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Outlook for REITs in 2025

Chase McWhorter, Institutional Real Estate, Inc's managing director, Americas, recently spoke with **Todd Kellenberger,** client portfolio manager, real estate securities, with Principal Asset Management, about current trends affecting the public REIT market. Following is an excerpt of that conversation.

Where are we in the cycle for listed REITs, and how does that influence your views on their return prospects, going forwards?

Principal's real estate team has gone through many cycles in the past 25 years of REIT investing. The story of this recent cycle, which I mark as the start of 2022 when the REIT market peaked and the US Fed started to hike rates, has been about inflation and rising interest rates. What's been surprising is the sustained US economic expansion despite these headwinds, a positive tailwind for REIT earnings in recent years.

Rising yields brought an increase in the cost of capital for real estate and a meaningful resetting of pricing for real estate equity values, including REITs. As public REITs often do, they led private markets in this cycle, reaching a bottom in late 2023 and rising approximately 25 percent from their lows through the beginning of 2025, while private real estate markets are still searching for that bottom. REIT stock prices remain approximately 21 percent below their previous peak, suggesting plenty of room for growth.

Where we go from here will depend on the direction of yields and company earnings. The global economy appears well positioned to sustain its growth expansion, and economic tailwinds should support accelerating earnings growth for global REITs in 2025. Central bankers stand ready to adopt a more accommodative stance and continue their normalisation of rates but are keeping a cautious eye for data suggesting any reacceleration of inflation. In the United States, we believe policy shifts by the new administration could present upside risks to inflation and bond yields. If so, then investors will need to adjust their return expectations for REITs if rates remain elevated or even go higher.

While the prospects for falling yields to help turbocharge returns for listed REITs has faded in the short term, 2025 should bring an inflection point in supply trends and transaction activity. Lower supply is on the horizon, as construction starts slowed the past two years. We expect transaction activity can also pick up and provide another lever to earnings growth for REITs via acquisitions. We believe this external growth driver, coupled with organic growth in rents and occupancies, should help most REITs to deliver 5 percent to 10 percent earnings growth in 2025. While dividends are not guaranteed, this may help fuel growth in REIT dividends. Entering the year, REITs were yielding approximately 4 percent. Overall, we are optimistic on the outlook for the REIT market but recognise uncertainties and obstacles remain.

After a prolonged drought of capital inflows into real estate broadly, investors appear poised to increase deployments into real estate in 2025. What's the case for making listed REITs part of that allocation?

Liquidity and diversification are important in any investor's portfolio, and REITs can help strategically bring both to a real estate allocation. In the context of today's environment, where investors are likely to increase allocations to real estate, REITs provide the ability to have immediate deployment of capital into the real estate market in a very efficient way across several high-quality portfolios owned, operated and managed by these companies.

That liquidity benefit can also be leveraged tactically. If you always have REITs in your portfolio, you now have the ability to dial up and dial down that exposure to take advantage of pricing opportunities between public and private real estate markets, or relative to other asset classes in a diversified portfolio. At the time of this interview, that disconnect between public REITs and legacy private real estate equity fund valuations still exists. In the United States, the implied cap rate of REITs remains well above the average appraisal-based cap rate reported by NCREIF. We would note spot market cap rates and implied cap rates for REITs are closer to parity.

The final point about liquidity is the ability to "skip the line" the next time property markets are frozen. Many investors are still sitting in private equity redemption queues – and this will not be the last time that happens. REITs could potentially offer the opportunity to skip the exit lines next time and have their real estate allocation change dynamically with market conditions. It could also help avoid the suboptimal result of finally redeeming your real estate allocations at a time when property markets are just starting to turn back up.

In addition to liquidity, a REIT allocation provides investors exposure to alternative or nontraditional property sectors that many are seeking. The public REIT market has typically been ahead of this curve for several years, with several companies creating large portfolios of assets that specialise in senior housing, data centres, self-storage and single-family rental. A customised portfolio of REITs to complete their overall real estate market or sector exposure is a trend we expect to continue.

What is your outlook on REIT market transaction activity?

We believe an increase in activity is likely in 2025. Sellers will potentially come off the sidelines as private equity valuations reach a floor and debt maturities rise. Recent improvement in the cost of capital and overall capital availability for REITs puts them in a strong position to capitalise on these opportunities.

With public market access and generally low-leverage balance sheets, REITs have an advantage. We saw REITs increase their activity this past year and continue to build up their liquidity. This will likely accelerate their external growth prospects.

The green light for REITs to be more aggressive is where they have a strong cost-of-capital advantage versus current market values — in other words, trade at a premium to price to NAV — and attractive uses for the capital. For example, US healthcare, shopping centres, and data centres are sectors where we think REITs will likely remain on the offensive. Industrial REITs, on the other hand, may be on the sidelines for a bit longer until stock prices recover and cost of capital improves. In office, there will probably be some increase in activity with select REITs, but in general, there is still investor caution for the office sector overall.

Are there certain themes Principal Real Estate is focusing on in your REIT investments, and does that cause you to favour certain sectors today?

At Principal, when we're looking for attractive investment opportunities, we do so with a fundamental approach that seeks to identify where REIT stock prices do not reflect the market value of the real estate and intrinsic value of the company. We allocate capital with an emphasis on individual security selection and favour higher-quality REITs where their attractive long-term growth isn't fully priced in. This approach means sector or thematic tilts in the portfolio are most likely the result of finding several REITs we believe are compelling within that sector.

The healthcare sector, and specifically the US senior housing market, is a sector where we're finding an attractive risk-reward across a number of ideas, as we enter 2025. There is an accelerating secular demand driver of demographics with the age-80-and-older part of the population growing. We also see improved affordability due to wealth accumulation by seniors in recent years, and annual supply growth of assisted and independent living facilities is at its lowest level since 2013. This should result in very attractive earnings growth at the property level, and external property acquisitions from REITs could provide an additional boost to earnings growth.

Another compelling thematic involves AI and technology. We have ample opportunities within the global REIT market to invest in the data centre space. We have to be mindful of the relative valuations for pure-play data centre companies, but other opportunities are emerging as other REITs, such as industrial REITs, monetise their land banks and their development expertise to build out an attractive data centre development pipeline that provides growth opportunities.

Finally, I would mention residential. Home ownership is still very expensive, driving strong demand for renting across a number of property types, whether apartments or single-family rental. The public market offers some large, specialised operators and owners within this space, and we like the confluence of challenging home affordability, relatively low supply and very low transaction activity for home ownership, making the demand for single-family rental very attractive and sticky.

Are there other sectors or markets within REITs that require a more cautious approach?

US office remains an area of caution overall; however, we are seeing selective opportunities in certain markets. There has been a pick-up in transaction and leasing activity, for example, in some submarkets within New York, as return-to-office trends pick up and a flight-to-quality trend favours REITs in that market. But big picture, office is still very much a wait-and-see sector for us. The Sun Belt apartment market is another such area, as it has been hit with record-high new construction of new apartment buildings that will take time for the market to absorb. Another market where we are taking a cautious approach at the beginning of this year is Japan. We must be mindful that Japan is in an environment of potential interest rate increases, whereas most other countries are seeking to cut rates. Importantly, it does not mean we won't still invest in these sectors or countries if there are mispricings at the security level; it just means these are areas where the time to own them in a considerable way isn't right now.

Do you expect the new US administration to create headwinds or tailwinds for the REIT market?

The presidential election and changing US administration has created a bit more uncertainty in terms of our outlook for interest rates in the year ahead. The path for REITs can be a favourable one if inflation remains under control and President Trump's policies do not reignite it. But if a sustained second wave of inflation materialises, interest rates and real estate cap rates will potentially rise given tight spreads. Possible tailwinds would likely come from any pro-growth initiatives the new administration could enact. A strong economy isn't a bad thing for real estate. If a strong economy is sustained, and the policies are not overly inflationary, that could create a favourable set-up for the REIT market in 2025.

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Principal Real Estate is the dedicated real estate investment team of Principal Asset Management℠. Our knowledge and expertise span the spectrum of public and private equity and debt. Our specialised market knowledge, dedicated and experienced teams, and extensive connections across all four real estate quadrants allow us to maximise opportunities and find the best relative value on behalf of our clients. Visit our website at **www.PrincipalAM.com/realestate**

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