Special commentary from the Investment Advisory Group

Real estate opportunity as structural shift and resilience underappreciated

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Executive summary: As the economy recovers/reopens, inflation firms, and the vaccine rollout ramps up in the U.S., segments of commercial real estate have some catch-up potential, specifically those sectors that were most vulnerable during the pandemic. Unlike the broader equity market, real estate investment trusts (REITs) remain well below their prior peaks reached in early 2020, and are at the most attractive price level relative to the S&P 500 in more than a decade.

Our work suggests that investors underappreciate how dramatically the industry mix has shifted within the REIT asset class over the past decade. The pronounced divergence in performance across sectors last year was a true reflection of an evolving asset class, where some sectors were hit hard by the pandemic, while others gained.

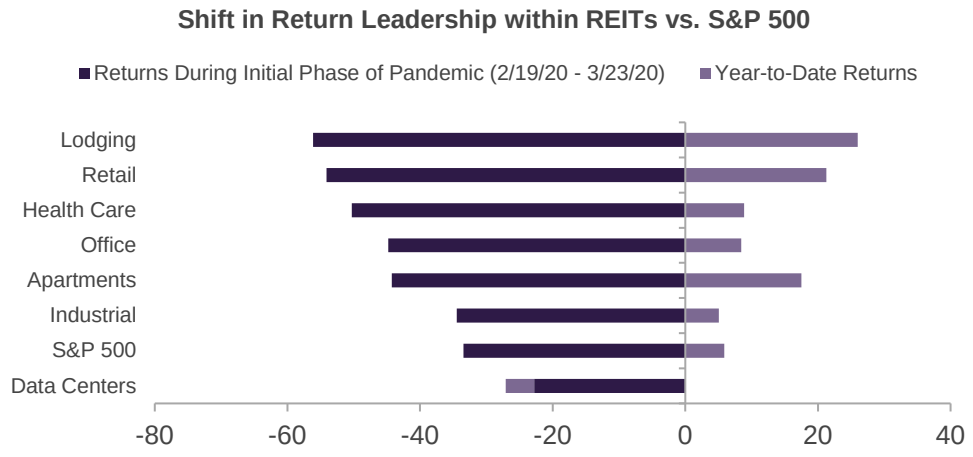
A full recovery will take time and be uneven, but there are signs of fundamental improvement across certain property types. We favor a more diversified approach with meaningful exposure to growth-oriented technology sectors along with those cyclical sectors that stand to benefit from the U.S. recovery.

What happened?

The pandemic forced business closures, travel restrictions, working from home, and social distancing measures, creating an external shock to an otherwise healthy U.S. economy and commercial real estate landscape. Equity REITs are companies that own, operate or finance income-producing real estate and are a liquid and tradable proxy for the commercial real estate market. While all risk assets declined sharply during the first two months of the pandemic, REITs faced even greater pressure in light of these restrictions. On the whole, REITs were down more than 40% compared to the S&P 500's 33% loss during those initial months. That was especially true for sectors like lodging (i.e., hotels and resorts) and retail, where vacancies rose and commercial rent forbearances and delinquencies grew. That said, there was some variation in operating fundamentals across property types.

Unlike the broader equity market in 2021, REITs, in aggregate, have yet to reach their pre-pandemic levels and are trailing the broader market by 25% over the past year. This is the most extreme underperformance since the Global Financial Crisis. Those highly cyclical REIT sectors, such as lodging and retail, however, have regained momentum in recent weeks, recouping much of their 2020 losses as the economy recovers, inflation firms, and the vaccine

rollout ramps higher. In our view these beaten-down sectors have further upside potential going forward.



Data Source: Truist IAG, FactSet

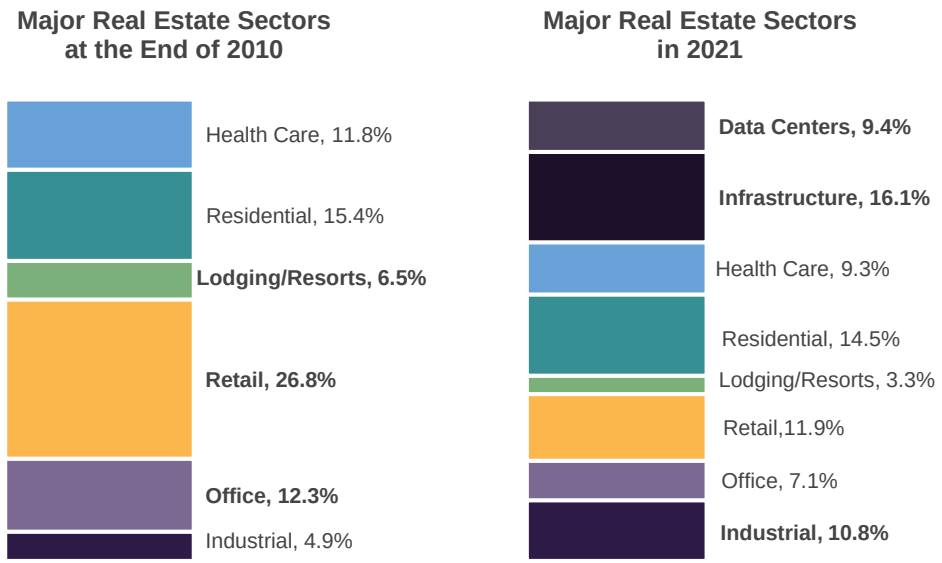
REIT sector mix has evolved over time

There has been a dramatic shift in the REIT sector mix during the past decade. This is evident in the pronounced divergence in performance across the asset class.

REITs that support the digital economy have seen a surge in demand in recent years. This includes the industrial REIT sector, which has been in existence for some time and includes manufacturing plants, warehouses and distribution centers. The landscape now also includes e-commerce related facilities. Data centers house the servers that host internet websites and other data communications, while infrastructure/cell towers transmit voice and data for teleconferencing and e-commerce transactions. These specialized property types were not part of the asset class a decade ago, but now represent nearly 40% of the U.S. REIT index.

Infrastructure, industrials and data centers now make up nearly 40% of the U.S. REIT index.

The most COVID-impacted sectors, such as retail, office and lodging, were 46% of the index in 2010 compared to only 22% today.

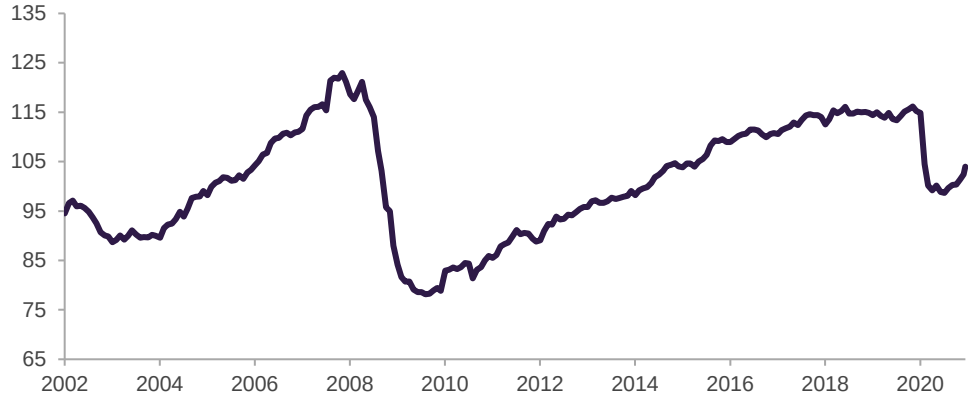


Data Source: Truist IAG, NAREIT

Conversely, traditional REITs that have exposure to the property types most impacted by the pandemic, such as hotels, offices and malls, represent a much smaller piece of the REIT pie than they did a decade ago, 22% today as compared to 46% at the end of 2010.

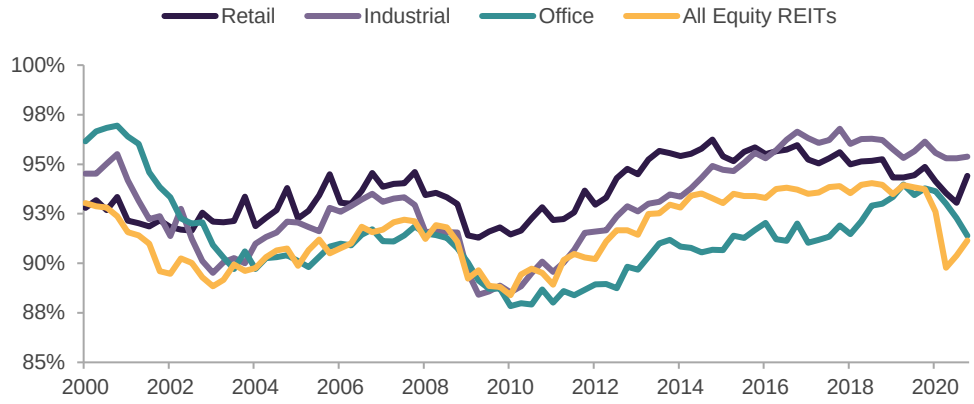
The shifting sector mix and the growing dependence on e-commerce likely explains why REITs were more resilient during this recession than in prior economic downturns. Property cash flows, as measured by fund flows from operations, were not hit as hard during the pandemic as they had been in the prior two recessions. Moreover, while rents continue to stabilize, occupancy rates have held reasonably steady for most major REIT sectors. Additionally, REITs are in better financial shape since the Great Financial Crisis. REITs have raised capital, lowered leverage down to record levels, lengthened debt maturities, and improved liquidity.

REIT next 12 months fund flows from operations*



Data Source: Truist IAG, FactSet *(iShares US Real Estate ETF used as proxy indexed to 3/2001)

REIT occupancy rates



Data Source: Truist IAG, NAREIT

Our take: Unevenness in the REIT recovery

Our macro team's view is that the massive fiscal response to the pandemic in the U.S. has set the stage for several quarters of spring-loaded economic growth for the second half of 2021 and into 2022. The weight of the evidence in our work suggests further improvement in REIT performance given overall property cash flow estimates moving higher, REITs announcing

dividend increases in recent weeks, and stronger balance sheets in this cycle than the Great Financial Crisis. But it will remain uneven across property types.

We remain positive on growth-oriented property sectors, such as industrials, infrastructure, and data centers, which stand to benefit from an acceleration in the innovation and adoption of technology due to the pandemic. In our view, while these sectors are experiencing a healthy reset over the short term, there is a long runway for future growth. This should be aided by the continued demand for storage and logistics services resulting from e-commerce trends along with the increased need for data and cloud computing as people utilize technology to work, study, and communicate virtually.

In the near term, further reopening of the U.S. economy will support those properties most negatively affected by reduced travel, business closures, and social distancing, including lodging, health care/senior housing, and retail. With many individuals in better financial shape, there will be pent-up demand to resume some sense of normalcy and return to prior behaviors, such as in-person shopping and travel. The timing of when those activities will fully return to pre-pandemic levels, however, is uncertain.

We acknowledge that certain property types, such as malls, faced secular declines prior to the pandemic, and will continue to be challenged by the acceleration in e-commerce trends. Offices also remain vulnerable in the near term following the upsurge in remote work and uncertainty with respect to how long that trend will last. The longer-term nature of leases on these properties suggests rents will take some time to bottom. Ultimately, though, the more resilient companies will learn to adapt and optimize their traditional business models. For example, while some office properties may become obsolete, others will learn to respond in a changing environment by investing in space reconfigurations along with local health and safety department guidelines.

Bottom line

The state of the U.S. economy and the ramp up of vaccinations suggest restrictions will be lifted on consumer behaviors and mobility. Commercial real estate and REIT investments, in particular, stand to benefit in this environment. Yet, the shifting composition in the asset class also highlights the continued unevenness in the REIT recovery, as evidenced by the remarkable divergence in returns across property sectors during the pandemic and as we move further into the recovery phase.

A full recovery will take time and be uneven, but there are signs of fundamental improvement across certain property types. We favor a more diversified approach with meaningful exposure to growth-oriented technology sectors along with those cyclical sectors that stand to benefit from the U.S. recovery. A faster rise in interest rates than we expect or a spike in COVID-19 variant cases are risks to REITs, but our base case suggests a positive risk/reward at current levels.

REITs are subject to risks, including; market, natural disasters, and interest rate increases.
The dividend income received from REITS isn't tax advantaged like corporate dividend

Disclosures

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