HEITMAN
A REAL ESTATE INVESTMENT MANAGEMENT FIRM

Today's core real estate offers investors income and capital growth

Chase McWhorter, Institutional Real Estate, Inc.'s managing director, Americas, recently spoke with **Blaise Keane,** executive vice president for Heitman's North American Portfolio & Asset Management group and senior portfolio manager for Heitman America Real Estate Trust (HART), and **Amy Krass,** senior vice president for Heitman's North American Portfolio & Asset Management group and assistant portfolio manager for HART. Following is an excerpt of that conversation.

Why does investment into a private core real estate vehicle seem prudent at this time?

Blaise Keane: We believe the current dynamics set up well for a generational opportunity and an attractive entry point for investors looking to invest capital into core investment vehicles. Few other moments, historically, have provided similar circumstances to those evident today, where investors who have moved capital into these vehicles have been rewarded with multi-year periods of outsized returns. There are a number of conditions present that create this opportunity this time around.

First, property fundamentals, particularly for sectors we utilize in our portfolio construction, remain well occupied and are producing stable cash flows. In addition, the go-forward outlook for net operating income remains solid. And, in the case of several of the property sectors we invest in – for example, self-storage – operating fundamentals are poised to potentially reaccelerate as we move through the stretch ahead. Second, in the face of a rising interest rate environment during this recent period, the capitalization rates and discount rates used to value core real estate have risen, which has resulted in a decrease in the value of those assets of approximately 20 percent during that period. Finally, as core investors, we are less reliant on the use of debt financing in making investments. We believe this gives us an advantage in a market where we're competing against others who may use a higher quotient of debt financing in their capital structure and, thus, may be limited in terms of making investments at a time when the cost of that debt is higher.

In summary, portfolios with creative sector allocations, such as those we use in our portfolio construction, are expected to see strong cash flows on a go-forward basis, and combined with the recent repricing of real estate, we believe creates an attractive investment window for investors to experience consistent income returns and the opportunity to see capital growth in their investments.

Given the market dynamics you describe, what is your approach to investing in the core space?

Keane: Certainly, we look very carefully at our property sector allocation and our asset selection as we form our portfolios. We look to a few high-level themes to guide our investment decisions. These themes include a focus on assets and sectors that have a lower capital expenditure investment requirement, those that have higher operating margins, those that are generally lower beta or less volatile, and those that have shorter lease terms. Our research indicates portfolios constructed with biases towards those themes tend to have higher risk-adjusted returns. In addition, they provide a higher level of current return, in the form of the dividend paid to investors. That is an important point because many of our investors are looking to the dividend, and the cash flow they receive from these investments, to match the obligations they have to their beneficiaries.

How does Heitman view how core has changed over the years – specifically, the changes made to the ODCE inclusion criteria?

Keane: The definition of core real estate has been evolving, and it will continue to evolve. This evolution has allowed investors to have greater diversification in their portfolios and less reliance on any particular sector or sectors. There is greater geographic diversity that can be accessed with a broader array of investments and less exposure to the volatility that is introduced based on the changes in the economic cycle. NCREIF recently broadened its criteria to recognize the use of alternatives and niche areas of traditional sectors to keep pace with the evolving definition of a core portfolio. We believe this benefits investors because alternative sectors have demand drivers that are less reliant on the economic cycle and have independent demand drivers relative to the traditional property types.

What differentiates your firm's approach to alternative property sector investing?

Keane: Two differentiators are our early-mover advantage and our experience in a number of these sectors. For example, our initial investment into the self-storage sector occurred in 1996. Investing in these sectors over a long duration gives us an advantage over the peer group and benefits our clients, in that we have been able to cultivate relationships with many of the operating partners who are important in terms of the operation of these types of assets. We have developed and deepened the talent of our team investing in these types of properties and managing these types of properties over time and we have been able to witness the evolution of the fundamentals and watch the maturity cycle that has occurred in these sectors. We believe that experience makes us better investors. In addition, we have global experience. Our investment in these types of sectors spans four continents, which gives us a broad perspective in terms of the geography and the nature of the behavior of these investments in those environments. We have been able to stand out from our peers because we provide our investors with a broader array of tools for portfolio construction.

We are proud to have played a role in the evolving definition of core. We have a decades-long ethos for our core portfolio construction, which relies less on traditional property types, such as commercial office. When defining core real estate, it is essential to consider migration patterns, demographic trends, technological advancements and market-demand patterns. Observing how humans are interacting with the built environment drives how we think about constructing portfolios, and we believe this is to the benefit of institutional investors.

Can you elaborate on the aspects of alternative property investments you believe benefit portfolio construction?

Amy Krass: Several of the niche and emerging alternative sectors have a number of attributes that position them to be additive to a core portfolio, and we believe investment in these sectors offers outsized reward in comparison with the associated risk that is assumed. The first portfolio construction benefit is the demand/supply dynamics. Tenant demand for many alternative sectors is less linked to — or delinked from — macroeconomic cycles because demand is often driven by life events and demographic drivers. Many alternative property sectors have attractive supply-side characteristics due to urban planning, zoning and other structural roadblocks to further development. Second, alternative sectors also provide a diversification benefit. They are generally less correlated to the macroeconomic cycle and less correlated to the trajectory of the four primary property types. For the sectors we invest in, the properties tend to be smaller and more geographically diverse than the traditional property types, providing further benefit. Third, the cash-flow profile of alternative sectors is strong and an important part of core portfolio construction. The strongest-performing sectors in terms of net-operating income growth since 2014 have been alternative sectors, such as self-storage and single-family rentals. Go-forward projections for these sectors tend to indicate this trend will continue. Further, for the alternative sectors we invest in, less of the net operating income is reinvested in the form of capital expenditures. For example, the sectors we invest in report an average capital expenditure investment of 13 percent of net operating income, versus 22 percent for the traditional property sectors.

In summary, we believe these three enhancements to core portfolio construction combine to benefit our investors with (1) higher current returns, (2) higher total returns and (3) lesser volatility.

What is your outlook for self-storage, in particular?

Krass: When thinking about the self-storage sector, it is instructive to recollect the sector's dynamics during the past several years. Prior to the pandemic, there was strong demand for self-storage and strong rent growth, driven mainly by the various generational cohorts adopting utilization of storage. Then came the pandemic. Home sales and migration rose tremendously. Demand was boosted significantly, and this drove a peak in operating fundamentals. Recently, a sharp increase in mortgage rates created a disincentive for homeowners to sell. This has affected self-storage fundamentals because housing sales are a significant driver of demand in this space, so new customer demand has been dampened. Existing self-storage customers tend to be very sticky as the rent they pay is typically a small portion of their monthly expenses, and many people are reluctant to organize or move their goods. This has given the sector continued revenue growth, even as there has been pressure on the demand side from new customers. Heitman has a large portfolio, which provides us a deep data set for monitoring fundamentals, and interestingly, we have not seen a dramatic decrease in operating fundamentals.

Looking ahead, in the short term, there will likely be some level of continued pressure on fundamentals while the housing market remains sluggish. Looking out over the intermediate term, the housing market should unlock, and the sector could benefit from a release of pent-up demand for self-storage. In the long term, our research team feels strongly there are significant tailwinds that should support investment performance, justifying the sector's inclusion in portfolio construction.

CONTRIBUTORS

Blaise Keane

Executive Vice President, North American Portfolio & Asset Management Group

Senior Portfolio Manager, HART

Blaise Keane is an equity owner of Heitman and member of the Board of Managers. Keane has overall responsibility for the HART fund, including strategy development and implementation, investments, financings, dispositions, asset management, and client service and marketing. Keane is also an executive sponsor of EPiC, one of Heitman's employee resource initiatives focused on celebrating inclusiveness in the workplace. Prior to heading HART, Keane was the senior portfolio manager for one of Heitman's largest separate account client portfolios.

Amy Krass

Senior Vice President, North American Portfolio & Asset Management Group

Assistant Portfolio Manager, HART

Amy Krass is an equity owner of Heitman and is involved in the oversight of HART's fund strategy, investments, financings, dispositions, asset management, and client service and marketing. Krass is a member of Heitman's DEI Council. Prior to her current role, Krass worked in Heitman's North American Acquisitions group for seven years and the Asset Management group for 10 years.

HEITMAN

COMPANY OVERVIEW

Heitman is a global real estate investment management firm with more than $50 billion in assets under management, as of March 31, 2024. Founded in 1966, we have 10 offices worldwide and are an active participant in three key segments of the global real estate property and capital markets. Our collaborative investment process uses input from some of whom we believe to be the most experienced investment and research professionals in the industry.

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