Research @ Citi Episode 69: The Reality of Real Estate

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Transcript:

Anne Malone (00:01)

Hey everyone. I'm Anne Malone, the North America Head of Equity Research at Citi. With me on the podcast today is Nick Joseph, the Global Head of Real Estate here at Citi Research.

Nick has just returned from the Citi Global Property CEO Conference. He's going to talk about themes and insights from the real-estate sector. Welcome, Nick — always good to talk to you.

Nick Joseph (00:20)

Thanks for having me, Anne. Excited to do it.

Anne Malone (00:22)

All right. So this should be good and fresh feedback from Florida. What are the themes that we have facing us in ‘26?

Nick Joseph (00:30)

So it's actually a pretty exciting time for real estate overall. We've seen underperformance eight of the last 10 years, actually. And so REITs are coming into the year and have seen significant outperformance to start 2026.

I think it's a handful of reasons.

Number one, you actually are seeing solid cash-flow growth — that's always good — driven predominantly by internal growth, but also some external growth. We've seen a return of a cost of capital to go out and acquire in a handful of sectors that's driving additional growth right now. You have solid and growing dividend yields.

You have inflecting and improving KPIs. Each subsector is a bit different there, but overall fundamentals are improving. And this is all with the backdrop of lower supply. And as you can imagine, we've had an oversupply situation in a handful of sectors — particularly apartments, industrial, life science — coming out of COVID. And right now those development pipelines have emptied out a bit, and we haven't seen the backfill. And so we're entering a period where you actually have pretty stable demand with lower supply and good operating fundamentals.

At the same time, valuations are reasonable. REITs aren't inexpensive, but they're not expensive either. And so we think that people have been able to focus on what is happening on the ground, and that's been a good story to tell.

Anne Malone (01:41)

OK, that's a lot. Let's start with, give some numbers on outperformance, just so we can put this in context.

Nick Joseph (01:48)

Absolutely. So I know we're talking in early March. REITs year-to-date are up about 10% total return. Broad market at this time is about flat. So pretty significant outperformance. But as I said, REITs have underperformed eight of the last 10 years, and so there's a lot of catch-up to continue.

Anne Malone (02:04)

Eventually it had to turn around, Nick, right? So I have all these positives, legit and fundamental to it. And I wanted to talk a little about those KPIs and I wanted to dig into supply. But first, in order to have an outperformance like that, and I would assume REITs as a percentage of the whole market, the flows in, let's talk a little about that. So you have a good setup, but then there's got to be money that's finding its way. So, where's that coming from?

Nick Joseph (02:30)

We do track fund flows weekly, actually. We publish on it. As you can imagine, the past few years, we've seen outflows from REITs to other areas of the market. And that's across mutual funds, that's across ETFs. And actually, there's about 3% ownership across U.S. REIT from Japanese mutual funds, and we've seen outflows from that channel as well.

This year, the flows have been about flat. That's a big improvement over what we've seen the past few years. To your question, what's driving it? I think it is AI broadly. If

I think about what has held REITs back over the past few years, outside of data centers, there isn't a direct AI beneficiary, as much as there are in some other subsectors across the broad market. This year, as you've seen more AI disruption as a theme across SaaS or other subsectors, I think REITs being tangible and maybe not having as much of a disruption potential — and there's certainly a broader potential that we can get into — I think REITs have been the beneficiary of that. I think they've been a safe haven, and actually retitled our conference review “A Shelter From the Storm.” And I think that really gets to it.

Anne Malone (03:38)

Oh, witty! That's a good one. What does that mean about who — is this generalist interest? Did you see anything from being down in Florida that tells you who and why and what is bringing the money into this?

Nick Joseph (03:50)

It's generalist. There's a large community of REIT dedicated investors, and so they are going to be invested in real estate and REITs broadly if REITs are doing well or REITs are not doing well. They're always in REITs. It's the dedicated interest that will really dictate how the absolute performance it is.

What we've seen this year in 2026 is actually more generalist interest. And I would tell you it's mostly on larger and liquid names. I think REITs have hit a thematic theme that generalist investors are interested in, and so you've seen kind of those inflows.

We saw that from our conference earlier this month. We had record attendance. We were up about 5% year over year. I think that's driven by those incremental people that may not have attended last year because REITs may have been more out of favor.

Anne Malone (04:33)

So the money flows into larger liquid names. Any geographic bias, or no?

Nick Joseph (04:37)

Not as much. It's been more market cap. Typically, what we'll see kind of the second leg of generalist interest will be diving into more different subsectors. It might be something that's focused on housing, or focused on storage, or healthcare, or industrial, all the different subsectors. But thus far, I would tell you, it's been much more of a market-cap and liquidity outlook.

Anne Malone (04:56)

All right. So, let's talk a little about the comment you said about lower supply post-COVID. Can you take us through that just a bit, set that scene of how that works? I can't believe this many years later there's still this COVID … I would call it "hangover," although it's sometimes positive. How do the mechanics on that work?

Nick Joseph (05:13)

Absolutely. So supply is very rational. During COVID, you saw a lot of demand, as you can imagine, for e-commerce that drove industrial rents. You saw a lot of demand on the life-science side, given some breakthroughs that we've seen on that front. And you also saw a lot of demand for residential, particularly on the apartment side, and single-family rental, as population shifts occurred.

And you've seen this from some of the coastal states, into the Sunbelt. That spurred higher rents in those Sunbelt markets. That then led to developers developing more product, because rents rose, underwriting improved for the ability to deliver. And so you saw construction pipelines increase.

But you can't just snap your fingers and deliver product. There's typically a development lag. Sometimes it could be up to 12 months, sometimes it could be up to 36 months, depending on where you're building and what you're building. And so coming out of COVID, we saw development pipelines grow significantly: coastal or Sunbelt apartments, industrial and life science.

We've started to see those deliver and those in-process pipelines coming down. Apartments probably peaked last year in terms of the number of units delivering. Industrial peaked earlier in 2025. Life science is still the area that we're still seeing deliveries, but even those are coming down. And so what that has done overall is brought down supply at a time that demand has normalized, and brought that more in equilibrium and allowed KPIs to inflect more positively.

Anne Malone (06:39)

OK, makes sense.

Now it is time — I held off as long as I could — to dig back into AI. You went through a couple of the subsectors here, and we should dig into those as favorites as well.

So what does AI bring on some of these subsectors? I assume this starts with what happens to the office of the future, just like we used to discuss, "Is the mall dying?" But what does AI do to some of these subsectors?

Nick Joseph (07:06)

It's a great question. I think there's the macro question and there's the micro question.

So the macro question is exactly what you asked. AI is clearly impacting every aspect of the economy, and we always say that REITs and real estate are the landlords to the economy. And so how people work, live, play is going to impact the demand for real estate and ultimately the value for real estate.

So where we have seen the most concern I would say right now is on the office side. And as you can imagine, if there's a concern that AI is going to have an impact on job growth overall, and white-collar job growth more specifically, that could ultimately impact the demand for office. I will tell you, in the near-term we have not seen that. If anything, you've actually seen new AI companies out in the market for office space.

Anne Malone (07:51)

I was just going to ask that.

Nick Joseph (07:54)

You've seen an increase in office demand. People are looking at the residual value in the medium and longer term. The concern is that organizations and companies are going to need less office space eventually, and you've seen that in the performance of the office stocks year to date.

We've also seen that on the commercial real-estate service firm side, and that is really because they have a decent exposure to office, both in terms of leasing and in terms of asset sales. And so you've seen some weakness there.

But clearly the question is, “What is this going to do to the economy?” And what does that mean for where people are going to work? How many jobs are needed? How shopping will be done? What the impact of business travel is for hotels? It really does impact every single aspect.

I'd mentioned early on, the one direct beneficiary of AI has been the data centers. And so what you've seen is obviously that's one area of supply you're actually seeing pick up. Now, power is a real constraint there, but you have seen data centers be the beneficiary of AI already. But that's the macro question, and I think it's something that we're trying to really keep a close eye on. And as you can imagine, it's changing by the day.

The micro question: We had 180+ CEOs from around the world at the conference earlier this month, and we asked each one, how are they using AI within their own organizations? And they're all experimenting in some way.

I'll tell you, real estate typically is — this might not surprise anyone — maybe not the first mover that other companies are. But real estate, they're trying different things. And I think they've seen some progress in terms of efficiencies on the back end. That could be on the leasing side, that could be on the underwriting, both in terms of tenant and new assets.

And then there's some exciting client-facing ones. I'm sure we've all been on different websites and talking to chatbots. As you can imagine, if you're renting an apartment or a hotel or a storage unit, there's a lot of improvement that you could have there, and they're already starting to see some benefits of that.

Anne Malone (09:42)

When you invest in AI, it's not always cheap. Anything material that you see coming to play as they invest? And as you said, they're all experimenting: Is that a pressure or a concern for anyone?

Nick Joseph (09:55

I wouldn't say it's a concern yet. We did ask each company, Are they building their own? Are they buying? Are they partnering? Almost all are partnering or buying. And so it's more licensing fees. There's certainly probably some increased spend on the technology side of it.

And I don't think, at least yet, we have heard directly efficiencies of headcount. There were a lot of conversations around, instead of using as many outside consultants, that they probably could have an opportunity to save money there. But right now, I think the spend is early days, and there is a lot of excitement on the potential efficiencies from those, and it's really productivity gains.

Anne Malone (10:33)

If we double back on macro, there was a lot I hadn't thought about the impact that you can have. Is it a question how much data centers are as a percentage of REITs as a whole? Just so we could talk a little about the algebra of their growth vs. everything else, or something like that? Do you have a number that you put on that?

Nick Joseph (10:52)

We do. And there's five different indices that REIT investors typically index to. The most common one, data centers, are about 10% of the REIT index.

Anne Malone (10:59)

OK. And I assume years ago, that would have been very low single digits, right? Explosive.

Nick Joseph (11:05)

That's exactly right. And one of the things that's kind of exciting about real estate and REITs is that sectors grow and sectors shrink. Office at one point was 15% to 20% of the overall index. Right now, it's 3% of the index.

Anne Malone (11:17)

Wow!

Nick Joseph (11:18)

Things change.

Anne Malone (11:19)

And I love that a REITs analyst says that's what's exciting about real estate and REITs, that you're living it. So outside of data centers … let's take them out for one second, because I do believe that's another animal. REITs' performance, does it tend to be homogeneous? Does it separate out? How does that perform?

Nick Joseph (11:34)

No, and that's maybe another thing that excites me. There's a massive dispersion every year within REITs. One of my favorite charts is looking at the top quartile vs. the bottom quartile of REITs in any individual year. It's nearly 50 percentage points. So there's massive alpha opportunities each year within real estate and REITs. Of course, the hard part is figuring out which stocks are going to outperform or underperform.

And it's different themes, right? Sometimes it's geography, sometimes it's balance sheets, sometimes subsector, but there's a lot of dispersion within listed real estate.

Anne Malone (12:02)

That is exciting, but also very amusing that that's your favorite chart.

OK. So if we go back on the economy: I have thought about the office and where will we all work in the future, but I haven't thought about hotel travel, etc. So, there's an old theme, right? An old question always used to be, “Is the mall dead?” Do you have a call, or is there a consensus on that?

Nick Joseph (12:26)

So that was definitely one of the questions we got the most frequently, call it five years ago. And I think everyone was right. I think the mall was dead if you had a lower-quality mall, and those malls really did die and get put to better use. Ultimately, that might be redevelopment into a different asset type. But high-quality malls are thriving, and the good news for the public market is that typically the REITs own higher-quality assets.

And so what you've seen is actually retail doing incredibly well, even coming out of those questions of, is the mall dead, or is retail all going online? And we're actually seeing very good fundamentals, both in terms of high-quality malls and also just real estate broadly.

Anne Malone (13:01)

And then what's your thought and consensus on hotels and the future of travel?

Nick Joseph (13:07)

I think group hotels — and we've seen this coming out of COVID — I think group is going to remain strong. I think there's a real benefit to getting people in person. And some of that is a reflection of different hybrid strategies for work, right? If people are in five days a week, are they in three or four days a week and getting on the road to see clients and doing different conferences and events? And so what we've seen is group strength, and we would expect to continue to see group strength.

In terms of the leisure side of hotels, it's the K-shaped economy that everyone's talking about. Luxury hotels are doing very well still. Lower price points are not doing as well. We would expect that trend at least to continue through 2026.

Business transient is a big driver of hotels broadly, and I would expect will be somewhat dependent on what happens with GDP growth. I think as GDP and as companies continue to invest and grow, people will be on the road meeting clients and doing different travel associated with business.

Anne Malone (14:00)

It's amazing. The resilient consumer is a theme that every time I do a podcast, it follows through. And surprisingly, I think for most.

So when you just said the lower-end hotels not doing as well, but luxury does, that's similar in airlines and in retailing. It's crazy how much it mimics. Each sector has a very similar one.

So you come back from Florida. What are the other meetings or milestones that are coming up in REITs that you can keep checking in about the mood here?

Nick Joseph (14:28)

Earnings are coming up in about a month, that'll obviously be interesting. But I will tell you, a lot of businesses, storage, residential, have peak leasing seasons. As you can imagine, people tend to move in the spring and early summer. Some of that is tied to school calendars, right? People want to be in their housing before the next school year starts. And so the peak leasing season really starts, call it later in March and April, and ends kind of mid-summer — July, August. It sometimes shifts around just a bit, but that's the general cadence to it.

And so I think we're really entering the time where operating updates from different companies are really important to keep an eye on. We'd expect to start to get those, we got them with our conference in early March. I would say the next data point will probably be in mid-April. And then we'll go to a big industry conference, the Naireit conference in early June. Those will be the key data points to keep an eye out over the next few months.

Anne Malone (15:21)

Do you think this is the new normal for REITs, where the flows are related to the country's current thinking on AI, and flows in and out of software? Do you think that is going to be it for a while?

Nick Joseph (15:36)

I think so. I think certainly AI is a theme. REITs are obviously correlated with interest rates. Not perfectly, but obviously rates matter for REITs. The broad economy is going to matter. And I think real estate and REITs used to be within financials and they became their own GICS sector nearly 10 years ago now.

I do think that being their own sector has created a bit more volatility, whereas when they were within financials, there's probably a bit more stability associated with them from a flow perspective.

Anne Malone (16:04)

I don't think we're ever complete if we talk about a sector without talking a little about, Does this lend itself to more M&A? How are balance sheets? What's the thoughts on the financials?

Nick Joseph (16:16)

Absolutely. So balance sheets are in a really good position. You have low leverage. This was really a lesson learned during the GFC. If you look at any chart of REIT leverage, they came down considerably over the last 15 years. And the balance sheets are good: debt mature, well laddered, good percentage of fixed-rate debt and low leverage. The balance sheets on average are in a very good spot.

M&A is a really interesting question. We do think the environment is ripe for additional M&A. We did ask every company at our conference, “Do you think you'll have more, or fewer, or the same number of companies a year from now within your sector?” 52% said fewer, 9% said more, so only 40% said the same. And so that lends itself both in terms of either liquidations, M&A, maybe some IPOs, but just broadly more capital activity across real estate.

Anne Malone (17:01)

Wow. Those are pretty impressive numbers on what consensus is.

Nick Joseph (17:05)

It'll be interesting. But we talked about how REITs all don't trade the same. There's a wide dispersion of valuations relative to NAV, and also relative to peers. And usually that environment lends itself to more activity.

Anne Malone (17:16)

OK. Going to be exciting! Thank you, Nick.

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Disclaimer (17:40)