Trinity Student Managed Fund
Sector Reports

Real Estate

September 2024

TRINITY SMF
STUDENT MANAGED FUND

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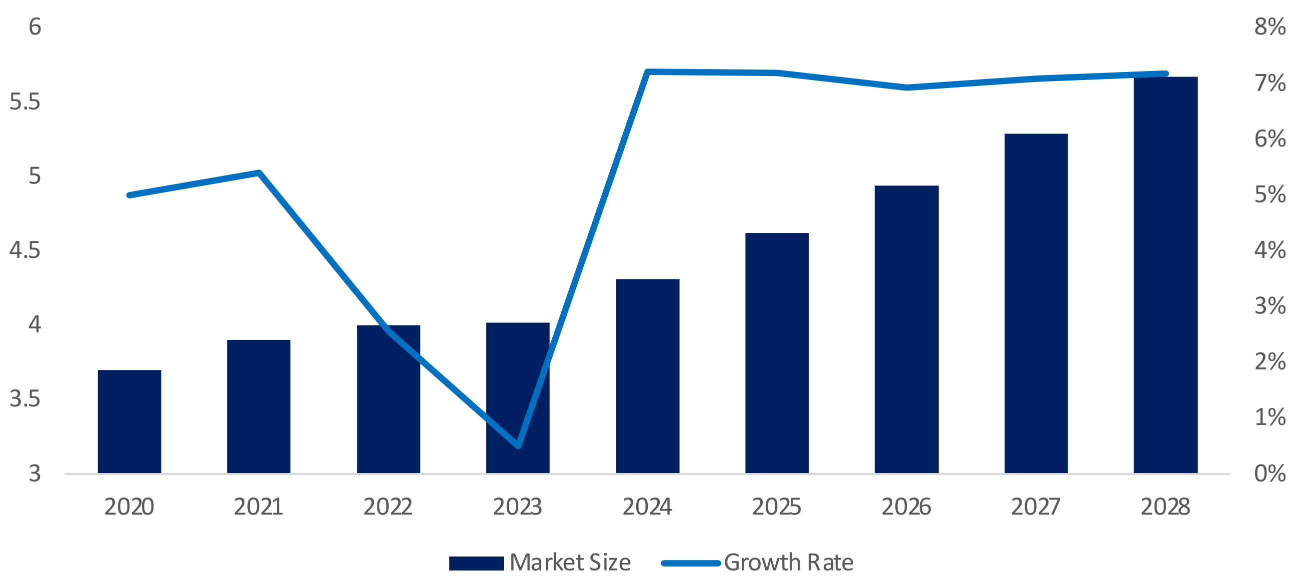
Sector Overview

Real Estate Investment Trusts (REITs) are companies that own, operate or finance real estate. REITs provide a means for individuals to invest in real estate through the purchase of individual company stock, through a mutual fund or through an exchange traded fund. By investing in a REIT, an individual gains partial ownership of the REIT's underlying properties, which are long-term holdings and have potential for income through either rent or property appreciation. The income generated is distributed to shareholders in the form of dividends. In order to qualify as a REIT, companies must derive 75% of their gross income from property-related sources, as well as distribute at least 90% of their taxable earnings as dividends. REITs are an attractive investment as they present the opportunity for portfolio diversification without the large cost of purchasing and operating property, alongside historically providing a steady stream of income through dividends.

The real estate sector exhibits cyclical behaviour, characterised by periods of expansion and contraction that are influenced by factors including changes in interest rates, economic growth trends, and shifts in consumer sentiment. Compared to broader financial markets, real estate tends to be more volatile in the short term, showing more pronounced cyclical patterns which historically lag behind the stock market, especially in the early stages of economic recovery. However, during later stages, real estate may outperform due to stable income from rents and long-term property appreciation.

*Figure 1: **Global Real Estate Market Size ($ Trillion) (Forecast from 2024)***



As of 2024, the global real estate market is valued at approximately $4.31 trillion and is positioned to grow to around $5.67 trillion by 2028, growing at a CAGR of 7.1% in the forecast period (1). The market's growth is driven by factors including urbanisation, increased infrastructure investments, and government initiatives.

Types of REITs

Understanding different REIT types can provide insights into how they might perform under various economic conditions. Each REIT type has a different exposure to market risks and opportunities, depending on its underlying asset structure. For instance, mortgage REITs are likely to be more sensitive to interest rate fluctuations than equity REITs. The three most common types of REITs are as follows:

Equity REITs: Own and manage income-generating property, collecting payments from tenants as rent. These make up the majority of REITs, with 96% of the market share.

Mortgage REITs: Also known as mREITs. This type of REIT lends money to real estate owners and operators either directly through mortgages, or indirectly through a mortgage-backed security, earning income through the interest paid on these.

Hybrid REITs: These REITs use investment strategies from both equity and mortgage REITs. They have held a negligible market share since 2009 as REITs have become more specialised.

Types of Key Leases

Understanding different kinds of leases can help to identify which REITs are likely to perform better in different market conditions. For instance, in volatile markets, leases with variable rental rates lead a REIT to be exposed to market fluctuations, making them more vulnerable. The three most common leases are as follows:

Single Net Lease: Tenant pays property taxes in addition to a usually lower base rent.

Triple Net Lease: One of the most commonly used types of commercial real estate leases, a triple net lease (also known as an NNN lease) is one in which tenants are required to pay the monthly rent alongside the property expenses (insurance, property taxes and maintenance costs).

Absolute Net Lease: Similar to a triple net lease, but also includes major building repair costs. This type of lease requires no landlord responsibilities, reducing the financial burden on the property owner.

Key Players

American Tower Corp.
Market Cap: $104.88 Billion
American Tower Corp. Operates properties related in the infrastructure and data centre sub-sectors. Among its properties are data centres, cell towers and radio towers.

Prologis Inc.
Market Cap: $117.20 Billion
Prologis is the global leader in logistics real estate, owning and managing space for warehouses, manufacturing, distribution and large-scale storage.

Digital Realty Trust
Market Cap: $49.93 Billion
Digital Realty Trust is a fast-growing REIT that focuses on network neutral data centres.

Equinix
Market Cap: $78.41 Billion
Equinix is the market share leader in the data centre space, with 13% market share.

REIT Sectors

Gaming REITs: concentrate on owning and managing experiential real estate assets, such as casino and entertainment properties.
Key Players: VICI, GLPI

Office REITs: own and manage office buildings and rent property space to tenants. Office REITs can focus on specific market types or specific tenant classes.
Key Players: BXP, Vornado

Industrial REITs: own and manage industrial facilities, such as warehouses and distribution centres renting spaces to tenants. Demand for these properties has risen alongside the rise in e-commerce.
Key Players: Prologis, EastGroup Properties

Lodging REITs: own and manage hotels and resorts.
Key Player: Host Hotels and Resorts

Residential REITs: own and manage forms of residences. Residential REITS will usually specialize in a specific type of residence, for flats or family homes.
Key Players: Vonovia, Camden Property Trust

Health Care REITs: own and manage health care-related real estate including retirement homes, hospitals and medical centres.
Key Players: Healthpeak, Sabra

Self-storage REITs: own and manage storage facilities, renting space to both individuals and businesses.
Key Players: Public Storage, Extra Space Storage

Infrastructure REITS: own and manage infrastructure real estate such as fibre cables and energy pipelines.
Key Players: American Tower, Crown Castle International

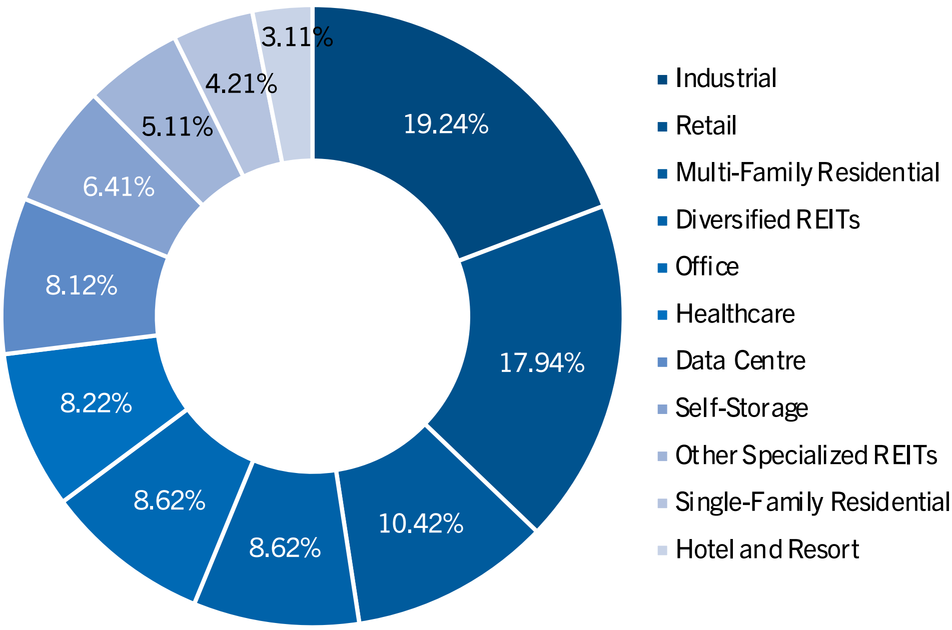
Data Centre REITs: own and manage facilities that allow customers to store data.
Key Players: Equinix, Digital Realty

Retail REITs: own and manage retail space.
Key Players: Simon Property Group, Realty Income Corporation

Diversified REITs: own and manage a mix of property types.
Key Players: W.P. Carey, Broadstone

Speciality REITs: own and manage a unique mix of property types that do not fall under the previous REIT sectors.
Key Players: EPR Properties, CoreCivic

*Figure 2: **S&P Global REIT Index Breakdown by Sector (2)***



Key Performance Indicators

Valuation Methods

REIT Valuation Differences

REITs are often valued differently compared to regular companies. This is because the vast majority of a REIT's assets consist of land and property which generally appreciate or maintain their value over time, unlike most firms' assets, such as machinery, which depreciate in value due to wear and tear. Therefore, we must utilise a valuation method which takes this into account. We can use several metrics to compensate for this.

Price to Funds From Operations ratio (P/FFO)

This is used instead of the traditional Price-to-Earnings ratio (P/E) with the benefits of P/FFO being:

- P/FFO adds back depreciation and amortization, which is necessary as land is not subject to depreciation.
- P/FFO subtracts any profits made from the one-off sale of an asset as this isn't income from continuing operations of the REIT (and therefore doesn't reflect regular business operations of a REIT).

FFO = Net Income + Depreciation Expense + Amortization Expense + (Losses on Sale of Assets) - (Gains on Sale of Assets + Interest Income)

Net Asset Value (NAV)

Used instead of Price-to-Book ratios. Unlike regular companies, a REIT's assets are relatively liquid and comparable to other real estate assets constantly being bought and sold. This allows us to find the fair market value of assets comprising a REIT's portfolio rather than having to estimate future cash flows and discount them to the present.

NAV = Market Value of a REIT's Total Assets – Value of All Liabilities (e.g mortgages)

Dividend Discount Model (DDM)

DDMs are a less commonly used valuation method as not all companies pay out dividends. However, as REITs are required to pay out 90% of taxable earnings, investors will receive a consistent dividend if the REIT is making money. A DDM discounts all future expected dividends to the present value at the cost of equity.

Alternative Performance Indicators

Alongside valuation methods, we can use other financial and non-financial performance indicators to provide insight into potential future demand, economic activity, and industry trends. Some of these indicators are as follows:

Credit conditions

Credit is the action or contractual agreement of providing finance to another party and getting it back later with interest. Credit conditions, or rather lending practices among banks and other financial institutions, greatly affect the real estate market. Acquiring properties often requires loans and therefore tightening on lending practices, or a shift in credit conditions, can affect the sentiment to do so. We would expect REITs to underperform under more stringent credit conditions. This is because REITs often rely on debt to finance property acquisitions, meaning that the profitability of a firm will likely fall due to rising interest expenses, alongside slower growth resulting from a decreased ability to fund new projects.

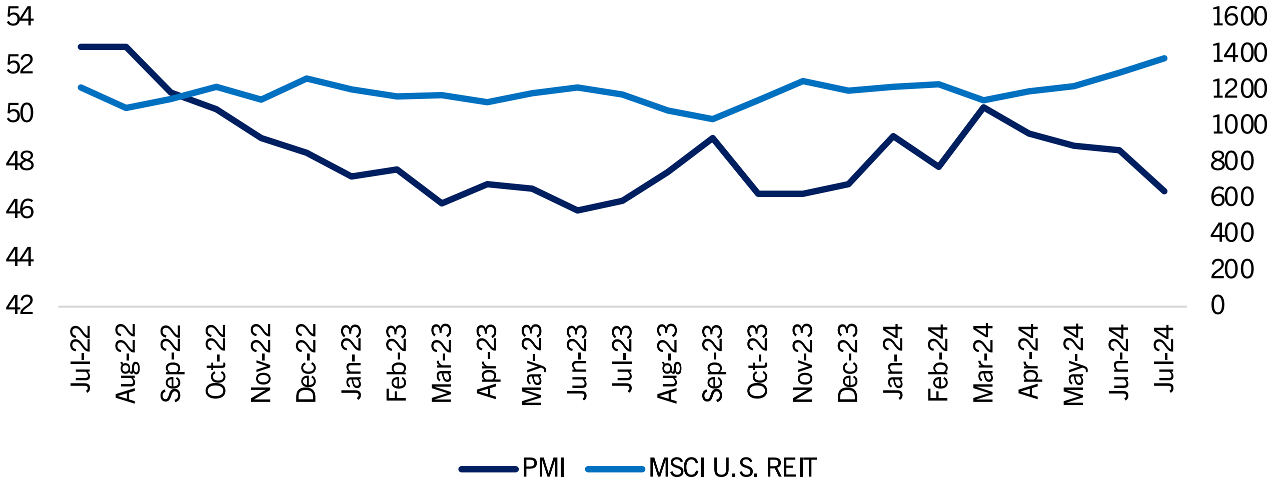
Building Permits

A building permit is the legal authorisation given by a government to commence construction. Respective countries' national statistics bureaus report the total number of building permits issued monthly. This can be viewed as an indicator of growth or stagnation in particular segments of the economy. For example, recent building permits in Europe have been primarily issued for residential property, likely indicating an upsurge in demand for private housing.

PMI

The PMI (also known as the Purchasing Managers Index) is a 'survey-based' index which aims to be a representative model of the economic health of various industries through managers' inputs on purchase and supply trends. The index is reported by both manufacturing and services, covering 19 industries. Due to the timeliness of the reports, economic trends can be identified quicker before they reflect on the whole economy. As this index can be utilised to view economic trends and peaks in purchases (or consumer behaviour), it is a key indicator for overall economic conditions.

Figure 3: ***US ISM Manufacturing PMI (3) vs MSCI U.S. REIT Index (4)***



Current Holding

VICI Properties (NYSE: VICI) – SELL

VICI Properties Inc. is an S&P 500 real estate investment trust that owns one of the largest portfolios of market-leading gaming, hospitality and entertainment destinations. VICI Properties' geographically diverse portfolio includes 93 experiential assets, consisting of 54 gaming facilities and 39 non-gaming properties across both the United States and Canada, totalling approximately 127 million square feet (5). These properties are occupied by industry-leading gaming and hospitality operators under long-term, triple-net lease agreements, occupying a great portion of the Las Vegas Strip.

VICI Properties, alongside the broader US casino gambling business, has demonstrated strong performance despite recent economic turbulence. Total revenue increased by 6.6% year-over-year to $957 million in Q2 2024, whilst the company continues to be a dependable income stock, most recently offering a dividend yield of 5.3%, a figure that has consistently grown annually since 2019 (6). However, the company's share price has only appreciated by 0.73% YTD, reflecting the long-term stock price stability observed since 2021, which suggests limited potential for capital appreciation. We must also consider recent economic developments and market conditions which pose risks that could constrain future performance.

Figure 4: ***VICI Monthly Growth (%)***

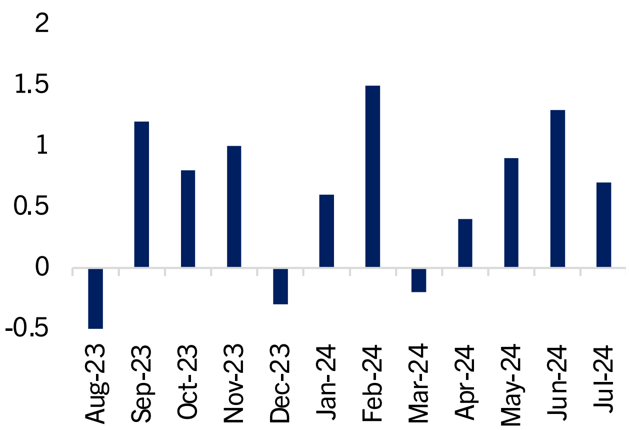
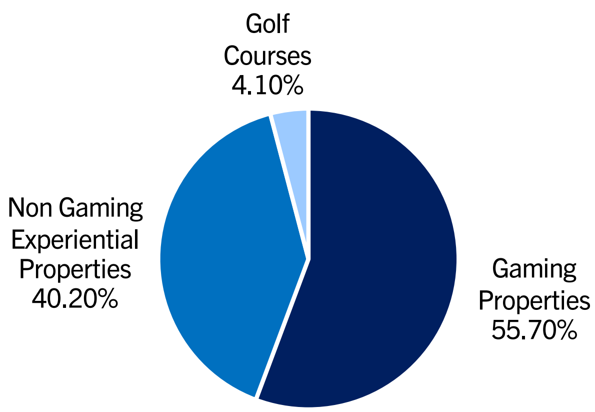


Figure 5: ***VICI Holding Types***



Recent developments in US interest rates present significant challenges for this REIT. As of August 2024, the Federal Reserve has maintained the federal funds rate at 5.25% to 5.50%, the highest level in over two decades, as part of ongoing efforts to control inflation. This higher interest rate environment is likely to persist, with rate cuts happening slowly, leading to increased borrowing costs and reducing the attractiveness of REIT dividends compared to fixed-income securities. For VICI, this means increased cost of capital, making debt refinancing and new acquisitions less appealing. Additionally with U.S. Treasury yields around 3.9% for the 10-year bond, VICI's dividend yield is less compelling, particularly when considering alternative yield investments (7).

Despite the U.S. economy expanding at an annualised rate of 2.1% in Q2 2024, consumer spending is showing signs of deceleration, particularly in discretionary sectors such as entertainment and travel. This trend is likely to have substantial implications for VICI, as its reliance on gaming and hospitality tenants exposes the company to cyclical downturns in consumer spending. As consumers tighten their budgets, VICI's tenants may face revenue pressures, potentially leading to reduced rental income or higher vacancy rates.

A further concern is tenant concentration risk. VICI derives 39% of its rental income from Caesars Entertainment, a company that has recently reported flat revenue growth amidst economic uncertainties and rising operational costs (8). Having a heavy reliance on a small number of key tenants introduces concentration risk whereby any financial stress on these tenants could lead to renegotiated leases or vacancies, adversely affecting VICI's cash flow.

Considering the persistent high-interest rate environment, industry-specific risks, and tenant concentration concerns, VICI Properties Inc. faces significant challenges ahead. Therefore, after thorough analysis, we recommend selling VICI at current levels to lock in gains and reallocate capital to investments with a more favourable risk-reward profile.

Investment Themes

Real estate is extremely diverse and flexible, as it can gain exposure to all other industries through subsectors. For instance, during the pandemic the healthcare industry experienced a peak in demand; this correlated to the resilience of healthcare REITs (operating hospitals etc.) during a time of wider downturn for the rest of the market. Growth within other sectors present opportunities for REITs which appeal to those property groups.

Supply Dynamics Across Real Estate Sectors

Demand for multifamily housing has surged as a result of high mortgage rates pricing out potential buyers. However, construction has failed to keep pace with this growing demand due to elevated construction costs and restrictive planning laws, meaning that there is a notable lack of supply in the multifamily housing sector, particularly in urban areas (9). In contrast, the shift towards hybrid work models has put significant pressure on the commercial office space sector with vacancy rates approaching historic highs, especially in central business districts. This trend presents opportunities for repurposing these spaces into data centres or residential units. However, these conversions require significant capital investment, likely necessitating developers to take on significant debt, especially given the current high interest rates.

Digital Infrastructure

With continued developments in technology and recent advances in AI, digital infrastructure has been noted to be a crucial sub-sector. Property types include data centres, cell towers and wireless infrastructure. 5G has been mainly driving the telecom industry similarly to how AI has sparked a new wave of interest in data centres. The global data centre market is expected to grow from $332.86 billion in 2024 to $1,251 billion in 2032 (10). According to the 2024 global investor survey conducted by the CBRE over 37% of respondents estimated over 50% of their global assets under management will be in data centres by 2029.

Sustainability and ESG

Growing demand from tenants and investors for buildings that align with ESG principles provide opportunities for developers and landlords. Demand for properties that reflect a tenant's own sustainability values has increased as companies aim to meet their corporate ESG goals, resulting in ESG-aligned buildings outperforming their non-ESG counterparts in terms of rental income, occupancy rates, and property value appreciation (11).

Risks

Interest Rates

High inflation in the past couple of years has been addressed by significant hikes in the bank rate (which is the interest rate at which the central bank loans money to a commercial bank). These currently sit at 5% in the UK and 4.25% in the Eurozone.

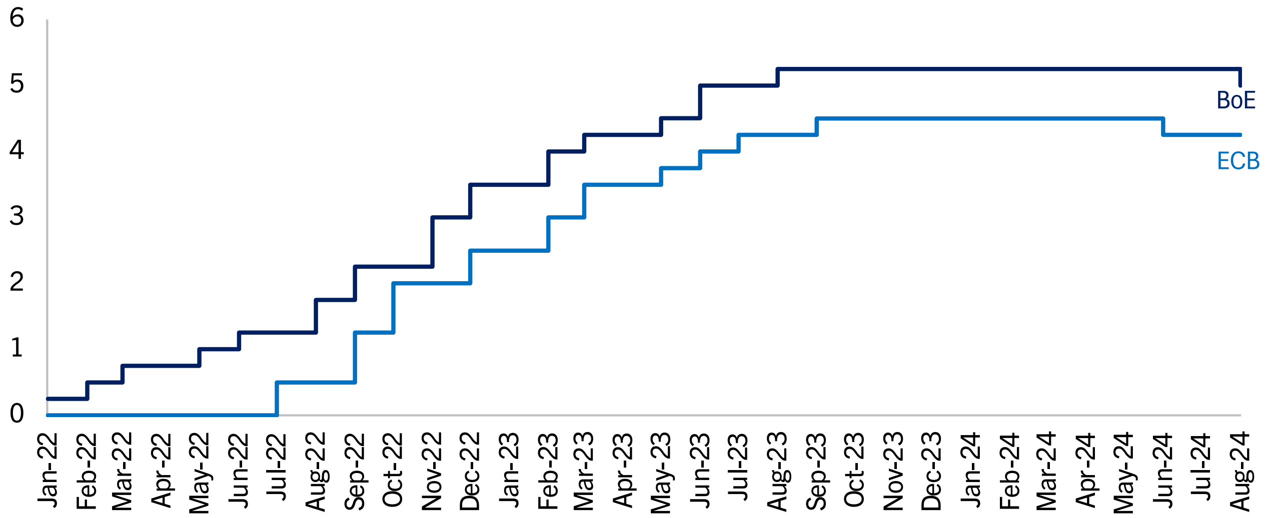
Elevated interest rates tend to decrease the value of property and increase the borrowing costs for a REIT, which commonly use a combination of both debt and equity to finance property acquisitions. As a result, they are far more sensitive than other asset classes to rising interest rates, particularly those employing variable rate debt, due to their significant debt obligations.

Despite this, high interest rates are often linked with economic growth and rising inflation, which tend to positively affect real estate investments. Economic growth typically translates into greater demand and higher occupancy rates, benefiting real estate assets. Additionally, during inflationary periods, property owners are generally able to increase rents, supporting growth in REIT earnings and cashflow, and consequently increasing dividends.

Debt

REITs are required to pay out 90% of their taxable income to shareholders, which limits the funds available for reinvestment and growth. As a result, REITs take on large amounts of debt, often comparatively more than other types of companies, in order to facilitate the acquisition of new properties and support overall company growth. In periods of economic downturn or a tightening in lending practices, this can significantly damage a REIT's finances if they are heavily dependent on bank loans. Additionally, if the loan is subject to variable interest rates, the company becomes highly susceptible to financial risks concerning rate hikes.

*Figure 6: **UK (12) and Europe (13) Interest Rates 2022-24 (%)***



Inflation

Inflation is the general increase in the price of goods and services over time, which results in a decrease in the purchasing power of money. Inflation can impact the real estate market through increased loan defaults, as the cost of living rises, or increased maintenance expenses for landlords.

Despite this, real estate has historically appreciated alongside inflation, proving to be a reliable hedge against it. Inflation-resistant REITs will often incorporate rent escalations into their leases, meaning rents automatically rise with inflation.

With global core inflation projected to remain sticky at around 3%, inflationary risks are not expected to be as severe as those experienced in recent years, such as the 2023 global inflation rate of 6.8%.

Regulation

The real estate industry operates under stringent regulatory frameworks, imposing various laws and regulations on developers and landlords. This has been demonstrated by Ireland's implementation of a 2% annual rent increase cap and Scotland's rent freeze, both of which have led to a significant reduction in investment within the Private Rental Sector (PRS) (14). These instances highlight the substantial impact that political decisions can have on the real estate market.

Outlook for the Year

A period of high interest rates in 2022 and 2023 proved to be a headwind in the real estate sector as borrowing costs increased and office and retail space occupancies fell. Despite these challenges, supply-and-demand dynamics remained favourable as existent supply, alongside a lack of lending which prevented development, failed to match the demand for property.

In a shift from these rapidly rising bank rates, bank rates set by the Fed, the BoE and the ECB are predicted to stay steady, at the current rates of 5.5%, 5% and 4.25% respectively (as of August 2024), for the foreseeable future. This allows investors to adapt to a long-term outlook of higher-for-longer interest rates, likely increasing investor confidence after a volatile period of interest rate hikes (15).

Surging demand for data centres has come as a result of digital transformation which requires data centres for data storage and processing solutions, with AI advancements being a particular driver. When evaluating **data centre REITs**, it is becoming increasingly essential to consider the significant energy consumption associated with data centres, which may present challenges in achieving net-zero emission targets. Consequently, it is likely to be advantageous in the long term to focus on data centres that align more closely with ESG guidelines by implementing sustainable energy practices. These include utilising renewable energy sources or reusing waste heat in agricultural production.

In the residential real estate market, European residential transaction volumes fell 15% in 2023 alongside rental growth of 7.1% in the same time, this indicates strong demand for rental residential property, predominantly led by a higher renting youth population. This suggests the opportunity for high returns for **residential REITs**.

Looking forward, the data centre and residential sub-sectors have growth potential in the coming months which our sector will be focusing on, in aiming to diversify our holdings.

Figure 7: ***US Data Centre Revenue Growth ($million) (16)***

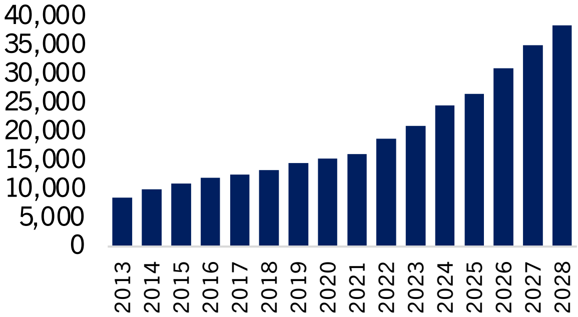
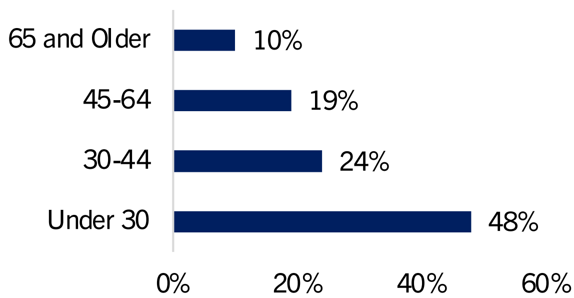


Figure 8: ***Distribution of US Renters by Age (17)***



Buy-List

Vonovia (ETR: VNA) – BUY

Vonovia is Europe's largest listed residential real estate company, with a portfolio valued at €82.5 billion, comprising 543,000 residential units across Germany, Sweden, and Austria. In addition to these properties, Vonovia manages over 71,000 apartments on behalf of third parties (18). Despite its position as Germany's leading real estate company, Vonovia's market share is only 2%, reflecting the highly fragmented nature of the real estate market.

Residential REITs, particularly Vonovia with its substantial holdings of city apartments, offer strong secular growth potential. This is driven by the supply and demand imbalance caused by high construction costs and low rents, and increasing urbanisation, with over half the world's population now residing in cities. Specifically, in Germany, rental prices currently remain well below those in comparable European locations, presenting an opportunity for future rent increases.

The company's competitive advantages primarily stem from the diversified nature of its portfolio. The regional diversity of its properties reduces reliance on individual rental markets, making Vonovia less vulnerable to localised economic downturns. Additionally, its larger size enables it to maintain the sector's lowest maintenance and property operation costs, providing an advantage when bidding for property portfolios. Vonovia also has significant modernisation potential, with two-thirds of its portfolio yet to be upgraded. Upon modernisation, rental increases can be implemented on existing tenants, increasing earnings.

Risks facing Vonovia particularly lie in incremental regulatory changes. The ongoing tightening of rent caps could reduce the earning potential of its properties. Additionally, the aforementioned modernisation opportunity relies on successful execution of the company's, likely costly, modernisation program.

*Figure 9: **Vonovia Dividend Yield (19)***

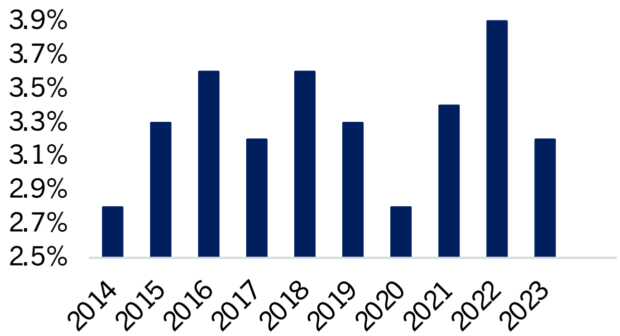
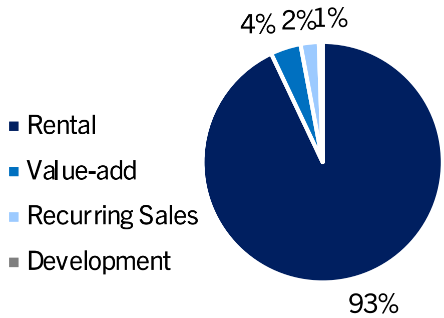


*Figure 10: **EBITDA by Segment (20)***



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