast communication sites leased mainly to cellphone service providers. These companies have attracted significant investor interest due to the rapid growth of wireless communications, with the next leg of growth being driven by 5G. In addition, growth opportunities have emerged in many international markets. Revenues are relatively predictable due to long-term lease contracts. Compared with U.S.-focused REITs, wireless-communications REITs face more foreign currency and geopolitical risk. Any industry consolidation among cellphone service providers could also present future challenges. We believe demand has been relatively unaffected by the virus.

7) Data Centers

Data centers are another infrastructure property type that we believe will be relatively less affected by COVID-19. In fact, with the accelerating digitalization of the economy, we think data centers stand to benefit over the long term. Demand for data centers will be driven by trends such as cloud computing, 5G, artificial intelligence, and working from home. We think data-center REITs that have strong customer relationships with leading cloud and communication services firms will be able to attract many other tenants to their ecosystems.

Figure 1. REITs Followed by Edward Jones

Property Type	REIT Stocks and Ratings
Apartment	Equity Residential (EQR - Buy)
Cell Tower	American Tower (AMT - Buy)
Data Center	Digital Realty Trust (DLR - Hold)
Data Center	Equinix (EQIX - Buy)
Health Care	Ventas (VTR - Hold)
Health Care	Welltower Inc. (WELL - Hold)
Industrial	Duke Realty (DRE - Hold)
Industrial	Prologis (PLD- Buy)
Retail - Mall	Simon Property Group (SPG - Hold)
Retail - Single-Tenant	Realty Income (O - Buy)
Self Storage	Public Storage (PSA - Buy)

Why do we not recommend many of the other sectors that our clients ask about? We believe the sectors we identified above may be less susceptible to downturns and have attractive total return prospects. Edward Jones also cautions against the ownership of REITs in very cyclical businesses, such as owning timberland. Below is a discussion of the risks and misconceptions associated with some other REIT sectors.

Mortgage REITs

As a whole, due to interest rate risk, we consider mortgage REITs too risky for individual investors to own. Although these companies can invest in high-quality mortgages, they do so using a lot of borrowed money. In essence, mortgage REITs are buying mortgage securities on margin. Using margin to buy investments can boost returns if the price of your investment goes up; however, they also magnify losses if the price of the assets decline. This makes the earnings, dividends and stock prices of mortgage

REITs very susceptible to rising interest rates. For additional information regarding mortgage REITs, please see our sector report "Mortgage REITs – High Yield but High Risk."

Hotels

Most hotel REITs do not operate hotels. Instead, the REIT leases the property to a hotel operator who then conducts the day-to-day operations of the business. As a result, by purchasing and leasing hotels to operating companies, hotel REITs essentially serve as providers of capital rather than hotel operators. Many of the hotel REITs lease the properties to the affiliates of senior management of the REITs. As a result, the potential exists for conflicts of interest between the REIT and the hotel operator when signing leases. The hotel industry is also cyclical, characterized by very short-term leases (often one to two days) and considerable risk of overbuilding. As a result, the REITs in this sector have greater risk than we feel investors seeking exposure to the Growth & Income investment category should assume. Due to the virus, we believe travel demand could be suppressed for years to come, as both leisure and business travel are affected.

Offices

The office sector tends to be cyclical in nature. Strong job growth, particularly in professional services, can lead to strong rental demand. REITs positioned in large coastal markets, such as New York and San Francisco, have high barriers to competition due to the scarcity of available land. On the other hand, suburban markets tend to have the risk of overbuilding. In response to social-distancing measures and shelter-in-place orders, many industries have utilized technology to work from home. Coming out of this crisis, we believe demand for office space will be lower than in previous recoveries, as many workers and companies have adapted to remote working. In our view, companies will look to cut office space to lower costs and hire more workers remotely to geographically expand their talent pools.

Private REITs

In addition to publicly traded REITs, there are also a number of private- and publicly registered nontraded REITs. While these private/nontraded REITs are generally required to meet the same general rules and regulations as publicly traded REITs (including payout of taxable net income as a dividend, holding at least 75% of its total assets in real estate assets, and deriving at least 75% of its gross income from rents from real property or interest on mortgages financing real property), there are also important differences between public REITs and private/nontraded REITs. These differences include very limited liquidity compared with publicly traded REITs, high selling commissions, dealer management fees and offering expenses, significant property and asset management fees paid to affiliates of the private REIT, and less transparency and public market scrutiny compared with publicly traded REITs.

We suggest clients consult with their financial advisor regarding any private REIT holdings. Edward Jones currently does not provide our clients with secondary market prices and/or assist in the sale or reregistration of private/nonpublicly traded REITs currently held outside of Edward Jones.

Valuation

In our analysis of equity REITs, we employ several valuation techniques. These include the current price-to-funds-from-operations (FFO) ratio versus historical ranges, the REIT share price in relation to its estimated real estate value, the average common dividend yield compared with historical ranges, the current common dividend yield compared with U.S. Treasury bond yields, and indicated value via a dividend discount model.

Risks

We believe economic recessions present the biggest risk to investing in REITs. During a recession, rents and real estate occupancy levels generally fall, resulting in lower earnings and related property values. In addition, if interest rates rise rapidly, REIT share prices could decline. Other risks to investing in REITs include a considerable increase in the amount of new construction (which would reverse the favorable demand-supply characteristics of the current market) and the potential for large common stock issuances. We note that because of their high payout requirement, REITs generally need to raise capital in order to finance their growth plans. These capital raises can impact the common share price of the REIT.

Conclusion

Although there may be REITs in some sectors that are considered solid companies, we feel individual investors are best served investing in REITs leading the apartment, industrial, self-storage, and health care property sectors, along with certain niche sectors such as wireless-communications towers and select retail property types. We feel these companies will provide appropriate total returns for investors seeking exposure to the Growth & Income investment category.

For more information, please see your financial advisor.

Please see our opinion on each of the companies mentioned in this report for more information on the benefits, valuation, and risks of investing in these stocks.

Required Research Disclosures

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