Breaking Away from the REIT Mafia

"Just when I thought I was out, they pull me back in!"
- Michael Corleone (Al Pacino) in The Godfather Part III

Key Findings

- For many REIT subsectors, the majority of shares held by active managers are held in diversified portfolios, not REIT focused funds.
- When targeting generalist investors, use FFO (or a derivative) to see how your company's fundamentals are aligned with all of a portfolio's holdings.
- When engaging generalist investors, be sure to translate your REIT story to the drivers of total return and risk – generalist investors may not share the same assumptions that more real estate focused investors have.

Introduction

Many REIT IROs have long yearned to attract non-real estate focused investors to their shareholder base. REIT portfolios perform poorly when real estate is out of favor, leading to redemptions and putting pressure on PMs to trim their holdings. The thinking goes, when rising interest rates or inflation expectations are already buffeting industry economics, the last thing you want as an IRO of a REIT is an over-supply of sell orders.

This paper addresses a primary concern of REIT IROs: Do generalist investors buy REITs? If so, who are they and how do we engage them?

REIT History in a Nutshell

Over the past three decades, REITs have gradually become mainstream.

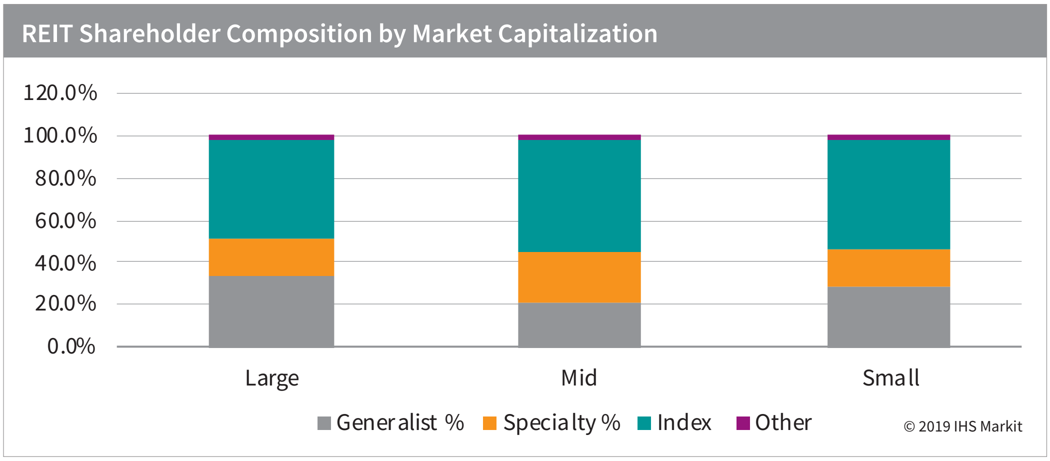
- REITs got their start in the aftermath of the savings & loan crisis that arose during the 1980s – banks had shut down their lending to increasingly cash-strapped private commercial real estate companies, so the latter turned to equity markets. From the Kimco Realty IPO in 1991 through the early nineties, REITs exploded onto the scene.
- In the early 2010's, diversified portfolios expanded their REIT exposure as: 1) former non-REITs – some not necessarily regarded as real estate companies – elected REIT status for tax purposes; and 2) some operating companies with real estate exposure (e.g., hospitals, hotels, etc.) spun out their real estate assets as independent REITs. Both these developments suddenly introduced REIT ownership to generalist portfolios, with attendant responsibility for the PMs to learn more about the REIT industry.
- More recently, in August 2016, the S&P Dow Jones Indices and MSCI revamped their industry classification system to include non-mortgage REITs as the 11th GICS classification (REITs had previously been subsumed under Financials.) Once real estate was broken out as a standalone sector, diversified portfolios with a mandate to track the broader market have either had to include REITs or risk underperformance relative to the market due to a failure to adequately diversify.

Current Environment

We believe the current environment is a welcoming environment for REIT IROs looking to expand their marketing efforts to diversified portfolios. John Stewart, SVP of IR at Digital Realty, concurs:

> "Non-traditional REIT investors have been quite receptive to our outreach, which is good for us as a team because broadening our shareholder base is an explicit KPI in our year-end scorecard, and we're not going to achieve our objective by focusing exclusively on REIT specialists," says Mr. Stewart. "For example, early last year, our investor targeting screen identified a promising $20 billion EUM West Coast generalist ESG investor. We began courting the investor early last year, and by year-end, they held a $360 million position."

Broadly speaking, most REITs have a significant opportunity to expand the market for their stock by targeting generalist investors. While REIT sector funds continue to own large chunks of most REITs, they account for less than half of active management in many REITs. For Digital Realty, sector funds account for a mere 20% of active fund ownership. Table 1 below details the level of investment in REITs by generalist investors by sector and market capitalization (backup data available upon request). To be certain, generalist REIT ownership varies dramatically and eludes clear interpretation, but here are two observations:



— Investment by generalist funds tends to be lower in mid-cap names than either small caps or large caps, which tend to be most widely held by generalists.

— Investment by generalists also tends to be lower in more traditional REIT sub-sectors including residential, retail and office, while subsectors with a companion story to the REIT message including infrastructure, natural resources, and technology themes tend to attract more generalists.

Whether your company is held primarily by sector funds on the one hand, or generalist portfolios on the other, the growing level of investment in REITs by diversified portfolios across the broad market is encouraging – and an indication that IROs would be wise to include portfolios with unexceptional exposure to REITs in their marketing efforts. Keep in mind, only a portion of the data we reflect in the charts above is destiny – likely, some variance in investment by generalist investors across sub-sectors is the result of differences in the communication and engagement strategies of IROs.

Marketing to Generalist Portfolios

Here are three tips to keep in mind as you engage generalist investors:

1. Many good candidates for your stock may not have exceptional – if any – REIT exposure. In the case of DLR's large new investor, the fund that owns the largest share of the firm's overall position invests in just four REIT securities (including DLR) totaling less than 5% of total portfolio assets. While that level of investment certainly qualifies as REIT-friendly, it is a small fraction of the fund's total assets, suggesting that successfully identifying generalist candidates requires a careful analysis of the entire portfolio (not just the ~ 5% invested in REITs.)

2. When analyzing a portfolio, use the whole portfolio. Some REIT IROs believe FFO reporting handicaps their marketing to generalists. Specifically, many believe that FFO reporting is incompatible with GAAP reporting, rendering moot any comparison of a REIT's fundamentals to the fundamentals of non-REITs held by a generalist portfolio. But it's important to recall that the underlying purpose of FFO – similar to EPS and non-GAAP measures – is to represent the economic performance of the company. With this perspective in mind, we find that with some minor adjustments, FFO compares reasonably well to EPS, as do other more cash-oriented growth and valuation metrics.

3. Translate everything that's going on in your company and industry into stories connected to value creation. For example, your company's dividend yield may be a multiple of the average yielding stock in a portfolio, while your price appreciation is a fraction – but your total return may be a perfect fit. Focus on your business model and the underlying economic conditions that create opportunity and mitigate the risk of investing in your company. Avoid industry jargon and assumptions about what your new audience wants to hear, such as your performance relative to peers.

Finally, to break out of the REIT mafia, you will need to work hard to identify and communicate directly with generalist portfolio managers. It may seem counter-intuitive to target a PM who may not have REIT expertise, but bear in mind that generalists are required to make bets across the board – they are used to doing things they are not used to doing. It's an uphill climb, to be sure, but the opportunity is real, and your success will be transparent.

> "I am bullish on specific REITs that can differentiate themselves, and don't pitch themselves necessarily as REITs, but rather as solid investment ideas. There are only a few companies presenting themselves this way, and those are the ones we spend time researching and using to diversify our holdings, regardless of what subsector they are in within the REIT space."
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> **Portfolio manager at value-oriented investment advisor**

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