RAYMOND JAMES®

We are maintaining our more constructive view for the **REITs** versus the broader market but note that the REIT index is up 12% YTD, and since interest rates peaked last October, the REIT index has outperformed the S&P 500 by 1,100-1,200 bp. We continue to believe REITs will face some headwinds from interest rates in a growing economy but would expect from this point, assuming modest GDP growth and consequently a more benign interest rate outlook, REITs to generate 7-9% annualized returns, driven by 4-5% FFO growth and 4% dividends.

Two factors drove our shift in opinion from an underweight on the REIT sector, and we continue to support a relatively constructive view versus the broader market.

- First, we are less optimistic about the outlook for the economy and corporate earnings growth, and point out that REIT earnings growth, secured by leases in most cases, offers predictable cash flows with what we believe are relatively secure dividend streams.
- Second, we think some of the near-term interest rate pressure has subsided as domestic and world GDP growth forecasts have been trimmed. However, it bears repeating that interest rates remain a primary risk for investing in these yield-oriented securities, and we expect modest interest rate pressure to persist. We note again for reference that a 25 basis point increase in cap rates pushes NAVs down 5-6%.

REITs have had a strong 16% bounce from the recent December 24 low and are now fairly valued with an average dividend yield of 3.9%, trading at 18x 2019 consensus FFO estimates and in line with NAV estimates. This investment cycle for commercial real estate (CRE) and REITs is impressive, however, given that we are 10 years into the recovery and still delivering reasonable 4-6% earnings growth.

Contributing to this is more discipline in new supply and capital allocation to development than in previous cycles, and asset construction cost inflation, which continues to track 2-3x the rate of CPI inflation. The movement to securitize real estate, now a sector in most broader market indices, has helped drive demand for more information, and consequently there are numerous sources of third-party research tracking new supply for almost every asset class in CRE. This visibility is leading to more discipline in financing the growth and development of new supply. Rising construction cost, permitting, and land costs are driving up replacement cost, which is also serving to restrict excessive development and underpinning the value of REIT property portfolios, and pushing rents higher in most asset classes.

We believe U.S. REIT dividends are safe and growing. We believe that dividend growth will be driven by 4-5% growth of FFO/AFFO and conservative AFFO payout ratios continue to provide an accommodative backdrop for more dividend increases. AFFO payout ratios are tracking 75-80% on 2019 estimates, which compares favorably to the historical average of 80%. We point out that dividends have accounted for approximately half of the annual 10% total return in REITs over the past 20 years.

The new GICS classification for Real Estate is driving visibility and some interest in the sector, and the U.S. mutual fund industry continues to be under- invested in real estate relative to their benchmarks. However, as the performance track record of the REITs and CRE accumulates in this era of increased visibility and information flow, we expect a more stable and predictable CRE cycle to garner broader market investor attention, and attract defensive-minded investing in REITs as an alternative to other defensive sectors in the S&P 500.

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