Sector updates

Global Real Estate – Ideas to play the Blue Wave

Research Team

Global | Real Estate

The Path to a New Normal

Investment summary

We believe there are several tailwinds supporting the recovery in the US real estate sector. These include i) a stronger-than-expected recovery in economic growth in 2021, ii) earnings rebound this year, iii) rising inflation from low levels and iv) negative real yields. Historically, the earnings of cyclical sectors such as real estate have been more sensitive economic growth, and thus we expect the sector to be a beneficiary of the reflation theme ahead. Real estate has also historically been seen as a good hedge against inflation. However, we are cognisant that the road to recovery is expected to remain bumpy. Within the real estate sector, we expect property consulting firms to see stronger earnings rebound from a recovery in real estate transactions in the market. Construction companies will see a boost from fiscal stimulus rolled out by the government and continued low mortgage rates in the near-term. For US REITs, notwithstanding the recent spike in the 10-year Treasury yield, the MSCI US REIT Index is still trading at a forward yield spread of 264 bps, which is 1.1 standard deviations above the 10-year average. Our preferred US real estate picks in 2021 are: **AvalonBay Communities* (AVB US) [BUY; FV: US$194]**, **Jones Lang LaSalle* (JLL US) [BUY; FV: US$175]**, **Simon Property Group* (SPG US) [BUY; FV: US$151]**, and **Welltower Inc* (WELL US) [BUY; FV: US$72]**. We would also put **Lennar Corp* (LEN US) [HOLD; FV: US$88]** in our watchlist and await a more favourable entry point.

- Real estate sector a beneficiary of the reflation theme
- Valuation of US REITs sector still reasonable despite spike in US 10-year Treasury yield
- Preferred US real estate picks: AVB US, JLL US, SPG US and WELL US

Tailwinds to support the recovery in US real estate sector

Our Investment Strategy team upgraded US equities to overweight on 11 Jan. Our more positive stance on US equities is premised on i) stronger-than-expected recovery in economic growth in 2021, ii) earnings rebound this year, iii) rising inflation from low levels and iv) negative real yields. We believe all these tailwinds would benefit the US real estate sector, which had underperformed in 2020. Historically, the earnings of cyclical sectors such as real estate have been more sensitive economic growth, and thus we expect the sector to be a beneficiary of the reflation theme ahead. Real estate has also historically been seen as a good hedge against inflation. However, we are cognisant that the road to recovery is expected to remain bumpy. Key downside risks include further lockdowns to control the pandemic, slower-than-expected administration of Covid-19 vaccines and sharper-than-expected spike in US 10-year Treasury yields and borrowing costs.

Within the real estate sector, we expect property consulting firms to see stronger earnings rebound from a recovery in real estate transactions in the market. Construction companies will see a boost from fiscal stimulus rolled out by the government and continued low mortgage rates in the near-term. Although investors might be concerned over the spike in US 10-year Treasury yield on US REITs, we note that real yields remain in negative territory and the rebound in economic activities is also likely to support the operational performance of US REITs' underlying assets.

Our preferred US real estate picks in 2021 are: **AvalonBay Communities* (AVB US) [BUY; FV: US$194]**, **Jones Lang LaSalle* (JLL US) [BUY; FV: US$175]**, **Simon Property Group* (SPG US) [BUY; FV: US$151]**, and **Welltower Inc* (WELL US) [BUY; FV: US$72]**. We would also put **Lennar Corp* (LEN US) [HOLD; FV: US$88]** in our watchlist and await a more favourable entry point. Lennar is the largest homebuilder in the US by revenue and it has been a direct beneficiary of the strong housing demand in the US. We maintain our **Overweight** stance on the overall **global real estate sector**.

Exhibit 1: Preferred US real estate picks

	Ticker	Curr.	Last Close ($)	Fair Value ($)	Dividend Yield FY-1	Dividend Yield FY-2	P/B FY-1 (x)	P/B FY-2 (x)	Potential Upside	Rating
AvalonBay Communities	AVB US	USD	157.38	194	4.0%	4.3%	2.1	2.1	23%	**BUY**
Jones Lang LaSalle	JLL US	USD	152.79	175	0.4%	0.6%	1.5	1.3	15%	**BUY**
Simon Property Group	SPG US	USD	85.43	151	7.0%	6.1%	7.9	9.0	77%	**BUY**
Welltower Inc	WELL US	USD	61.09	72	4.4%	4.0%	1.6	1.6	18%	**BUY**

Source: Bloomberg, BOS-Morningstar estimates, as at 12 Jan 2021 closing prices

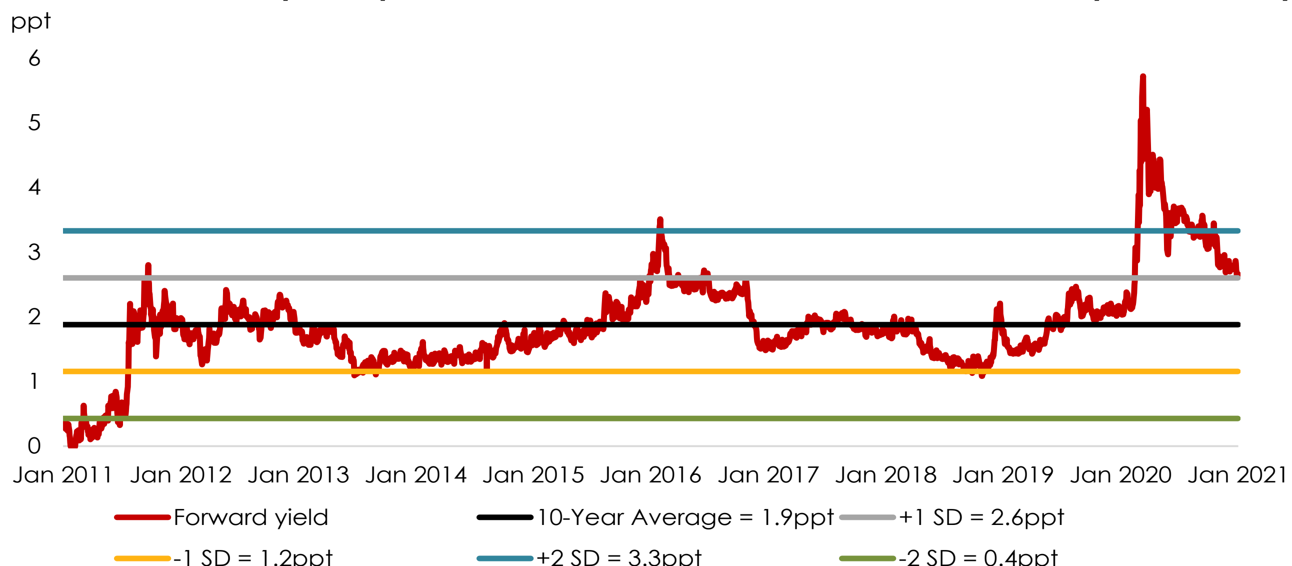
Note: FY-1 denotes current financial year; FY-2 denotes next financial year.

Valuations of US REITs sector remain supportive notwithstanding recent spike in US 10-year Treasury yield

The MSCI US REIT Index (RMZ Index) registered total returns of -7.5% in 2020, underperforming the S&P500 Index (+18.4%). In terms of valuation, the MSCI US REIT Index is trading at a forward dividend yield of 3.81%, according to Bloomberg consensus estimates. Although this is tighter than the long-term mean (10-year average: 4.0%), from a relative basis, the yield spread between the MSCI US REIT Index and the US 10-year Treasury yield currently stands at 264 bps. This is 1.1 standard deviations above the 10-year average of 188 bps despite the recent spike in 10-year Treasury yield to 1.17%.

Furthermore, we believe US REITs largely entered the pandemic with relatively healthy balance sheets and liquidity positions. Although some REITs suspended or cut their dividends in 2020 given the impact of the pandemic and lack of earnings visibility at that time, we have gradually seen some dividend increases being announced for the 4Q20 period.

Exhibit 2: Forward yield spread between MSCI US REIT Index and US 10-year Treasury yield

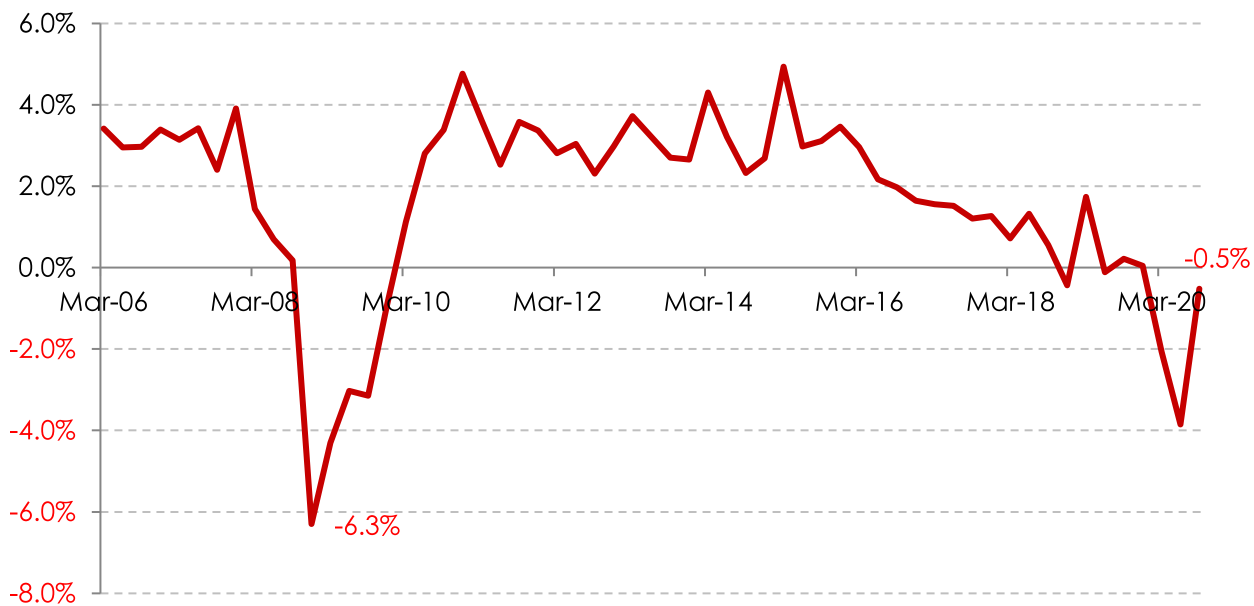


Source: Bloomberg, internal estimates, as at 12 Jan 2021

Retail

The retail sector has undoubtedly suffered under the debilitating effects of Covid-19. Advance estimates of US retail and food services sales showed a 1.1% MoM dip for the month of Nov, following a slight 0.1% decline in Oct 2020. According to the NCREIF Property Index, which measures the unleveraged total returns (income and capital appreciation) for private commercial real estate properties held for investment purposes only, the QoQ return for Retail came in at -0.5% for 3Q20. Although this was the third consecutive quarter of negative returns, we note that the magnitude of decline has moderated as compared to 2Q20 (-3.9% QoQ) and 1Q20 (-2.1% QoQ).

Exhibit 3: QoQ change for NCREIF Property Index (Retail)

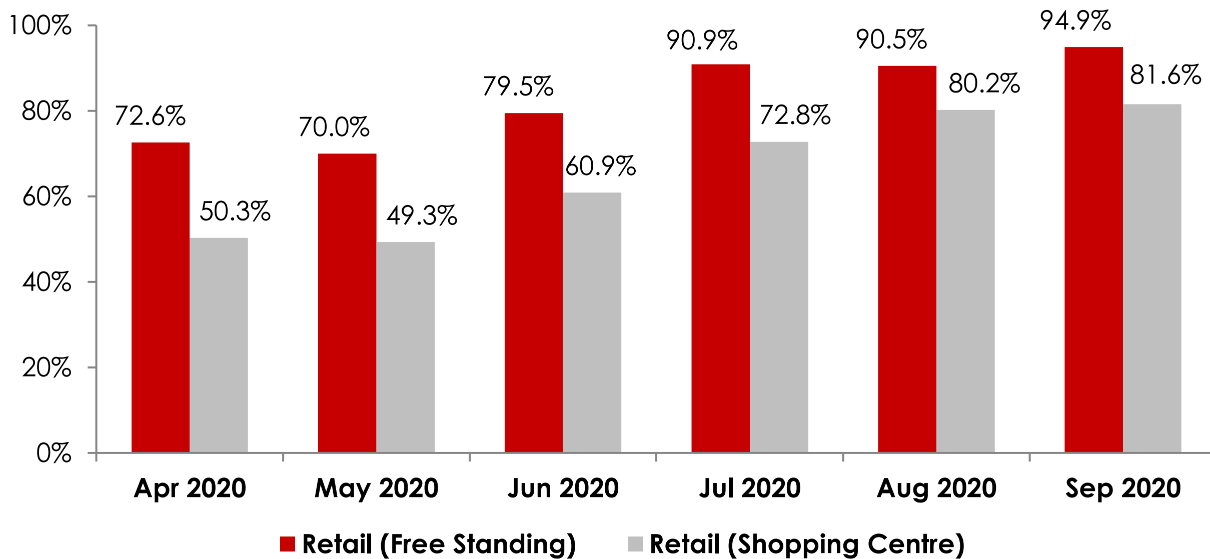


Source: NCREIF, Bloomberg, Internal estimates

While the overall retail operating landscape remains challenging, we believe a more aggressive path of fiscal stimulus under a Blue Wave would result in improved consumer sentiment and spending. There are risks to the retail sector given the possibility of more stringent lockdown scenarios under a Biden administration, in our view. However, as more of the population gets vaccinated and the spread of Covid-19 cases becomes more contained, we believe this would encourage the return of shopper traffic back to the shopping malls.

There has also been a pick-up in rental collection rates, as seen from a survey by Nareit on its equity REIT members. The estimated rental collections in Sep 2020 was 94.9% for Retail (Free Standing) and 81.6% for Retail (Shopping Centres). This reflects a firm recovery as compared to the 72.6% and 50.3% rental collection rates back in Apr last year for Retail (Free Standing) and Retail (Shopping Centres), respectively. Furthermore, both retail sub-sectors have been seeing a gradual decline in rental deferrals since May. For Sep 2020, this was slightly above 5% for Retail (Free Standing) and approximately 4% for Retail (Shopping Centres).

Exhibit 4: Estimated percentage of monthly rentals collected for retail sector

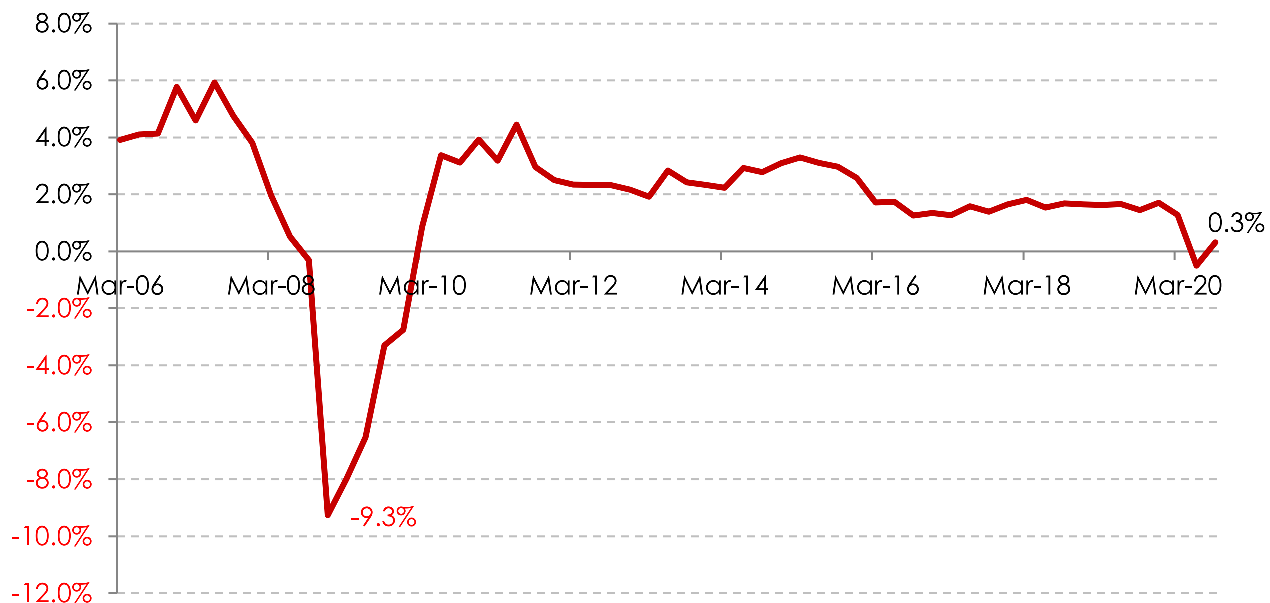


Source: Nareit, based on survey on listed equity REIT members. Percentage shown is market cap weighted

Office

The US office sector was also negatively impacted by Covid-19 due to rising unemployment rates, dip in business confidence and work from home trends. According to the NCREIF Property Index, the QoQ return (income and capital appreciation) for Office came in at -0.6% for 2Q20. This was the first negative return since 4Q09. However, the fall was short-lived as overall return swung back to positive territory at +0.3% in 3Q20.

Exhibit 5: QoQ change for NCREIF Property Index (Office)

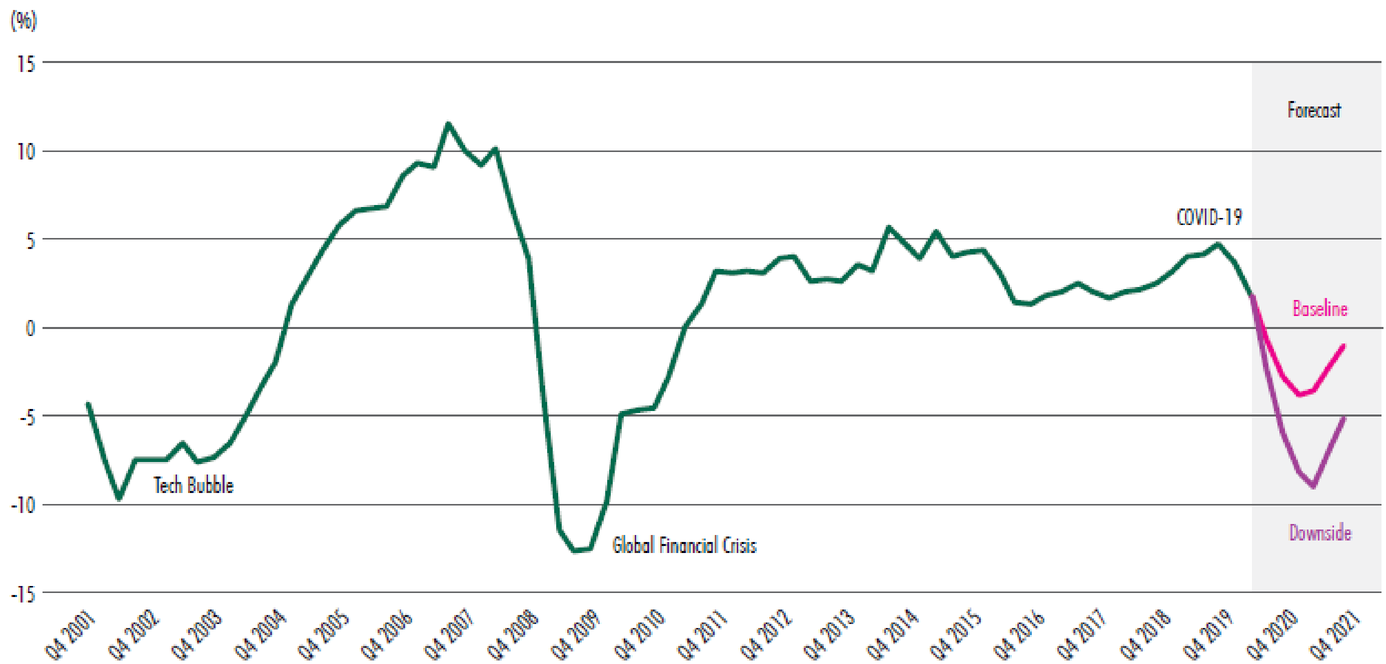


Source: NCREIF, Bloomberg, Internal estimates

Looking ahead in 2021, we expect to see some stabilisation, but a more meaningful recovery is likely to take place only in 2H21 or 2022. According to market watcher CBRE, US office rents are expected to continue its decline and vacancy rates expected to increase at least through 1H21. CBRE believes the office cycle will

bottom out in 2021 as positive net absorption resumes. Within the office segments, suburban office and Class A office space are expected to see a faster rebound due to work from home trends and flight to quality, respectively.

Exhibit 6: Rental forecast of US office market (YoY change)



Source: CBRE Econometric Advisors, as at 3Q20

On the topic of telecommuting, a CBRE survey in late 2020 revealed that remote working could potentially lower the overall demand of office space by 15%. We believe the situation remains fluid and there are many companies who have not decided on their future real estate requirements over the medium to longer term. A hybrid model looks likely to be the most viable modus operandi going forward with a combination of working from home and in office so as to not lose the important aspects of collaboration, brainstorming and mentoring.

Hospitality

The hospitality sector continues to struggle under strict border controls internationally and relatively high number of Covid-19 cases. According to data from STR, the change in RevPAR in the US hotel industry has worsened for two consecutive months from -46.1% YoY in Sep 2020 to -48.8% in Oct 2020 and -52.6% YoY in Nov 2020. Weekly RevPAR declines in Dec have ranged from -42.5% to -58.4% YoY. There was a marked improvement seen in the first week of Jan 2021, as RevPAR decline came in at -35.1%. This was likely boosted by travel demand during the New Year's holiday. The US Transport Security Administration (TSA) said in late Dec that it had screened more than 1m passengers at airport checkpoints for five consecutive days. We expect this demand to taper off after the holiday season, and a firmer recovery will only be seen after a larger scale rollout of the Covid-19 vaccination to a wider population.

Exhibit 7: Operating metrics for US hotels industry

Week ending/Month	Occupancy	YoY change in occupancy	Average daily rate (ADR) (US$)	YoY change in ADR	RevPAR (US$)	YoY change in RevPAR
02 Jan 2021	40.6%	-17.2%	107.93	-21.5%	43.81	-35.1%
26 Dec 2020	32.5%	-33.0%	92.08	-28.8%	29.94	-52.3%
19 Dec 2020	36.8%	-26.4%	85.5	-21.9%	31.45	-42.5%
12 Dec 2020	37.8%	-37.4%	85.88	-31.7%	32.49	-57.3%
05 Dec 2020	37.4%	-37.9%	86.21	-33.1%	32.23	-58.4%
Nov 2020	40.3%	-34.3%	90.92	-27.7%	36.67	-52.6%
Oct 2020	48.3%	-30.1%	97.61	-26.8%	47.13	-48.8%
Sep 2020	48.3%	-28.2%	99.12	-24.9%	47.87	-46.1%
Aug 2020	48.6%	-31.7%	102.46	-22.8%	49.83	-47.3%
Jul 2020	47.0%	-36.1%	101.76	-24.8%	47.84	-52.0%
Jun 2020	42.2%	-42.5%	92.15	-31.5%	38.88	-60.6%
May 2020	33.1%	-51.7%	79.57	-39.9%	26.35	-71.0%
Apr 2020	24.5%	-63.9%	73.23	-44.4%	17.93	-79.9%
Mar 2020	39.4%	-42.3%	110.66	-16.5%	43.54	-51.9%
Feb 2020	62.2%	0.2%	130.78	1.4%	81.33	1.7%
Jan 2020	55.1%	0.8%	126.06	1.4%	69.47	2.2%

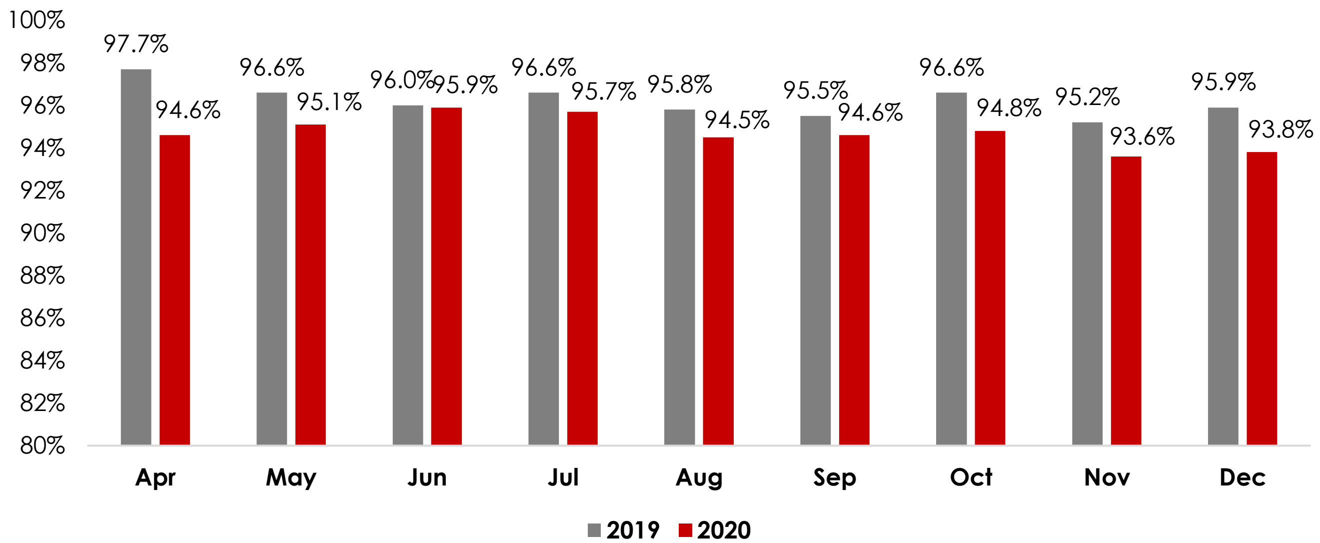
Source: STR

Residential

Within the residential rental market, we note that monthly rental collection in 2020 had continued to track below 2019 levels. According to the National Multifamily Housing Council's (NMHC) Rent Payment Tracker, 93.8% of apartment households made their rent payment by the end of the month in Dec 2020. This was marginally higher than in Nov (93.6%), but 2.1 ppt below Dec 2019 levels. Rental collection data was also released for the first six days of 2021, with 76.6% of apartment households having made a full or partial rent payment, versus 78.3% for the same period last year (rental collection usually increases further down the month). NMHC highlighted that steep challenges remain notwithstanding the positive breakthrough on vaccines and the recently passed Covid-19 relief package which includes US$25b of rental assistance.

AvalonBay Communities* (AVB US) [BUY; FV: US$194], one of our preferred sector picks, recently declared in mid-Nov 2020 its 4Q20 dividend of US$1.59 per share. This represents a YoY increase of 4.6%. Despite challenges in the industry and a 3.5% decline in its core funds from operations (FFO) for 9M20, AVB was able to increase its quarterly dividends and total dividends paid in 2020 also grew 4.6%. It has collected 96.1% of its 3Q20 residential revenue from its Established Communities segment, as at 27 Oct 2020.

Exhibit 8: Percentage of rental payments made for Apartment households at end of month



Source: National Multifamily Housing Council

Within the homebuilders market, the low mortgage rate environment has fuelled a housing boom despite the economy slipping into a recession in 2020. The US mortgage rates has hit record lows. According to data from Freddie Mac, the average US 30-year fixed loan rate has declined to 2.65%, versus 3.72% at the start of 2020. We believe **Lennar Corp* (LEN US) [HOLD; FV: US$88]** would be a firm beneficiary of robust housing demand in the US given that it is the largest homebuilder in the US by revenue. However, we prefer to wait for a more favourable entry point. Furthermore, mortgage rates are likely to increase later in the year and the tight housing inventory levels could result in higher home prices ahead and thus affect the affordability of homebuyers.

Exhibit 9: 30-year average fixed mortgage rate trend

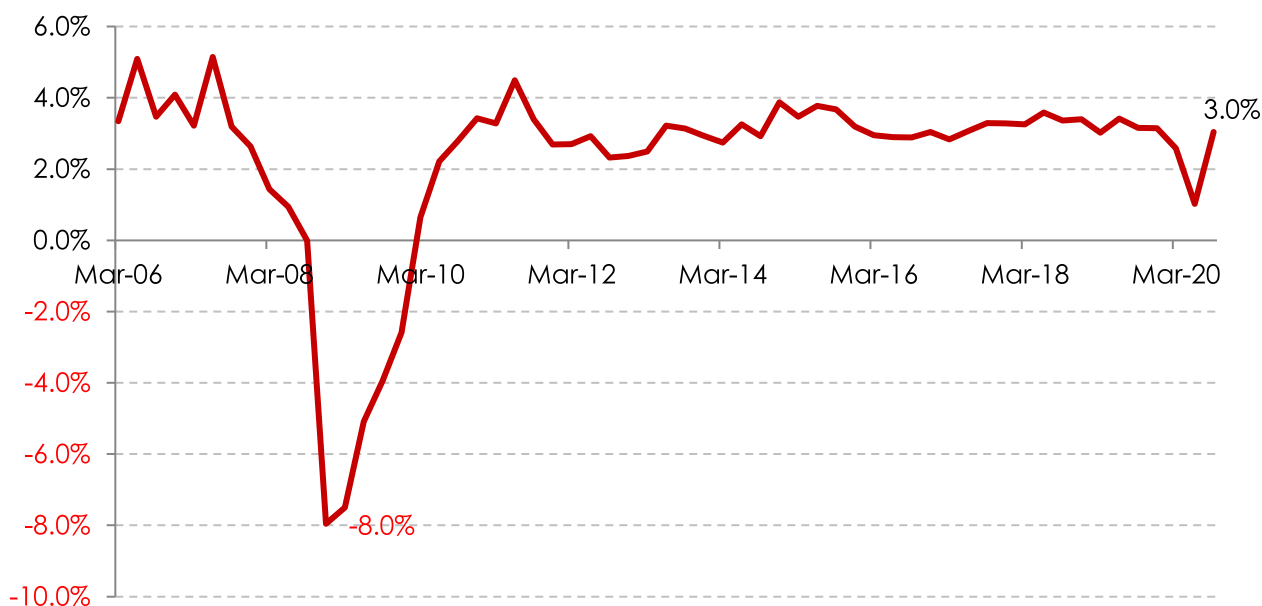
Source: Freddie Mac

Industrial

According to the NCREIF Property Index, the Industrial sector continued to eke out positive returns (income and capital appreciation) for 9M20 despite the Covid-19 pandemic. This came in at +2.6% for 1Q20, +1.0% in 2Q20 and +3.0% in 3Q20. This was the best performing sub-sector for 9M20, and we expect underlying capital values and rentals to remain resilient given structural tailwinds such as rising e-commerce penetration rates, notwithstanding some slight impact from a return to normalcy.

CBRE mentioned that every US$1b increase in incremental e-commerce sales is expected to generate 1.25m sq ft of warehouse space demand. As such, CBRE has projected US warehouse net absorption to hit 250m sq ft this year, which would be ~18% higher than the last five-year annual average of 211m sq ft.

Exhibit 10: QoQ change for NCREIF Property Index (Industrial)



Source: NCREIF, Bloomberg, Internal estimates

Senior Housing/Healthcare

Occupancy rates in the senior housing sector saw a decline for the third consecutive quarter in 4Q20 to 82.9% given the resurgence in Covid-19 infections across the US. However, we believe there is some light at the end of the tunnel. Construction starts has remained relatively low, and thus there will be less supply pressures in the future once absorption rates eventually recover.

The President and CEO of the American Health Care Association highlighted in a CNN interview at the start of the year that more than 90% of nursing home residents have consented to receiving the initial Covid-19 vaccine doses. This augurs well for the recovery of the sector. We believe senior housing operators would be more forthcoming in relaxing restrictions on community spaces once more residents are vaccinated. Occupancy rates may start to return to pre-Covid-19 levels in 2022 if the vaccine rollout to this group of at-risk nursing home population happens on a larger scale from mid-to-late 2021, in our view. Over the longer-term, occupancies should also be supported by demand accelerating over the next decade due to the aging baby boomers and rising life expectancies.

We believe the current share price weakness of healthcare REITs provides an opportunity for investors looking for an industry with long-term growth potential. We like **Welltower Inc* (WELL US) [BUY; FV: US$72]** within this space, and view its portfolio as a beneficiary of robust demographic tailwinds over the longer-term. We estimate that its senior housing portfolio will deliver a 10-year net operating income CAGR of 4.3%, although double-digit declines are expected in 2020 and 2021. In the near-term, Welltower's medical office

and acute-care segments would help to mitigate the headwinds from the senior housing portfolio, given that the former two have not faced any significant disruption.

Exhibit 11: Total US life expectancy at birth by gender

Gender	2017	2030	2060	Change in life expectancy from 2017 to 2060
Total	**79.7**	**81.7**	**85.6**	**5.9**
- Male	77.3	79.7	83.9	6.6
- Female	82.0	83.8	87.3	5.3

Source: US Census Bureau, 2017 National Population Projections

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** Stock under BOS-Morningstar coverage*

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Co.Reg.no.: 198301152E
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