

Research @ Citi Podcast, Episode 24: REIT or Wrong — Is Now the Time to Buy U.S. Real Estate?

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Transcript:

Nick Joseph (00:00)

I think there's always this kind of question for private investors and institutions of, okay, are REITs real estate? Are they part of my real estate allocation or are they part of my equities allocation?

Rob Rowe (00:12)

Hi, everyone, and welcome to our Research @ Citi podcast. My name is Robert Rowe. I'm the U.S. Regional Director of Research here at Citi. And my guest today is Nicholas Joseph, who is our REIT sector head in fundamental equity, and we're here to talk about the REIT market. Welcome, Nick.

Nick Joseph (00:29)

Thanks, Rob. Excited for this.

Rob Rowe (00:31)

I've always thought of the REIT sector as sort of the bloodstream or the heart of U.S. industry, in a sense, because it covers so many sectors. So there's always a lot of themes that are absolutely related to what's going on in the U.S. and also what's going on abroad. But at first, why don't we delve into it? Because I'm sure there's a lot of themes that we can look at, you know, in terms of rate sensitivity, in terms of what construction is looking like here in the U.S., also public and private valuations, as well as the impact to the public policy sector. But first, why don't we start off simply, and why don't you just give me what you think is the forecast for the U.S. REITs? I think you have them up 10% to 15% this year. What are the drivers of that?

Nick Joseph (01:17)

Absolutely. It's interesting you said that because we always say that kind of REITs are the landlord to the economy. So I do think there's a lot of those kind of domestic and global themes that certainly impact the sector. But that's right. We're expecting about ten to 15% total return. So that includes the dividend, which is obviously an important consideration for REITs, in 2025. We actually titled our 2025 outlook *The Dawn of a New Cycle*, because we think it could be a multi-year opportunity when we look at the supply picture going forward. So when we think about this year specifically, we're expecting accelerating year-over-year earnings growth. Nothing too exciting but going the right direction. So that's about 4% growth in 2025. That compares to about 3% last year in 2024. We're expecting lower supply deliveries, and that's probably a comment for 2025, 2026, and most likely 2027. All of this assumes a solid macroeconomic background. Obviously, if we go into a recession or there's other considerations there, that would change the earnings. And we think that REITs

currently have reasonable valuations. I know you mentioned public versus private, so happy to get into that if you'd like, but we think valuations generally are reasonable.

So how do we get to the up ten to 15%? I mentioned the 4% earnings growth. Current dividend yield is about 4% as well, so all else equal, that's about 8% there. But how we get to the ten to 15 is that we're assuming about a one multiple turn expansion or about a 25 basis points cap rate compression. If either of those occur, that would be about 6%. So to get to that 15, that's assuming that one multiple turn. If it's less than that, that's going to be closer to that ten. Earnings overall, I mentioned the 4%. We're assuming that's driven by stabilizing operating results, some level of acquisition development and redevelopment benefit, and then retention of free cash flows. And then I would say from a subsector perspective — because all REITs don't trade the same, there's actually a pretty wide dispersion — some of the subsectors like net lease or senior housing actually have a green light to do external growth, and so that could be a cherry on top of the internal growth that we're expecting.

Rob Rowe (03:27)

And before we go on, I just want to say congratulations, Nick. I know that this is the 30th anniversary of one of the biggest REIT conferences in the country, the Citi REIT conference, which I know is happening from March 2 through to the fifth. And I know that we get a lot of clients there, about 175. I've attended this conference. It's phenomenal, and we do hear a lot from everybody. Let me ask you this: to the point about the private market, because I think that's something that is becoming more pervasive in this field, right? How do you look at your — because you just mentioned valuations — how do you look at those valuations today versus the private real estate market and also other assets?

Nick Joseph (04:07)

It's a really important question because REITs only make up about 10% of institutional quality real estate across the U.S. And so we absolutely always consider public market valuations versus what's happening on the private side. So right now, we have them trading generally in line with each other. So we consider that kind of relative to NAV, which, of course, there's an art and a science to that. Right now, it's a bit more of an art because the transaction volume hasn't been all that robust. And so we make an assumption of where the cap rate would be on the private market by looking at private market transactions, but it's been a bit thinner. That means that REITs are trading at about a 5.7 implied cap rate. So we think it's generally fair as an overall index relative to the private market. Of course, some subsectors are trading at premiums, some are trading at discounts, but overall generally fair.

You also mentioned versus other kind of asset types, and that's certainly a conversation we have with generalists frequently. When we compare REIT valuations currently versus the broad S&P, REITs are trading about a 3 ½ turn discount on an FFO basis and about 2 turn discount on an AFFO basis. Those are both generally in line with the historical average. Where we're getting some pushback from generalists is REITs versus fixed income. And what we've seen is the highest correlation is actually REIT implied cap rates versus triple-B corporate bond yields. That spread is typically about 150 basis points. Right now it's only ten basis points, and so REITS look relatively expensive. I think there's a handful of reasons of why that could be, right now if you buy a bond, you're getting the coupon. If you buy a REIT, you're getting a growing cash flow. So a REIT implied cap rate is not static. We're comparing a current moment in time versus the history, and obviously the index has changed. I'd also say there's some large mark-to-markets just given what's happened on rent growth, particularly for a subsector like industrial, that shows that current implied cap rates maybe

aren't what a stabilized would be. All of those are reasons for why it's a little tighter. But ultimately, I think a lot of people will just look at that chart and say REITs look relatively expensive versus fixed income.

Rob Rowe (06:18)

Now, when you say fixed income, are you talking about high-grade corporate bonds generally, right? Those spreads have also come in, though, a lot, right? Is that generally then that REITs as well as high grade are considered more safe haven assets in a way?

Nick Joseph (06:33)

So we'll compare it to where we've seen the highest correlation is triple-B seven to ten year corporate bonds. And the seven to ten years kind of is generally in line with the typical real estate hold on the private market, and it's a similar amount of risk we've found. And so that's where the highest correlation is. We do also look at it versus ten year, you know, treasuries, and that spread is tighter, as well. But that's really where that seven to ten year corporate bond comparison comes in.

Rob Rowe (07:01)

Got it. And, you know, as a follow on to that, and what you're saying is maybe REITs look a little rich to that triple-B, I guess, seven to ten year sector. You know, you often comment, maybe generalists have historically tended to underweight the sector. Why is that? Do you expect that to change going forward given this tight spread?

Nick Joseph (07:20)

It's a frustration that the public REIT market has always had. Look, I think part of it is valuation, right? So we talked about the public versus private. Ultimately, it's hard to get too far away from public valuations versus private or you see privatizations. And so, as interest rates were low, the inverse of that would imply a high multiple and so REITs did not look all that attractive relative to the broad market at different times. So I think that's been one area. The other has just been volatility. REITs kind of sit in between equities and fixed income, right? They're very dividend focused. You don't have as much growth necessarily overall. And so I think there's always this kind of question for private investors and institutions of, okay, are REITs real estate? Are they part of my real estate allocation or are they part of my equities allocation? And so I think they somewhat sit in between that. And so that's led to some level of underweight. It's usually what's the magnitude of the underweight. More recently, we have seen REITs kind of fall out of favor. I will tell you, last year, beginning in July, we saw a lot more generalist interest in the space, and I really think that was due to interest rates coming down, REITs had underperformed, and there was more kind of call volume and interest. And we track fund flows very closely. So we publish every week on fund flows. This year, we've seen 1.2 billion of outflows. That was 260 million from ETFs, 270 million from mutual funds, and actually 700 million from Japanese mutual funds. But interestingly, just this last week, so last Thursday was the first time we saw positive inflows on a weekly basis since middle of October last year. And so maybe things are starting to turn, but in general, generalists seem to be underweight the space.

Rob Rowe (09:09)

And, you know, in that context, Nick, do you think at this present level of rates, do you think it's operational for REITs, or do you think rates need to be lower at this juncture, or interest rates need to be lower for a better working environment?

Nick Joseph (09:23)

It's a great question. Obviously, lower rates are going to be better for real estate and better for REITs. I think it's the volatility that's really hurt, right? When the 10-year's at 4.7 and then down to 3.8 and then back up to 4.6, that volatility really makes the private market and transaction volumes challenging, and typically the public market is trying to price in kind of a go-forward of what we're going to see on the private side. So I mentioned kind of this art versus science of cap rates and NAVs. The fewer transactions, the more volatility, the more I think you price in that risk on the public side.

Rob Rowe (09:56)

Got it. I mean, this is probably a question we're asking every sector, but how could changes or what changes do you anticipate with the new administration that could affect or impact real estate and thus impact REITs.

Nick Joseph (10:10)

It's a great question. It's something that we think about frequently. I would tell you that coming out of the election, our view is that maybe you're going to see higher growth, but that offset may be higher rates and slightly higher inflation than what was expected before. So that we believe will impact real estate overall. I think the specific policies that we're keeping an eye on, number one would be immigration, and the question is, where could that have an impact? It could have an impact on the construction market. Ultimately, if you have fewer people working in construction, does that push out the return of supply and is actually pretty good for real estate. If you have less supply coming in the future, that could be an impact. Number two, which is probably more of a negative for public real estate is on the labor side. So we've seen labor challenges coming out COVID for senior housing. We've seen it within hotels, but really across the board. And so if you have a smaller labor force, that could put pressure on wages and obviously pressure expenses for REITs. And then the third is what happens just housing? If you have somewhere between a million and 10 million people leave the country, that will obviously have ripple effects across consumer spending, housing, other considerations. And so those are kind of the considerations we're thinking through on immigration. Tariffs is the other big one. You know, the sectors that we think could be impacted the most either from nearshoring or onshoring or what happens with tariffs would be industrial and retail. And obviously, the news seems to change daily on that, but that's where we're kind of thinking through the ripple effects.

Rob Rowe (11:46)

And how does that affect your expectations for M&A in the space?

Nick Joseph (11:51)

So M&A has been, it's been quiet. 2024 was a bit subdued. You mentioned earlier the volatility in interest rates that obviously has played into it, the elevated cost of debt. And then there's also uncertain macroeconomic and political environment. We're expecting M&A to pick up. We've seen just a few deals over the last 12 months, but we actually had one announced I guess a week ago within the hotel space and we're expecting more deals. We run an M&A list that we kind of look at our coverage and say, Okay, who do we think relatively would be less surprising to have an M&A transaction? There's 11 names on that right now. That's the highest we've had for a while. Now, there's no timing associated with that. Obviously, M&A is always incredibly hard to predict and we don't recommend investing on an M&A thesis. But we always try to hold ourself to, was this a surprise or not? And we

consider if it was on our list, it's less of a surprise than if it was not on the list. But overall, we're expecting an uptick, but as we always say, it takes two to tango for M&A.

Rob Rowe (12:56)

Okay, this is going to be the exciting part, too, Nick. I want to know what your view is on subsectors. What are you recommending and what are you avoiding? And I've actually got a couple of sectors I want to ask you about, so go ahead, but you go first.

Nick Joseph (13:08)

Absolutely. So I mentioned at the beginning that REITs, there's actually a lot of volatility and a wide range of outcomes. So if you go back to 2000, if you look at the top quartile of REITs versus the bottom quartile of REITs in any individual year, it's about 50 percentage points. So to your question, it's really important to get the stocks right and the subsectors right at any time. We run a model portfolio, so we look at all the different subsectors. It's really bottoms up from a company perspective that rolls into our subsector views. If I look at where we're overweight right now, we're overweight the residential subsector. So that's apartments, single family rentals, and manufactured housing. We're overweight healthcare. We particularly like senior housing. That's an area that we think actually has the best supply demand dynamics in the U.S. over the next two years. And then we like industrial. Underweight subsectors, we've been underweight larger net lease names, so it's not necessarily that subsector, but more of a market cap consideration. We're underweight the self storage space, then we're underweight office.

Rob Rowe (14:10)

And that was going to be one of the ones I was going to ask you about is office space. It's obviously one that had a lot of focus a couple of years back or even last year, given the vacancies. Is there a revival in that area? Obviously, you're underweighting it, so it's probably not quite recovering yet.

Nick Joseph (14:26)

Well, it's a great question. So office is actually from a public market perspective only 4% of the REIT index. So it's not a huge driver for REITs, but it's very important for overall. It's obviously important for municipalities and budgets on the real estate tax side, and there's a lot of private ownership of office. So it has certainly gathered a lot of headlines. I think it's a geography question right now. We've seen a really strong leasing recovery in New York and the East Coast more broadly, but really led by New York. The West Coast has continued to struggle. The stocks themselves last year, particularly the East Coast, did well because I think they were coming off with such bottoms and you did see really good leasing momentum. Our expectation now is that it's going to generally office demand goes in line with corporate earnings. The business itself is typically high capex, and so we just find better opportunities elsewhere. There's certainly some names within each of these subsectors that we're recommending. So we have a tilt more towards New York right now within our model portfolio, but just broadly, we just find better opportunities elsewhere.

Rob Rowe (15:33)

And you didn't mention data centers. And I know that that's popular with AI. What do you think there?

Nick Joseph (15:40)

We like data centers. So I'd mentioned the top three subsectors that were overweight, but we do like towers. We like data centers. And so my colleague Mike Rollins covers data centers here at Citi, but we collaborate closely on them. And so Mike is positive on data centers, and it's a subsector that we continue to like. Interestingly, on data centers, a lot of our coverage on the industrial side, some on the net lease have also expanded into data centers. And I think obviously you have the AI demand. But what gives us a little more comfort overall is that supply is a bit constrained from a power perspective, because anytime there's a lot of demand that usually does lead to a lot of supply. And so data centers, that's something that we're watching closely.

Rob Rowe (16:22)

And you mentioned self storage, but what about the storage sector in general? I always find this fascinating because they tend to shift around a little bit depending on where storage demands are. So what's your view there?

Nick Joseph (16:35)

So storage, we think the business is a terrific business. It's somewhat sticky. It's very low capex, and there's real benefits to scale. Our challenge with the storage business right now is just that housing velocity has been so low. And so it's hard to quantify what percent of a driver housing is to storage, but it's clearly an important aspect. And as you can imagine, with interest rates higher and with the lock-in effect occurring with so many people having mortgage rates well below where they would be today, you just are not seeing as much housing velocity as what you typically would, and so that has led to a little lower storage demand. So that's— it's a business we really like. It's just right now, we just find better opportunities elsewhere.

Rob Rowe (17:20)

Fantastic. Well, thanks, Nick. This has been very informative, and we look forward to the conference coming up in March.

Nick Joseph (17:26)

This was great. Thanks so much for having me, Rob.

Rob Rowe (17:28)

Thanks, everyone for participating. Our next Research @ Citi podcast will feature Anne Malone, our U.S. Head of Equity Research, and will be joined by Paul Lejuez and Steve Zaccone, who will be discussing the consumer. Thanks, everyone. This podcast was recorded on February 19th.

[Disclaimer] (17:47)

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