U.S. REITs and COVID-19:
Property Fundamentals and REIT Balance Sheets Positioned Better than Credit and Equity Markets' Perception

Overview

What seemed to be a localized virus outbreak in China just two months ago has now brought public activities to a halt across the U.S. and many other parts of the world. The shock to the economy has been sudden and severe, exacerbated by the sharp decline in oil prices, which has added to the strain on credit markets.

This could last longer than people expect, increasing the risk of tighter financial conditions that could impact companies with weak balance sheets.

Our base case is that the U.S. economy will experience a sharp contraction in the second quarter with a recovery sometime in the second half. This scenario depends on social distancing measures lasting through May, the Federal Reserve providing liquidity to markets, and significant fiscal stimulus. Without one or more of those conditions, we could have a more pronounced recession.

> We believe most REITs are well prepared to manage—and, in some cases, even thrive—through this challenging period.

Highlights

1. **How recession risk is affecting REITs.** Since the market peak on 2/19, REITs have underperformed broad equities, weighed down by increasing strains in credit markets and the prospect of a sharp reduction in real estate demand. REITs with stronger balance sheets are generally outperforming, as are property sectors experiencing less disruption.
2. **This is not 2008.** REIT balance sheets are significantly stronger today, with leverage near historical lows. Staggered debt maturities will limit the need to refinance at a time when credit spreads have widened. And global central banks are taking decisive actions to support the financial system, cutting interest rates and providing liquidity facilities.
3. **What we are doing in our portfolios.** We have reduced weights in more cyclical sectors, including hotels and gaming, and remain cautious on retail. We continue to like apartments and single-family rentals, technology and well-positioned healthcare REITs.

How Recession Risk Is Affecting REITs

Why haven't REITs defended better? Despite relatively stable lease-based cash flows and strong balance sheets, REITs have underperformed broad equities, due largely to two factors: tightening credit conditions and the prospect of sharply weaker property fundamentals.

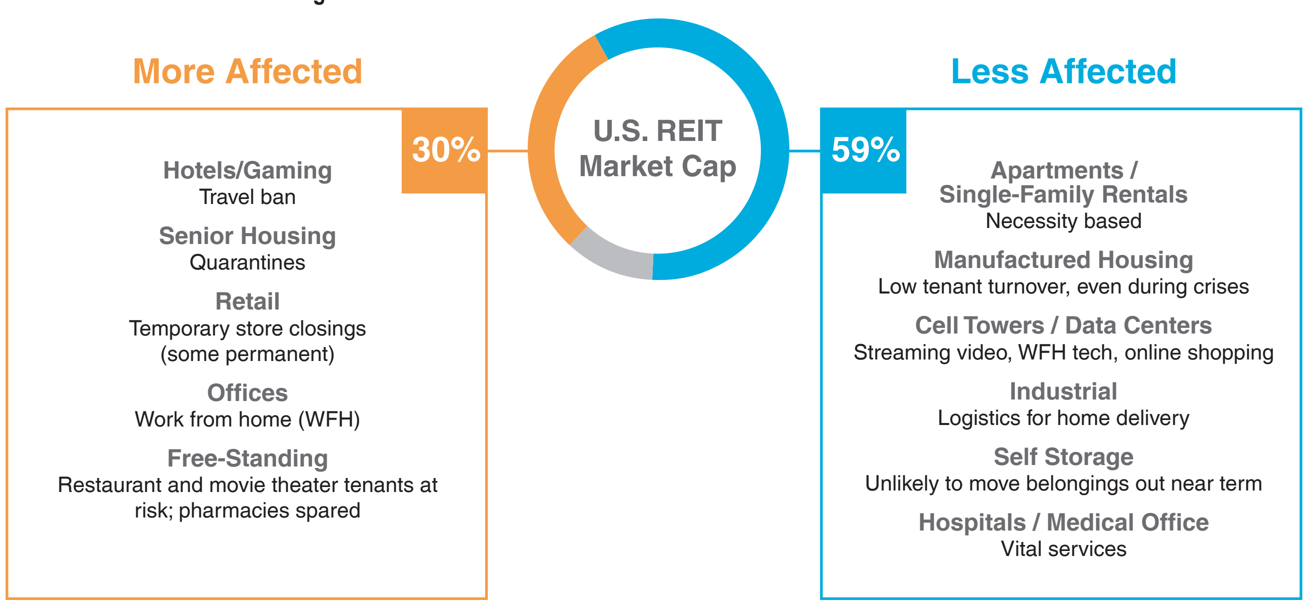
REITs provide space to many industries that are being directly impacted by efforts to slow the virus's spread, including travel, tourism, retail, senior housing, restaurants and business events. As a result, there is a fear that some landlords could face vacancies and extended disruptions in the payment of rents despite long-term lease obligations. However, many property sectors will likely see more limited disruptions, particularly housing, data centers and cell towers.

Hotels and gaming taking the worst of it. Businesses are suspending all non-essential travel, conventions scheduled for the first half of the year are being cancelled, and many restaurants have either shut down or have limited hours and seating. Hotel companies are no longer comfortable providing guidance amid this heightened uncertainty.

Senior housing fundamentals at risk. By their very nature, these facilities are among the most vulnerable to COVID-19, catering to a largely elderly tenant population that is at high risk. Senior housing centers in the U.S. could be affected by increased mortality rates and quarantines, thereby limiting current occupancies and slowing new demand.

Retail tenants were weak before the crisis. Many national and local retailers are closing stores temporarily or curtailing business hours, adding to the significant headwinds mall owners were already facing, including oversupply, the shift to online shopping and structural impairments in the department store business model. The current crisis could accelerate the shift to e-commerce, with potentially permanent effects. The impact is less acute for shopping centers, as grocery stores, pharmacies and discount stores are generally staying open and are seeing a substantial uptick in business.

EXHIBIT 1: REITs and Social Distancing



At February 29, 2020. Source: Cohen & Steers (sector categorization); FactSet (market cap).

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Office leasing to slow. Many offices across the U.S. are operating with minimal or no on-site staffing as companies institute business continuity plans. While this should have limited impact on in-place leases, we expect leasing activity to slow. The disruption could also be a major negative for co-working, which generally caters to smaller companies and operates with much shorter lease terms.

Net lease may not be so defensive. Most net lease companies own single-tenant buildings under long-term leases to both investment-grade and non-investment-grade tenants. While most will be largely unaffected by the current crisis because of the type of tenant (medical use, office, industrial), others have exposure to at-risk businesses susceptible to credit losses, such as restaurants, theaters, gaming or venues where large public gatherings happen.

Housing more a necessity than ever. Rental housing has been relatively healthy and should be the least impacted by the current crisis unless the economy enters a prolonged recession with material job losses. Likewise, we expect self storage to be relatively unaffected in the short term.

Data centers and cell towers link a sequestered population to the world. REITs in these sectors could see some impact from slower decision making on IT capital spending. However, increased home-based activity—including from working from home, video streaming and online shopping—should directly drive demand for greater data storage and processing capacity.

Logistics for getting packages to your doorstep. Industrial REITs are seeing a mixed impact, facing reduced trade and manufacturing and disruptions to supply chains on the one hand, and the need for increased logistics capabilities for e-commerce on the other.

Health care (ex-senior housing) faces little risk. Hospitals and medical office buildings should continue to see strong demand through the crisis. Furthermore, long-term leases may offer a significant buffer against near-term economic swings.

This Is Not 2008

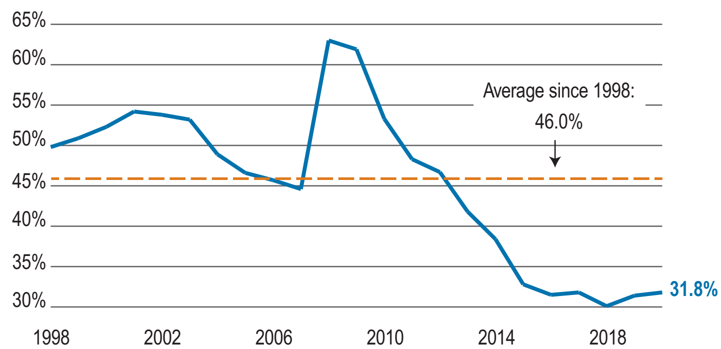
While the severity of the economic impact and the strain on credit markets may bring back memories of 2008 for some investors, there are several factors that we believe put REITs in a much stronger position.

REIT balance sheets are generally stronger than ever. In the aftermath of the financial crisis, many REITs spent much of the last decade strengthening their balance sheets, raising capital to pay down debt. Today, average leverage among REITs is near an all-time low of 32%, compared with 63% in 2008 (Ex. 2). We believe this puts companies in a stronger position to weather this storm. However, capital spending and external growth opportunities (acquisitions) will be limited until conditions improve.

Maturities have been staggered. Unlike during the global financial crisis, REITs have well-laddered debt maturities, with generally limited maturities through 2021. Covenants could be breached for certain sectors (such as retail, lodging and gaming) where cash flows are disrupted, and others may need lenders to temporarily relax limitations. However, we believe most sectors have sufficient liquidity.

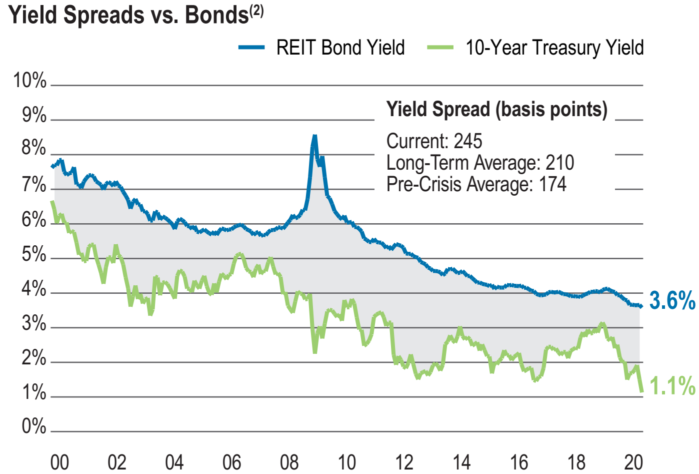
REITs have access to low-cost debt capital. Historically low financing costs, due to healthy balance sheets and high-quality properties and tenants, should favor REITs (Ex. 3).

EXHIBIT 2: REIT Leverage Is Near an All-Time Low[1]



At February 29, 2020. Source: Green Street Advisors.

EXHIBIT 3: REIT Borrowing Costs Are at Historical Lows Despite Wide Yield Spreads vs. Bonds[2]



At February 29, 2020. Source: Bloomberg, ICE BofA.

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The REIT market's business mix has become less cyclical. The emergence of new property types such as cell towers, data centers and alternative housing over the past decade has provided investors access to differentiated investment opportunities driven by secular themes such as the need for data infrastructure and the rollout of 5G wireless networks. This has helped the REIT market to become structurally less cyclical (Ex. 4).

Central banks are taking decisive action. Contrasting with the incremental easing measures enacted in 2008, the Federal Reserve has rapidly responded to the unfolding crisis, reducing the fed funds rate to zero, promising $700 billion in bond purchases and establishing a lending facility to provide liquidity to the short-term commercial debt market, helping to ease strains in overnight lending. Central banks in other countries have implemented similarly substantive measures to combat the sudden strain on credit markets.

What We Are Doing in Our Portfolios

With a significant level of negative news already priced in, we do not believe it makes sense to shift to a wholesale defensive stance. However, factoring in lower growth expectations and rapidly shifting relative valuations, we are making prudent adjustments to our portfolios.

What we still like:

- **Apartments:** With renting often an affordable option vs. homeownership, we expect reduced turnover, stable rents and occupancies.
- **Storage:** These companies tend to have stable cash flows and strong balance sheets with demand generally driven by life changes that are less economically sensitive.
- **Healthcare (selectively):** We have a positive view on hospitals and medical office buildings, which offer critical services that should be in heavy demand. We had limited exposure to skilled nursing and weaker assisted living owners/operators.
- **Technology REITs:** Data centers are not immune to the impacts of economic slowdown, but demand is likely to remain strong and valuations appear reasonable. We continue to believe in the secular growth story of cell towers, although valuations have become more expensive.

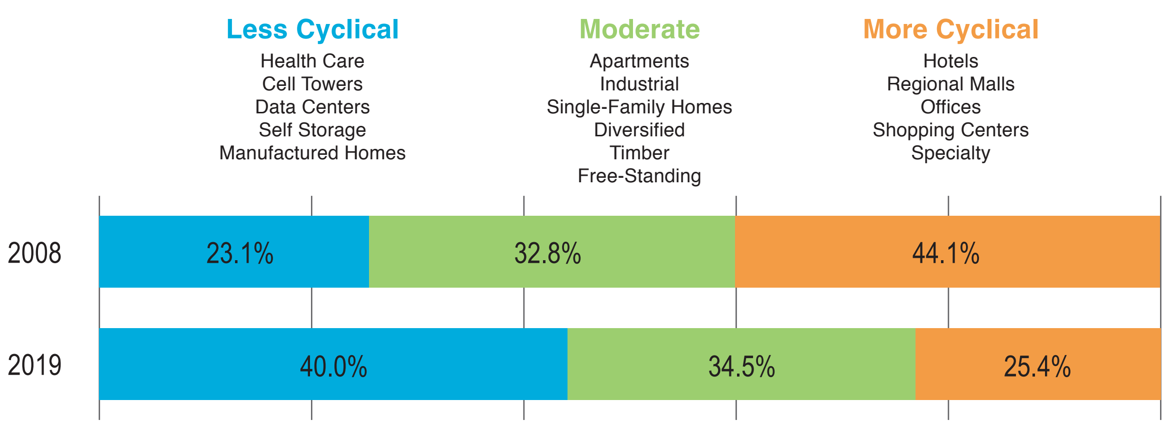
Changes we are making:

- **Reduced industrial:** We believe the sector's expensive relative valuations and the potential for trade disruptions outweigh strong secular logistics demand.
- **Reduced lodging and gaming:** We had become increasingly positive on hotels entering 2020 based on attractive valuations following their underperformance in 2019. Today, we believe the sector will face significant challenges for the foreseeable future.

Continued risks:

- **Retail:** Within this sector, we have modest exposure to companies with extremely solid balance sheets and strong market positions.

EXHIBIT 4: The REIT Market Has Become Structurally Less Cyclical
% of U.S. REIT Market Capitalization



At February 29, 2020. Source: FactSet, Cohen & Steers.

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What Should REIT Investors Do

For investors willing to be patient through this crisis, we believe REITs' strong balance sheets, attractive dividends and now discounted valuations could set the stage for a significant opportunity following the asset class's underperformance during these early days of the crisis.

Assuming the number of new COVID-19 cases peaks in the next few months and both monetary and fiscal policy are effective in providing liquidity and cushioning the blow to aggregate demand, we expect the economy will come out of this shock with a strong demand recovery at a time of record easy monetary conditions. As that happens, we expect financial markets could respond quickly.

For historical perspective, following the previous six market corrections of 10% or more, REITs on average have recovered faster and stronger than broad equities, benefiting from a reacceleration in demand combined with accommodative monetary conditions.

EXHIBIT 5: REIT Performance Following Corrections

					Returns 3-months After the Trough Date		Returns 6-months After the Trough Date		Months to Recover to Previous High	
Cause of the Correction	**Peak Date**	**Trough Date**	**S&P 500 Selloff %**	**U.S. REITs Selloff %**	**U.S. Equities**	**U.S. REITs**	**U.S. Equities**	**U.S. REITs**	**U.S. Equities**	**U.S. REITs**
"Shocktober" Worldwide Stock Market Downturn	9/20/18	12/24/18	-19.4%	-10.8%	20.0%	21.0%	25.2%	22.2%	3.6	1.1
Feb 2018 Correction	1/26/18	2/8/18	-10.1%	-9.1%	6.0%	9.5%	11.6%	16.1%	5.5	3.6
"The Great Fall of China" Market Selloff	7/20/15	2/11/16	-13.0%	-7.3%	13.5%	20.9%	20.8%	29.0%	2.1	1.0
European Sovereign Debt Crisis	4/29/11	10/3/11	-18.6%	-20.8%	16.9%	22.0%	30.1%	34.0%	4.0	4.0
Flash Crash	4/23/10	7/2/10	-15.6%	-13.3%	12.7%	16.1%	24.2%	23.9%	4.1	2.6
Global Financial Crisis	10/9/07	3/9/09	-55.3%	-69.6%	39.7%	60.8%	52.0%	78.3%	36.9	36.4
Average					**18.1%**	**25.1%**	**27.3%**	**33.9%**	**9.4**	**8.1**

At February 28, 2020.

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We understand these are unprecedented times. We will continue to provide updates as the situation evolves. In the meantime, please reach out to your Cohen & Steers representative with any questions.

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The S&P 500 Index is an unmanaged index of 500 large-capitalization stocks that is frequently used as a general measure of U.S. stock market performance.

The FTSE NAREIT All Equity REITs Index contains all tax-qualified REITs with more than 50% of total assets in qualifying real estate assets other than mortgages secured by real property that also meet minimum size and liquidity criteria.

The ICE BofA U.S. Real Estate Index tracks the performance of U.S.-denominated investment-grade real estate corporate debt publicly issued in the U.S. domestic market; it is a subset of the ICE BofA U.S. Corporate Index, including all securities of Real Estate issuers.

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Publication Date: **March 2020**