B&I Capital AG

REIT Management Meetings and Property Tours

2023 Global Property CEO Conference

Miami, 5-9 March 2023

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1. Background

We just returned from the Citi 2023 Global Property CEO Conference in Miami, Florida. The conference was a timely opportunity to meet with management teams from a diverse array of sectors and countries.

Over a busy five days, we toured apartment, retail, manufactured housing, and skilled nursing assets in the Miami area while also participating in 33 small group or one-on-one meetings. Additionally, we sat in on industry roundtable discussions and had the opportunity to talk with fellow REIT investors. We came away from the conference with deeper knowledge as well as greater clarity on the themes we believe will shape real estate in 2023 and beyond.

Due to the current stress in the banking system evidenced by SVB's failure through to the UBS and CS merger, it is important to highlight the following points about US REITs. Based on discussions at the conference and our research, we know that public REIT balance sheets are stronger than they have ever been; according to NAREIT, current net debt to EBITDA sits at 5.8x vs. its historical 22-year average of 6.3x and its Great Financial Crisis (GFC) 2008 average of 7.1x. Access to capital is critical, and REIT CFOs' noted credit markets remain open for REITs, especially high-quality businesses which we strive to own. Last week Simon Property Group opened a new USD 5bn unsecured revolving credit facility which replaced its existing USD 4bn facility.

The dividend is another proxy for safety, and we continue to see decent dividend growth of c. 5% and note the pay-out ratio is now 68% vs. its historical average of 79%, meaning there is safety in the dividend even if revenues drop a bit. YTD 39 US REITs have already increased their dividend.

Outside of the office sector, occupancy is high and tenant issues remain low. The REIT business model is battle tested and has survived though many stressful periods including Covid and the GFC. Despite the current market volatility, we believe our investment philosophy and process focusing on high-quality companies with steady dividend growth will provide investors with long term investment horizons sufficiently attractive returns.

Finally, the risk we have highlighted since the middle of last year is what happens with the PE and unlisted funds. We still believe this is an area to watch as these entities are now facing redemptions and will need to sell properties, this will present an opportunity for well capitalised REITs.

2. Big Picture Takeaways

REITs are defensively positioned.

1. **Stronger than expected leasing fundamentals but also sector bifurcation**
2. **Capital Markets Recession, a Transaction Pause, and the Liquidity Imperative**
3. **Rising non-controllable expenses & lease structures**
4. **South Florida Real Estate Market Vibrant**

Defensive Mindset

REITs essentially have seven possible capital allocation decisions. These include:

1. **Grow externally through acquisitions or development**
2. **Allocate capital to internal growth initiatives**
3. **Issue debt and equity**
4. **Sell assets**
5. **Buy back shares**
6. **Pay down debt**
7. **Pay dividends to shareholders**

Each REIT management team was asked during their presentation what the best capital allocation decision was for their company. Due to rising interest rates, macro uncertainty, and discounted share prices many inevitably and wisely said their best decision was to either pause for greater clarity or sell assets to generate proceeds to pay down debt, pair trade into higher quality assets, or buyback shares. Also, many REITs responded that they are focused on improving internal processes, often with technology, to drive growth and employee productivity.

We invest with management teams that focus on their cost of capital and share price to make the best possible capital allocation decisions.

Therefore, we were skeptical of management teams that indicated they feel now is the time to grow externally via acquisitions and developments. Firstly, with share prices weak combined with higher interest costs, the cost of capital has gone up, meaning acquisitions are more expensive. Additionally, seller asset prices have yet to meaningfully reset. Development costs remain elevated.

Stronger than expected leasing fundamentals but also sector bifurcation

Leasing growth and fundamentals remain strong for industrial, healthcare, retail, self-storage, and manufactured housing subsectors.

Industrial REIT Prologis (PLD) highlighted better than expected leasing achievement and YTD rent growth. PLD's peer, Eastgroup's (EGP) rental rates on new and renewal leases increased an average of 50% on a straight-line basis. Industrial REITs will be able to push annual escalators of 3% to 4% due to persistently strong demand.

Across all sectors same store NOI is expected to grow 4.4% in 2023. However, lease growth is not strong across all REITs, with below trend growth expected from triple net and office REITs. Apartment and single family rental REITs are seeing less pricing power as rent growth is declining from all-time highs, yet is still above historic levels.

Capital Markets Recession, a Transaction Pause, and the Liquidity Imperative

Rapid rate hikes have led to a capital markets recession as developers and buyers are understandably hesitant to borrow at SOFR rates 450bps higher than a year ago.

Higher interest rates and a rising cost of capital require REITs to underwrite higher returns to make deals accretive. We have yet to see sellers meaningfully reset values of assets lower (cap rates higher) and we are yet to see distressed sellers.

Development costs have continued to increase due to inflation and a tight labor market. For example, American construction workers hourly pay went up 6% YoY in February. On a positive note, material input costs have started to decline. Lumber, a major input in US single family homes, is down 63% YoY and copper prices are down 21%.

Many management teams bemoaned the lack of transactions and price discovery in their sectors. However, experienced management teams see this pause in transaction markets as an opportunity to store dry powder, so they are prepared to act opportunistically in the future. While strong balance sheets are always important, they are even more so now, as REITs that have less near-term maturities and more liquidity standing by will be able to act decisively if quality asset prices reset downward and frozen transaction markets begin to thaw.

US REITs went into this crisis with historically conservative balance sheets.

Rising non-controllable expenses & lease structures

Teams we spoke to highlighted their success in limiting controllable expenses but noted that uncontrollable expenses (for example insurance, taxes, interest rate costs) were rising well above historical levels and driving elevated operating expense guidance for 2023.

REITs that had seen asset values shoot up in 2020 and 2021 are now facing higher than expected property taxes which typically lag property price appreciation. This situation is particularly acute in the single family housing (SFH) and single family rental markets (SFR). American Homes (AMH), a large SFR REIT saw property taxes increase 20% in 2022 and is expecting 10% growth in 2023. In a rising operating environment, REITs that have fixed debt and can pass costs onto tenants through triple net or short-term leases are best positioned.

South Florida Real Estate Market Vibrant

Sentiment from residents, management teams, and fellow investors was that Miami and South Florida is arguably the hottest real estate market in the country. We toured AIR Communities (AIRC) apartment assets (pictures below) in Miami with ocean views where rents are increasing 40% while most apartments in the rest of the country are seeing 5% increases. An exodus of financial firms and highly paid employees from New York, Boston, and Chicago to sunny South Florida, and particularly the Wynwood and Brickell neighborhoods of Miami, has led to this real estate boom.

3. Sector Takeaways

Healthcare

Within healthcare we focused on meeting the senior housing operating portfolio (SHOP) and skilled nursing facility (SNF) REITs.

We believe healthcare and especially these subsectors within healthcare are set to outperform over the coming years for the following reasons.

Healthcare has lagged the broader Covid recovery, especially in the SHOP and SNF sectors which cater to older patients who were disproportionately affected by Covid.

While occupancy has increased substantially in these sectors from the Covid nadir of low 70% range to the low/mid 80% range today, it remains below the high 80% pre-Covid level.

Improved occupancy has led to significant rental pricing power and NOI growth. The largest SHOP operator in the country, Welltower (WELL) grew SHOP occupancy 19% in 2022 and expects 20% growth in 2023. This compares favorably to many other sectors where NOI growth is flat or in the mid-single digits range.

We toured an Omega Healthcare (OHI) SNF asset and noted the number of nurses and support staff working at the property. Both SHOP and SNF businesses are labor intensive with typically one nurse/worker for every two tenants. This causes labor expense to be an important driver for margins and profitability. Following Covid, there was an acute labor shortage in SHOP and SNF facilities which caused the cost of labor to skyrocket. Labor costs have normalized in SHOP and are beginning to stabilize in SNF facilities creating a more favorable situation for pressured healthcare operators.

Improving occupancy driven by an aging population, increasing demand and rents, stabilizing labor expenses, limited new supply coming online due to high development costs, and the opportunity for significant margin improvement left us feeling positive on the healthcare sector and our positioning there.

Office

Despite trading at steep discounts to NAV and offering high dividend yields we see most of the traditional US office REITs as value/yield traps. Office REITs sold off in 2022 and continue to be unloved by the market for just cause. Most office REITs have occupancy in the high 80% range and depending on the city, utilization is often below 60%. Office demand is often an echo of white-collar job growth which has slowed as many technology and media companies on the West Coast have laid off thousands of employees.

Silicon Valley Bank (SVB), a California bank for early-stage companies for technology and biotechnology companies, was taken over by the FDIC as the bank struggled to raise new capital. This led to shares of West Coast REITs such as Kilroy, Hudson Pacific, Essex, Alexandria (ARE), and Healthpeak selling off and underperforming the REIT index.

However, we remain positive on ARE (not the others mentioned) and view this sell-off as a good opportunity. According to ARE's recently published 8k, they do not have any financial exposure to SVB. ARE does have one lease, 0.08% of total annual rent, in the Boston area with an affiliate of SVB renting 32,000 sf. 90% of ARE's Top 20 tenants have an investment grade rating and only 10% of its rent is from public biotechnology companies in preclinical or clinical stages.

Timber

We were surprised to find our meetings with timber companies full.

Despite slowing single family home construction and lumber costs being down nearly 60% YoY, investors were interested in longer term timber catalysts stemming from decarbonization opportunities. We met with timber REITS Weyerhaeuser (WY) and Rayonier and about 50% of the time was spent discussing these companies nascent “carbon solutions business”. As companies and governments around the world seek to meet net zero carbon targets they will inevitably have to turn to timberlands as a solution.

Potential solutions involve companies buying timberlands outright to use for carbon capture instead of logging, companies buying carbon offset credits from timberland owners, or carbon being captured in the air and then pumped into timberland tract sub-surfaces. While the REITs carbon solutions businesses are often in the inception stage, CEOs told us timberlands are now being underwritten and acquired at significant premiums with these additional uses in mind.

Residential

Investors at the conference were focused on above average yet decelerating rental rates in the apartment and SFR sectors.

Apartment REITs sold off 32% in 2022 as investors priced in slowing residential rental growth (from incredible levels of 20% or more) and increasing expenses in the form of inflationary labor costs along with higher taxes and insurance. In addition to these pressures, residential supply in Sunbelt markets is booming with new supply accounting for 10% of total inventory in Sunbelt cities such as Austin and Nashville.

Our conversations with management teams made us more constructive on REITs with diversified coastal exposure such as UDR and AIRC. After touring apartments in Miami we believe investors would do well to tilt their portfolios long term to REITs with residential exposure to the South Florida market. After drops often exceeding 30%, we believe residential REIT valuation’s offer interesting entry points. Rent growth remains above historic levels and occupancy remains in the high 90% range due to strong demand and a persistent lack of affordable housing.

Retail

We met five management teams and toured several retail properties in Florida.

Overall, our property visits were impressive and confirmed the strength of the Miami, Ft Lauderdale, and Boca Raton. We noticed high levels of foot traffic in Federal’s (FRT) shopping center in Davie FL and we were positive on Tanger’s (SKT) new management contract at a West Palm Beach asset with strategic partner Clarion Partners.

Tanger assumes the marketing and leasing of the property and expects to improve the asset’s performance with its experience and scale in the outlet business.

In addition, we visited Simon’s Aventura Mall near Hollywood, FL. The mall was full of high-end stores such as Givenchy and mostly leased. Shopping Centers REITs highlighted their strong fundamentals and solid balance sheets but are increasing reserves for bad debt slightly above historical levels. We remain upbeat on shopping centers with high grocer exposure due to their defensive qualities.

Triple Net

We met with several triple net management teams (e.g., ADC, Essential) and visited Olive Garden, a large tenant of Four Corners, a restaurant REIT based in California.

Both ADC and Essential reiterated their robust external growth opportunities and strong capital position. ADC noted its portfolio is e-commerce and recession resistant due to its high-quality tenants. 68% of ADC tenants such as Walmart, TJ Maxx, and Target are investment grade.

Self Storage

The biggest story in the self-storage sector is Public Storage's (PSA) takeover offer for Life Storage (LSI) and the latter's rejection. Unsurprisingly, the respective management teams could barely discuss the topic.

Extra Space (EXR), PSA's biggest peer, was relatively cautious regarding mergers of public REITs, stating that it is difficult to make such deals accretive given you pay a premium to NAV.

The pandemic has permanently changed the self-storage business by boosting online rentals, which now accounts for a large share of new customers. Self-storage companies are also using pricing strategies with online rentals that have become more targeted and dynamic.

In 2023, the sector will return to more normal activity levels after record occupancy and rent growth the past two years. While lower economic activity and a weaker housing market will impact demand, companies don't expect NOI growth to turn negative given the sector's well diversified demand drivers. Companies expect low- to mid-single digit SS NOI growth and for external growth to slow significantly.

Industrial

Industrial REITs we met continue to highlight strong demand, low vacancy, and healthy rental growth.

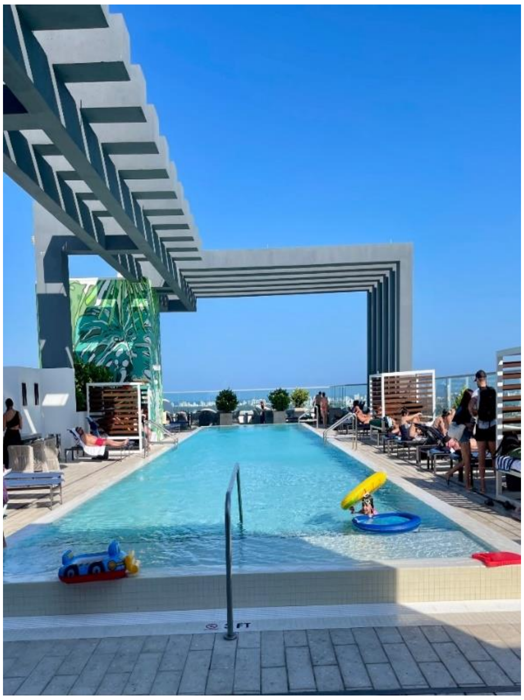
While Prologis (PLD) expects supply to outpace demand in 2023, this will only increase vacancies marginally and they still forecast 10% market rent growth. This will come on top of rent reversion above 60% already embedded in the portfolios for REITS like PLD or Rexford (REXR). Towards year-end, supply of new space will decline due the marked slowdown in development starts.

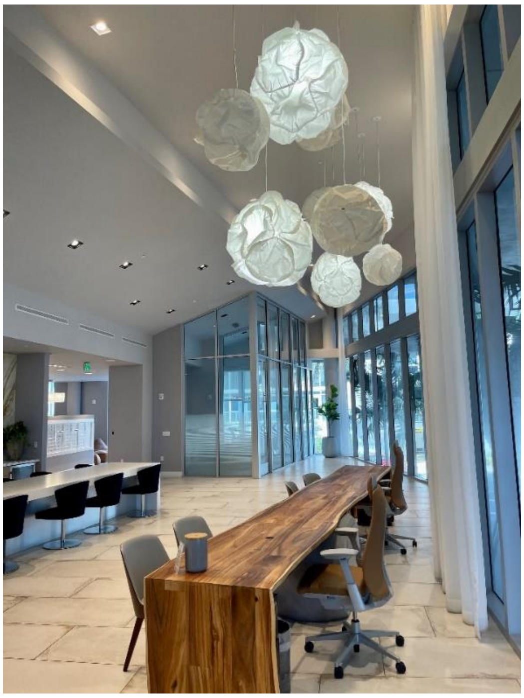
Unlike the sector in general, REITs focused on coastal markets, like Rexford and Terreno, are still finding accretive acquisition opportunities. Both REITs benefit from superior rental growth, attractive cost of equity, and low reliance on debt.

US Industrial REITs are mainly focused on the consumption-end of the supply chain. We also met with FIBRA Prologis, a Mexican REIT, which has a larger exposure to the manufacturing sector. The management sees particularly strong demand in border cities (Tijuana, Juarez, Monterrey and Reynosa) from nearshoring of production from Asia especially in electronics, medical devices, and autos which could be an interesting secular growth story in the coming years.

4. Asset Tour Pictures

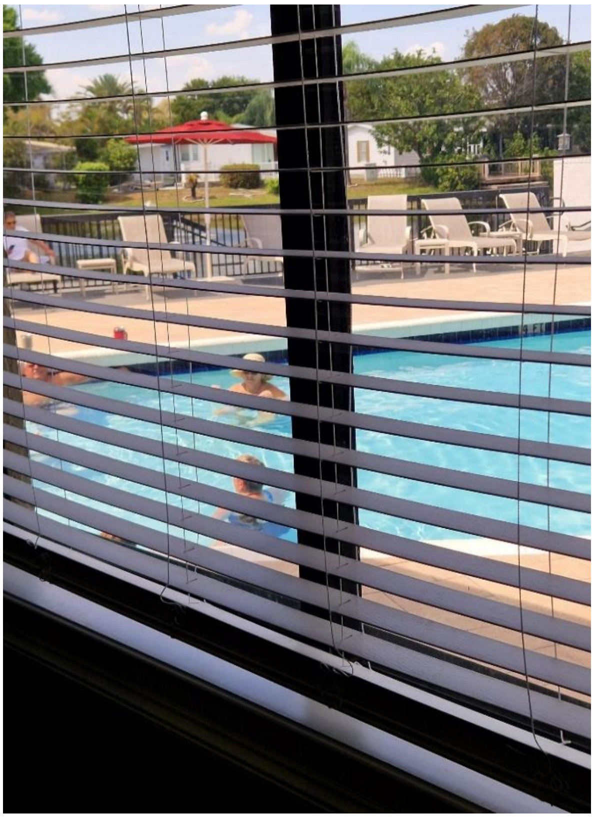
Air Communities (AIRC) Miami Property Tours, FL – 3/5/2023





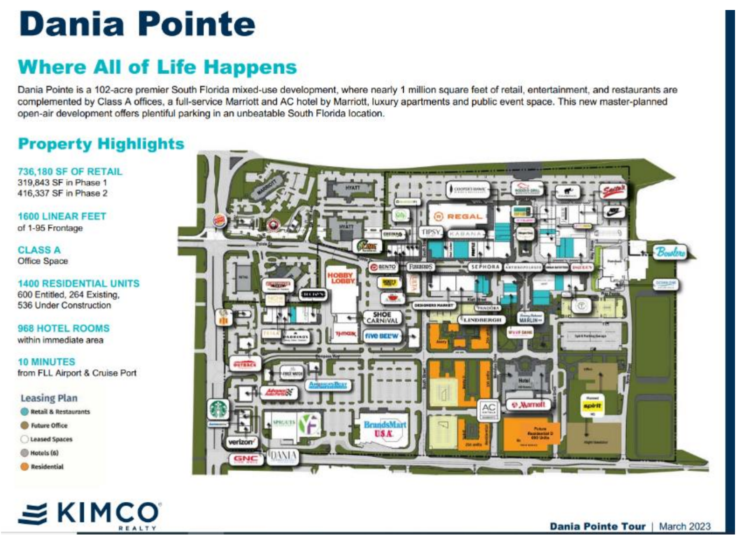
Hillcrest Health Care & Rehabilitation Center, Hollywood, FL Omega Healthcare Asset– 3/8/2023

Manufactured Housing Tours, Hollywood, FL – 3/5/2023

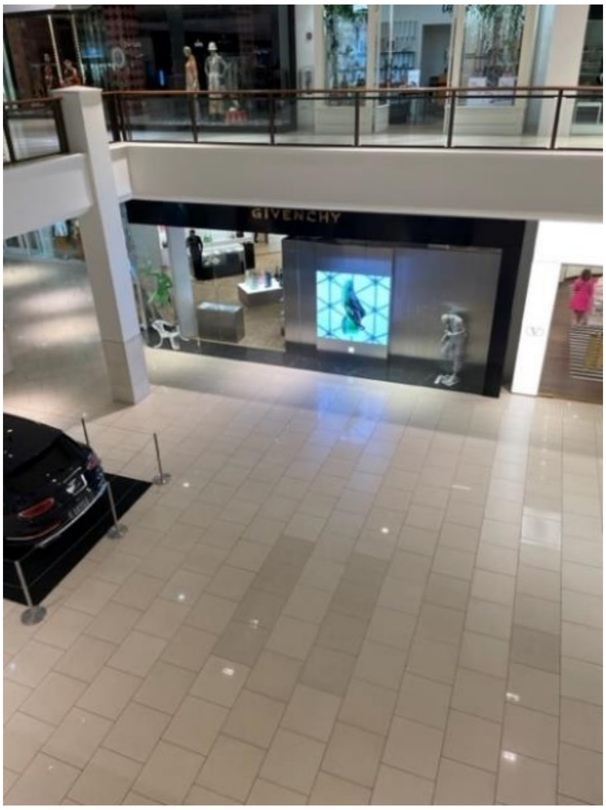


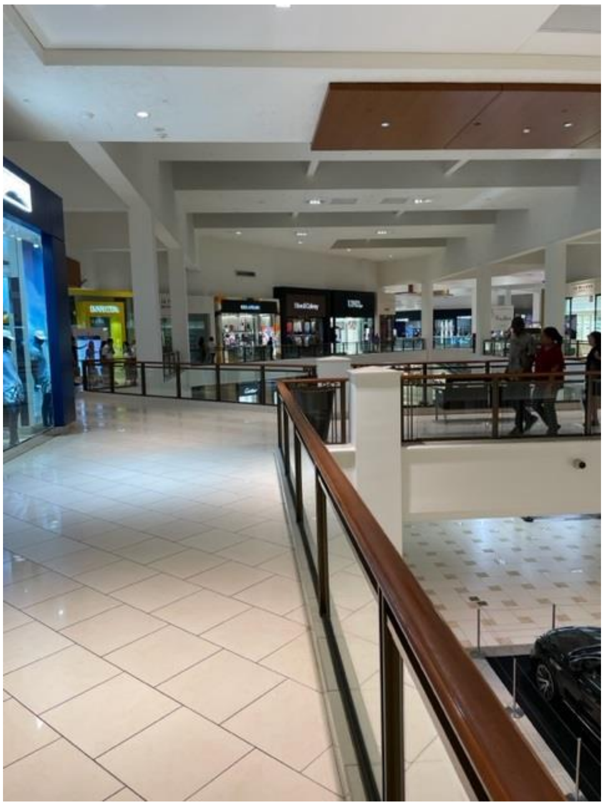
Retailing Tours – West Palm Beach and Hollywood, FL 3/5/2023:

Tanger Outlet, Palm Beach



Simon Property- Aventura Mall, near Hollywood, FL





Federal Realty, Davie, FL