Sanlam Investments

CATALYST FUND MANAGERS

REITs as an inflation hedge

Catalyst Fund Managers

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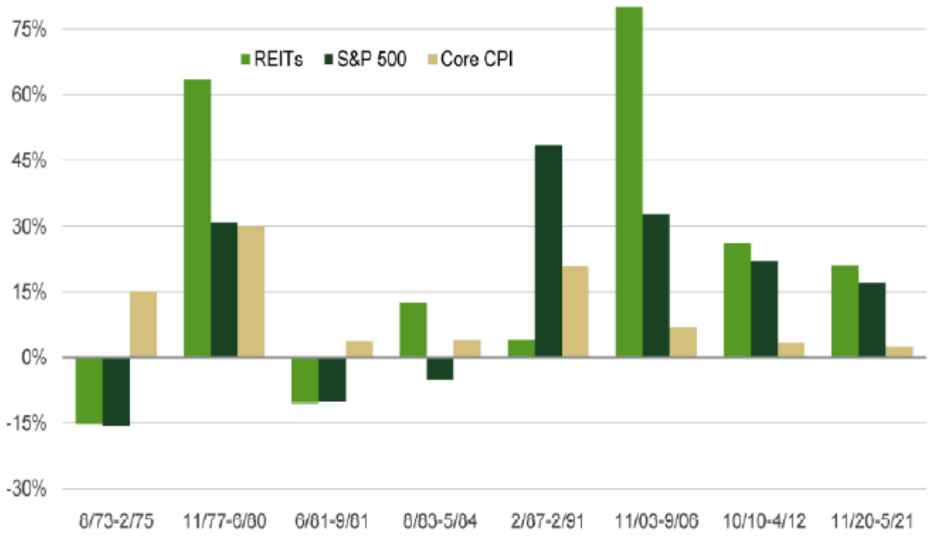
In 2021, worldwide consumer prices rose dramatically as the global economy navigated supply chain issues throughout its recovery from COVID-induced shutdowns. Annual inflation measured by the Consumer Price Index reached 7.0% in the US, the highest annual rate since 1981. While inflationary pressures are expected to continue well into 2022, historical analysis shows that REITs have provided protection against inflation and outperformed the broader stock market during periods of moderate and high inflation. Over the last 50 years, REITs outperformed the S&P 500 aRnd CPI, in five of the eight periods of an inflationary spike (instances where CPI > 100 bps; please refer to the graph below).

REITs' historical performance during periods of inflation

Total return during periods of rising CPI



The decade of 1973 -1982
CPI rose 8%/yr
S&P 500 delivered 7%/yr
REITs delivered a 13%/yr

During the 8 inflationary spikes, the average
REIT total return was 24%
S&P 500 15%
CPI 11%

Green Street Advisors, June 2021
Returns are month end to month end. Total return for S&P 500 during '70s estimated using price return plus 4%/yr for dividends

Worldwide, leases tend to have rents indexed to some measure of inflation or are contracted to escalate annually. Property values also tend to increase as higher prices for labour, materials and land make construction less economically viable without a proportionate rise in rental levels. This may result in a limit to new property supply, which creates a barrier to entry that results in existing property owners' ability to increase occupancy levels and corresponding rents.

Property sub-sectors with shorter leases should outperform longer, fixed leases during inflationary periods. Shorter lease periods can adjust to the prevailing economic climate which allows landlords to benefit from economic expansion and realise inflationary prices and rents more quickly upon lease expiration. However, longer leases can still offer protection as new rents are adjusted to higher levels during periods of increasing market rental growth.

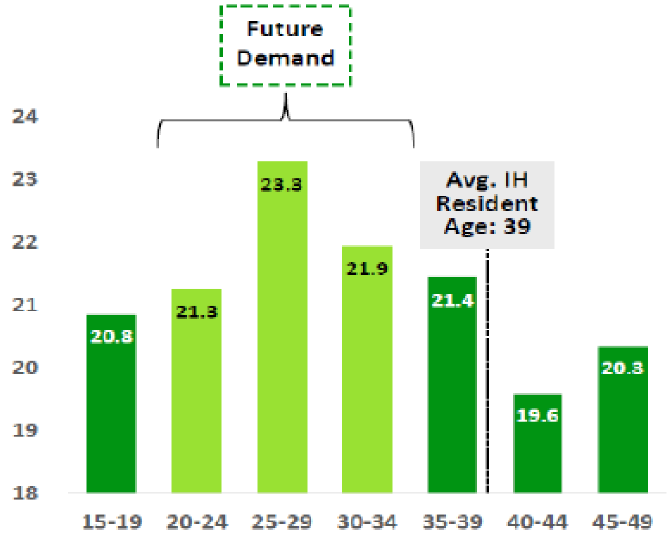
If supply is contained, and all things being equal, property sub-sectors that enjoy a higher growth in demand should also fare better than those sectors experiencing lower demand. Such sub-sectors bolstered by demand, combined with manageable levels of supply, should outperform sub-sectors that are experiencing lacklustre demand and/or elevated supply levels. The long-term, risk-adjusted investment approach that we use naturally skews our portfolio to those sectors with strong fundamentals. These sectors, by implication, have robust inherent growth potential that is often structural in nature, which should fare well in an inflationary environment. We have positioned our portfolios accordingly.

We continue to favour residential real estate as our largest collective overweight position. The overall fundamentals supporting residential are extremely strong, with significant future demand seen to come from the millennial generation as they move toward Single Family Rental over the next decade (thus creating a demographic tailwind).

Strong demand

Significant pent-up demand in millennial generation likely to move toward single-family rental over the next decade

Current population by age cohort
(millions of people)



Source: US Census Bureau, April 2020 (data as of 2019).

We also continue to favour industrial real estate given evidence of demand for industrial space to facilitate e-commerce, as well as the potential structural changes to worldwide supply chains away from JIT (Just-in-Time) inventory management.

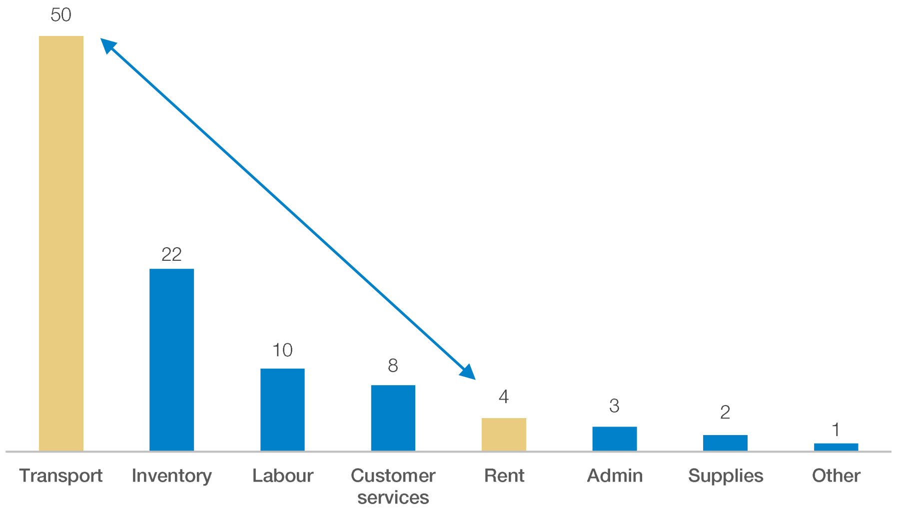
The possibility of diminished tenant profitability (or ability to pay) from spiking warehouse rents is not yet an issue as rent constitutes a small percentage of a tenant's total supply chain costs (~5%), while transportation and labour expenses are far more meaningful (>50% of costs) and are escalating. Warehouse rent, as a percentage of sales, is a rounding error for online and physical retailers. Relocating to a lower-rent market (and even submarket) is, in most cases, uneconomical as the rent savings would be more than offset by higher transportation costs.

Pricing power of industrial landlords

Industrial sector focus on supply chain efficiency

Composition of logistics costs (%)

When breaking down total logistics costs, operators are incentivised to reduce transport costs rather than rent



Source: Cushman & Wakefield, Morgan Stanley Research

Although the real estate sector, overall, is anticipated to perform well within an environment of increasing inflation, when coupled with economic and/or structural growth, we believe that ultimately the underlying fundamentals impacting the various property sub-sectors will drive long-term performance to a greater extent over time. Sectors with strong fundamentals and pricing power such as industrial, single family residential, and manufactured homes are better positioned to raise rents and achieve inflation-beating cash flow growth. On the contrary, in our view, sectors with weak fundamentals and high vacancy rates such as malls and offices will find it challenging to achieve any sort of rental growth.

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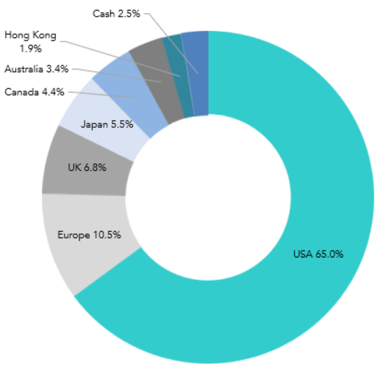
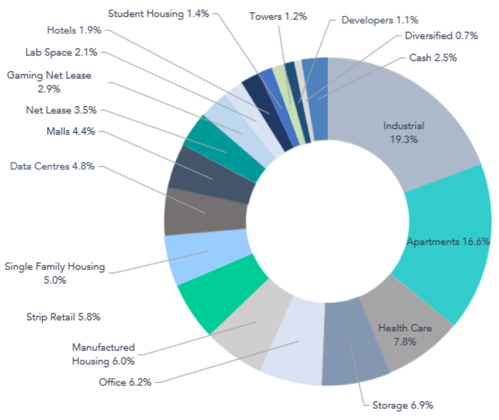
Tactical asset allocation

28 February 2022

Geographic allocation



Sectoral allocation



The following characteristics of listed real estate have historically impacted the ability to hedge against inflation:

1	Property types with shorter leases (hotels, apartments, residential) – vs longer leases (healthcare & net lease) – may better absorb the effects of inflation.	i.e. hotels which can benefit immediately from improving economic activity (by adjusting room rates daily) which typically more than offsets the impact of higher labor costs (housekeeping, etc.).
2	REITS typically have operating margins of around 60%. REITs' biggest costs are often property taxes which tend to rise slowly.	i.e. low labour costs as few onsite staff (except hotels & senior housing).
3	Leases are often linked to local CPI or have 'rental bumps' in the form of annual escalations between 2- 4% p.a.	Contractual escalations tied to inflation take time as rent increases may occur several years later based on trailing inflation.
4	As inflation rises, key inputs such as higher labour and materials costs result in higher replacement values and in consequence in-place asset valuations, which raises the barrier to new supply (i.e. hinder development pipelines).	This only matters when costs rise significantly as is the case with labour costs right now including the shortage of skilled construction workers).

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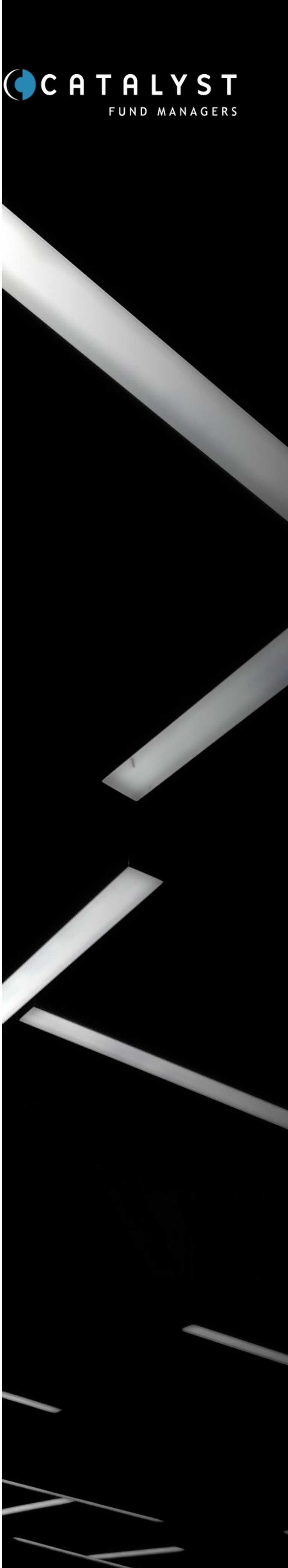

Conclusion

REITs' operating performance has generally achieved more than keeping pace with inflation over the past few decades. Long-term leases typically have inflation protection built in, and shorter-term leases are based on current price levels. Further, REITs keep a portfolio of leases, a portion of which are negotiated every year, so even REITs with longer-term leases have opportunities to reprice. Collectively, this supports the fact that REIT dividend growth should increase above inflation over the longer term, as has been the case in the US over the last 25 years.

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