Private Bank

Citi Global Wealth Investments

Global Equity Strategy | June 25, 2021

Equity REITs: Passing the baton back to secular growth

Joe Fiorica, Head - Global Equity Strategy
Steven Wieting, Chief Investment Strategist & Chief Economist
Charlie Reinhard, Head – North America Strategy

As originally published in the June 2021 Quadrant.

Passing the baton back to secular growth

- Amid the fallout from the pandemic lockdowns of last spring, it was conventional wisdom to assume that the real estate market would be forever changed by COVID. The future of restaurants, urban retail, nursing homes, and office were all simultaneously in question, leading investors in public real estate to flee the space.
- Despite consensus investor caution in REITs, last June the Citi Private Bank Global Investment Committee went overweight global equity and mortgage REITs as part of a series of tactical moves to position for a post-COVID world. The equity REIT sector has delivered 39% in total return since then, led by much more significant returns in COVID-impacted sectors like lodging and retail (Figures 1-2). Mortgage REITs, which were also deeply depressed a year ago, have returned over 60% including dividends.
- One year later, as investors look beyond COVID recovery, we revisit this tactical thematic overweight and its role in portfolios as a lingering reopening trade, an inflation hedge, and a yield enhancer. **We ultimately see the short-term recovery in COVID-impacted equity REITs as nearly complete, though we identify select areas like cell towers, data centers, industrial warehouses, residential, and health care that can continue as sources of long-run income in portfolios.**

Figure 1: 1 Year REIT returns vs Global Equities

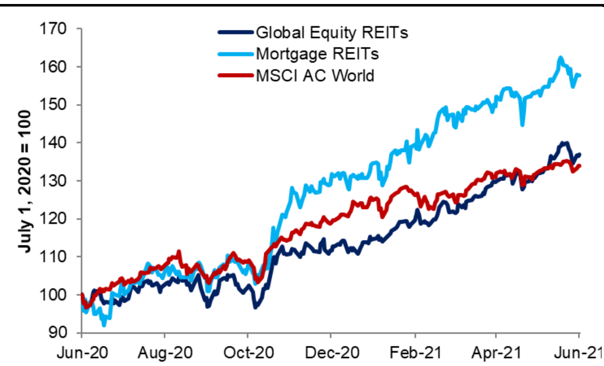


Figure 2: Equity REIT performance by sub-sector

Source: Bloomberg as of June 23, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

REITs: Bond Proxies or Inflation Hedge?

REITs as an asset class tend to trade like bonds in rising rate environments but as inflation hedges in rising price environments. Generalists often group REITs into the mix of bond proxies along with staples and utilities, given they often have investor bases that are focused on the income provided by these structures more so than capital growth. As a result, REITs typically trade like bonds over the short-run, with a negative correlation to interest rates (Figure 3).

However, REITs are unique among bond proxies in that they also serve as a reliable inflation hedge. Because REITs are structured to take direct ownership of physical property, rent cash flows and underlying property values tend to rise along with the real economy. Given this dynamic, and unlike other bond proxies like consumer staples, REITs tend to act as attractive inflation hedges as their underlying assets rise in with prevailing inflation (Figure 4). Therefore, while interest rate spikes are generally negative for relative performance of REITs in the short-run, investors worried about inflation can find solace that real estate allocations may serve as inflation hedges in portfolios.

Figure 3: Relative sector performance correlation with interest rates

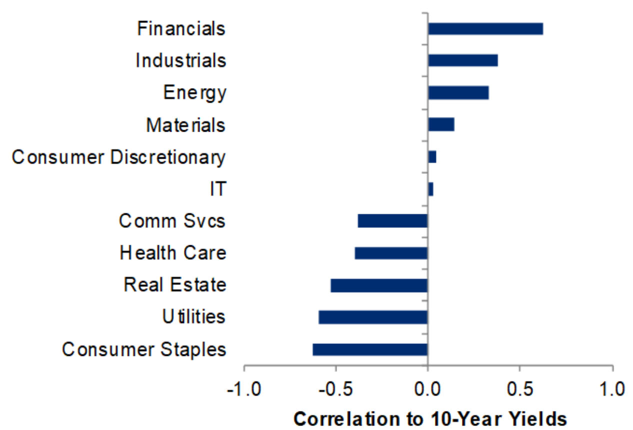


Figure 4: Sector performance during inflationary periods

Average Annualized Returns during Periods of Accelerating Inflation	Sep 2003 to Aug 2006	Jul 2009 to Jan 2012	Oct 2015 to Jul 2018	Average
Real Estate	24%	38%	9%	**24%**
Energy	31%	17%	12%	**20%**
Industrials	12%	23%	18%	**18%**
Materials	14%	20%	17%	**17%**
Information Technology	4%	19%	27%	**17%**
Consumer Discretionary	5%	27%	17%	**16%**
Utilities	23%	13%	12%	**16%**
Financials	12%	8%	18%	**13%**
Communication Services	14%	14%	8%	**12%**
Health Care	7%	15%	13%	**11%**
Consumer Staples	10%	16%	7%	**11%**

Source: Bloomberg and Haver as of June 23, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Unstoppable Trends within Real Estate

Two decades ago, the public REIT space was largely composed of multifamily, office, and retail managers. Today, the global REIT sector is much more dynamic, with specialists touching every element of the physical economy. Specialized REITs, which include cell towers, data centers, and self storage providers, make up nearly a quarter of the US Equity REIT index, while retail REITs have fallen to just 13% of market cap. We therefore view the REIT market is much more dynamic than it once was, and also an area where active management can identify secular growth while avoiding secular decline.

Figure 5: S&P US REIT Index by sub-industry

Sub-Industry	Index Weight	Forward Dividend Yield	Return Since Jan 2020	Return Since June 2020
Specialized REITs	25%	2.7%	40%	42%
Residential REITs	18%	2.5%	16%	41%
Industrial REITs	14%	2.3%	38%	36%
Retail REITs	13%	3.7%	(1%)	66%
Health Care REITs	11%	4.1%	2%	39%
Office REITs	10%	3.3%	(6%)	27%
Diversified REITs	5%	3.9%	6%	57%
Hotel & Resort REITs	4%	0.4%	(11%)	81%
S&P US REIT Index		**2.9%**	**12.0%**	**37.0%**

Source: Bloomberg as of June 23, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Industrial REITs: the backbone of e-commerce and reshoring

While the growth of ecommerce has wreaked havoc on traditional retail over the last decade, it may be easy to ignore the complex supply chain that transports your package from the retail manufacturer to your front door. Industrial REITs play an important role in that process, with many of these firms focusing on development and management of distribution centers and warehouses. Such properties have seen robust growth in the last decade as demand for logistics centers and regional distribution networks has skyrocketed (Figure 6). The dramatic shift to online purchases and grocery delivery during the pandemic are unlikely to dissipate even as vaccinations ramp up globally (Figure 7). In addition, trends like manufacturing reshoring are an additional tailwind for growth in Industrial REITs in the years ahead.

Figure 6: E-commerce-driven boom in distribution centers and warehouses

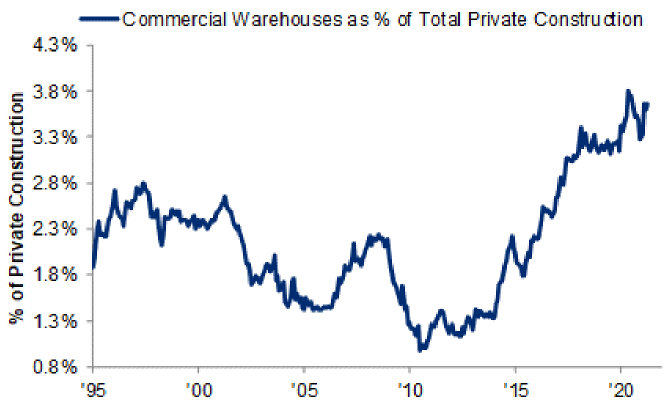
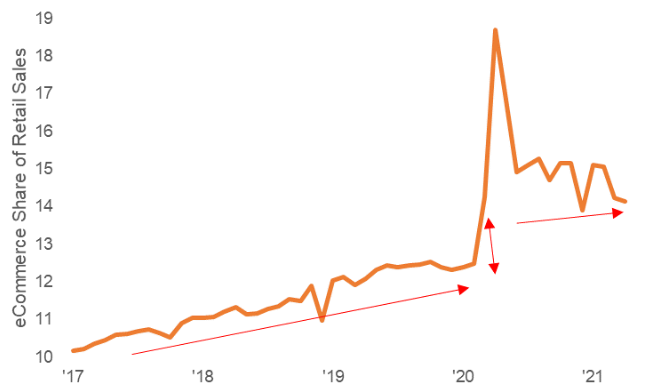


Figure 7: E-commerce as % of retail sales



Source: Haver as of June 23, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Cell towers & data centers: 5G's biggest winners

5G can be broadly described as a significant upgrade to the digital experience, an expensive necessity for telecom providers, and a windfall for tower REITs. High-band 5G offers speeds 30-80 times faster than average 4G connections, but with the caveat that signal range is greatly reduced. Therefore, 5G networks in dense urban centers require millions of individual towers spaced much closer together than previous generation protocols required (Figure 8). Given telecom providers' need to install many more towers than were necessary with 4G, cell tower companies, which often operate as Real Estate Investment Trusts in the business of leasing out network tower locations, are key beneficiaries to the 5G rollout that we outlined in Outlook 2021. Data center REITs, which focus on the physical server infrastructure needed to power "the cloud", should also continue to see robust growth as more data is collected, analyzed, and stored in the 5G-enabled digital ecosystem.

Health Care REITs: COVID-impacted secular growers

Health Care REITs were met with the epicenter of the COVID-19 pandemic last Spring. Operators of nursing homes, hospitals, and skilled nursing facilities all faced considerable challenges in an environment that was particularly dire for older and more vulnerable populations. But unlike other COVID-impacted REITs like malls and office, we expect managers of health care properties to make a full recovery and continue to grow over the long-run. Our Longevity Unstoppable Trend, outlined in Outlook 2021, underscores the economic implications of an aging global population, which is likely to drive an increased demand for nursing home services, hospital square footage, medical office, and lab research facilities in the decades to come (Figure 9).

Figure 8: Estimates for Global 5G Connections

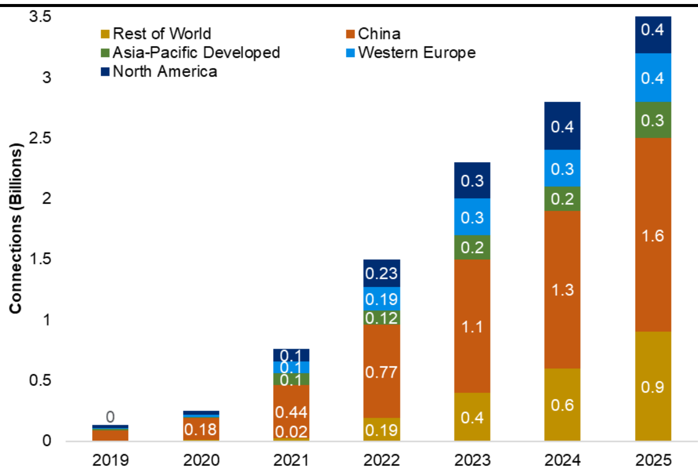
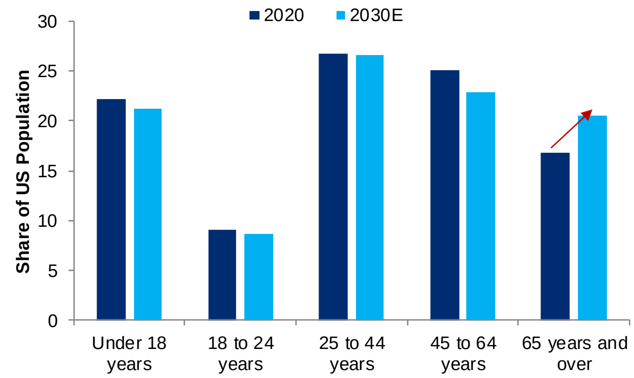


Figure 9: Expected US population by age



Source: Haver as of June 23, 2021. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.

Residential REITs and the work from home economy

The residential REIT market was traditionally comprised of multi-family apartment operators, but a growing portion of the sub-sector is now made up of single family REITs. Single family REITs, as the name suggests, buy portfolios of single family homes, often in clustered locations, and operate each home as a rental unit. Amid a flight to the suburbs and a boom in the US housing market over the past year, single family REITs have benefitted from a surge in demand for suburban real estate – especially in Sun Belt cities – as well as from rising property values. Returns in the space have well outpaced apartment REITs, which often have portfolios heavy in top-tier US cities which bore the brunt of the pandemic lockdowns (Figure 10).

However, with vaccinations in the US picking up and with most cities lifting social distancing restrictions, early signs indicate a resurgence in demand for urban apartments once again, while rents may have stabilized (Figure 11). We therefore see a short-term opportunity to play the ongoing recovery in apartments over the coming months. Over the next few years, however, structural demand for homes as the millennial generation ages coupled with a shortage in housing stock should keep single family home prices elevated, supporting both rents and property values for single family REITs.

Figure 10: Residential REIT returns by segment

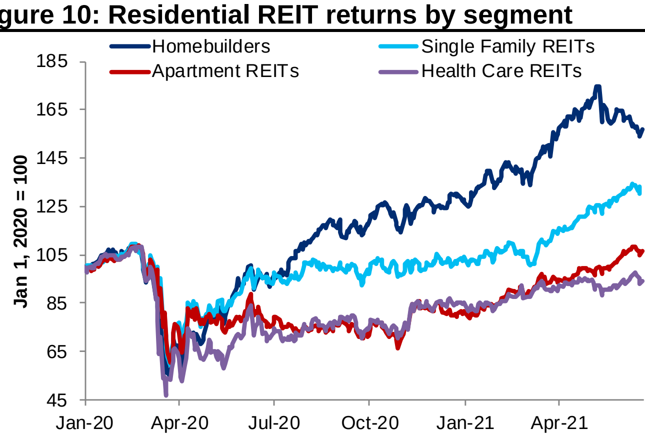
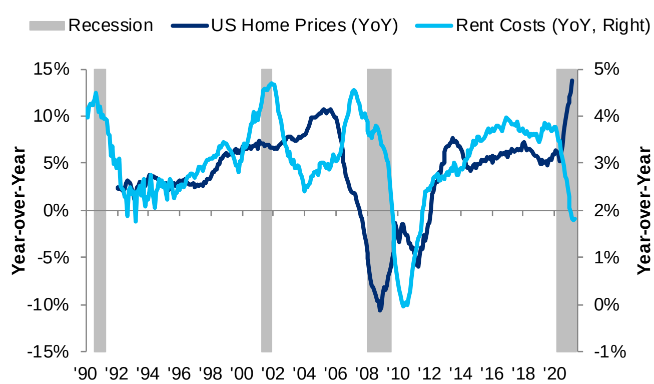


Figure 11: Home prices vs rent costs



Source: Factset as of June 17, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Near taking profits in the REIT mean reversion trade

Retail REITs are back to pre-COVID levels. Were you a buyer in January 2020?

If brick and mortar was struggling before COVID, the pandemic certainly didn't help things. With that said, we viewed a 60-70% selloff in higher quality retail property names last spring as excessive even for a structurally challenged sector. Unlike many retail chains which did not survive the pandemic, retailors' landlords still maintained control of the physical property once occupied by struggling shops, and with relatively limited overhead costs were able to wait out the storm. Some more savvy retail REITs have reinvented vacant mall properties by focusing on customer "experience", while others have fully converted big box stores into industrial warehouses for ecommerce processing and other commercial uses. Such creativity by retail property managers (and the development of safe and effective vaccines) have enabled investors to weather the worst of the storm, and retail REIT shares have recovered back to near pre-COVID levels (Figure 12).

While this is a nice "war story" for retail REIT managers to tell their grandchildren, we now have to look at valuations in many of these names with fresh, forward-looking eyes. The growth of ecommerce, and the consumer shifts to buy more goods or stream new movies online are unlikely to fully reverse, presenting structural challenges to mall and movie theater operators. With expected retail REIT dividend yields back below 4% (down from 10% in March of last year), we see the risk-reward in the retail REIT space as much less compelling today than we did a year ago (Figure 13).

Figure 12: Retail and Hotel REITs vs Google Mobility data

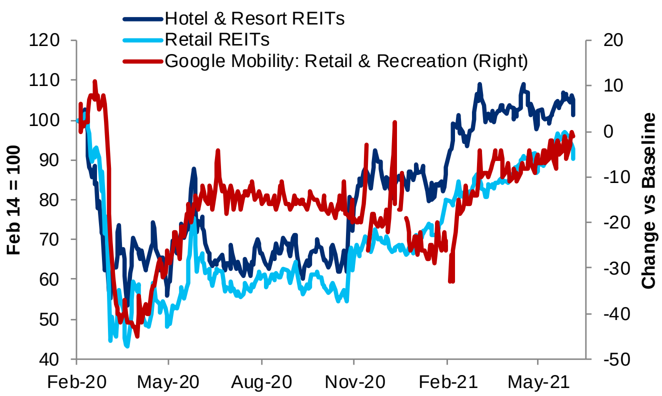
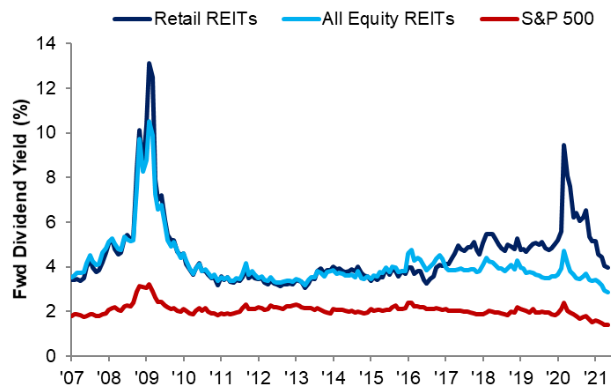


Figure 13: Retail REIT dividend yields



Source: Bloomberg as of June 17, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Office may not be dead, but a full recovery is unlikely any time soon

We believe office is among the real estate segments most permanently impacted by the COVID pandemic. While REITs with properties in suburban and second-tier US cities may see a faster recovery, we remain cautious on Office REITs concentrated in New York and other major cities as large companies experiment with hybrid or full remote work offerings. A Deloitte survey released in April 2021 found that 38% of organizations expect a permanent reduction in onsite requirements, versus just 26% that expect a return to pre-pandemic "normal". Office REITs have seen a nearly 50% recovery since October and while their shares remain slightly below pre-COVID levels, we are skeptical that this sector's fundamentals justify a full recovery this year.

Figure 14: Office REITs vs activity at workplaces

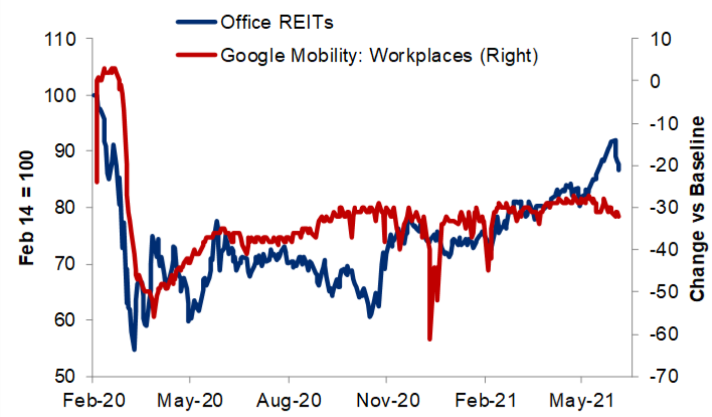
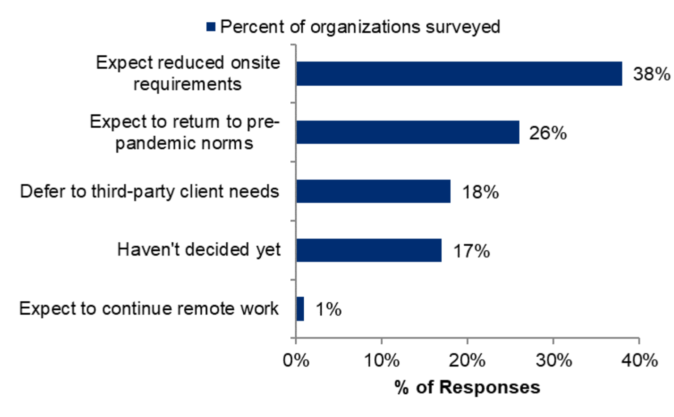


Figure 15: 38% of companies expect reduced onsite capacity for the foreseeable future



Source: Bloomberg and Deloitte as of June 23, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Travel and Leisure is more than a Hotel REIT story

In Mid-Year Outlook 2021, we outlined our view that pent-up demand for travel and vacations would benefit leisure-oriented shares like hotels, cruises, casinos, and airlines. While many hotel chains operate as C-corps, other well-known chains have divested their physical franchise properties to hotel-focused REITs. Most of the major hotel/lodging REITs cut their dividends to zero early in the pandemic as occupancy was expected to plummet for several months. Since the announcement of safe and effective vaccines in November, lodging shares have rallied 88%, and are close to pre-COVID highs. While we believe certain Hotel REITs and C-corps can still perform well as part of a broader leisure-oriented tactical trade, their relatively small size in passive REIT indices (4% in S&P REIT Index) means that active management or a stock picking exercise is key for monetizing such a view.

INVESTMENT PRODUCTS: NOT FDIC INSURED · NOT CDIC INSURED · NOT GOVERNMENT INSURED · NO BANK GUARANTEE · MAY LOSE VALUE

Announced in January 2021, Citi Global Wealth ("CGW") is comprised of the wealth management businesses of Citi Private Bank and Citi's Global Consumer Bank. Through these businesses, CGW delivers Citi's wealth solutions, products and services globally. The unified management and delivery of CGW's wealth strategy represents a further commitment by Citi to become a leading global wealth business. Citi Global Wealth Investments ("CGWI") is comprised of the Investments and Capital Markets capabilities of Citi Private Bank, Citi Personal Wealth Management and International Personal Bank U.S.

Citi Private Bank and Citi Personal Wealth Management are businesses of Citigroup Inc. ("Citigroup"), which provide clients access to a broad array of products and services available through bank and non-bank affiliates of Citigroup. Not all products and services are provided by all affiliates or are available at all locations. In the U.S., investment products and services are provided by Citigroup Global Markets Inc. ("CGMI"), member FINRA and SIPC, and Citi Private Advisory, LLC ("Citi Advisory"), member FINRA and SIPC. CGMI accounts are carried by Pershing LLC, member FINRA, NYSE, SIPC. Citi Advisory acts as distributor of certain alternative investment products to clients of Citi Private Bank. Insurance is offered by Citi Personal Wealth Management through Citigroup Life Agency LLC ("CLA"). In California, CLA does business as Citigroup Life Insurance Agency, LLC (license number 0G56746). CGMI, Citi Advisory, CLA and Citibank, N.A. are affiliated companies under the common control of Citigroup.

Outside the U.S., investment products and services are provided by other Citigroup affiliates. Investment Management services (including portfolio management) are available through CGMI, Citi Advisory, Citibank, N.A. and other affiliated advisory businesses. These Citigroup affiliates, including Citi Advisory, will be compensated for the respective investment management, advisory, administrative, distribution and placement services they may provide.

International Personal Bank U.S. ("IPB U.S."), is a business of Citigroup Inc. ("Citigroup") which provides its clients access to a broad array of products and services available through Citigroup, its bank and non-bank affiliates worldwide (collectively, "Citi"). Through IPB U.S. prospects and clients have access to the Citigold® Private Client International, Citigold® International, International Personal, Citi Global Executive Preferred, and Citi Global Executive Account Packages. Investment products and services are made available through either Citi Personal Investments International ("CPII"), a business of Citigroup Inc., which offers securities through Citigroup Global Markets Inc. ("CGMI"), member FINRA and SIPC, an investment advisor and broker–dealer registered with the Securities and Exchange Commission; or Citi International Financial Services, LLC ("CIFS"), member FINRA and SIPC, and a broker–dealer registered with the Securities and Exchange Commission that offers investment products and services to non–U.S. citizens, residents, or non–U.S. entities. CGMI and CIFS investment accounts are carried by Pershing LLC, member FINRA, NYSE, and SIPC. Insurance is offered by CPII through Citigroup Life Agency LLC ("CLA"). In California, CLA does business as Citigroup Life Insurance Agency, LLC (license number 0G56746). Citibank N.A., CGMI, CIFS, and CLA are affiliated companies under common control of Citigroup Inc.

Read additional Important Information

Past performance is not indicative of future results. Real results may vary.

****Citi and its employees are not in the business of providing, and do not provide, tax or legal advice to any taxpayer outside Citi. Any statement in this Communication regarding tax matters is not intended or written to be used, and cannot be used or relied upon, by any taxpayer for the purpose of avoiding tax penalties. Any such taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.**

MBS are also sensitive to interest rate changes which can negatively impact the market value of the security. During times of heightened volatility, MBS can experience greater levels of illiquidity and larger price movements.

Important information, including information relating to risk considerations can be found in the link above.

Views, opinions and estimates expressed herein may differ from the opinions expressed by other Citi businesses or affiliates, and are not intended to be a forecast of future events, a guarantee of future results, or investment advice, and are subject to change without notice based on market and other conditions. Citi is under no duty to update this presentation and accepts no liability for any loss (whether direct, indirect or consequential) that may arise from any use of the information contained in or derived from this presentation.

www.citiprivatebank.com