

B&I Capital

NAREIT Conference 2023

REIT Management Meetings and Property Tours

New York, June 2023

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1. Background

We attended the NAREIT Conference in Midtown Manhattan in NYC, participating in numerous property tours, meeting with 30 REIT management teams, and spoke directly to various sell-side analysts based in NYC.

Our recent hire to our Austin office and US analyst in training, Aditya Bapna joined us for the conference after graduating from the University of Texas MBA program in May. Aditya will be trained by the team in Zürich for the next six months before returning to Austin, Texas.

Midtown Manhattan and all of NYC was noticeably busier than when we visited a year ago. The city expects to attract 61.7m tourists in 2023, a 9% increase over 2022, and slightly below the 67m visitors in 2019. Subway ridership currently sits at about 75% of pre-pandemic levels on weekends and 65% on weekdays. Despite return to office announcements from large financial firms such as JP Morgan, daily office utilization in the city still sits at only around 50%, and most sell-side analysts we spoke to continue to work a 3-day per week hybrid strategy.

The conference came shortly after Q1 earnings, so there were no major surprises, but we came away from with a better understanding of the themes and fundamentals that will drive the various REIT sectors we invest in for the remainder of the year and into 2024.

2. Big Picture Takeaways

REIT fundamentals remain strong despite macro concerns

Encouragingly, management teams are more cautious than when we spoke to them last year, with more a tone of conservative optimism than worry or pessimism that the US CRE market was about to collapse.

Many REIT managers noted that SS-NOI growth is at or above historic levels, inflationary expense pressures (labor, materials, etc.) are showing signs of easing, and REIT valuations look cheap compared to past levels and especially compared with the S&P500.

REITs in sectors benefiting from long-term thematic or demographic-driven supply/demand tailwinds and possessing strong balance sheets are outperforming as will be discussed in the following sections.

REITs struggle when interest rates increase quickly (as we have seen in the last 16 months with Fed funds rates +500bps) but often outperform once rates stabilize.

AI a hot topic, and especially for technology REITs

In May, Nvidia (NVDA) reported \$1.09 per share of non-GAAP earnings, topping expectations for both revenue and earnings. The company cited generative AI driving exponential growth in global computing requirements as the reason behind increased demand across its business verticals, which ultimately drove the positive surprise.

AI is especially positive for data centers (DCs) as AI models need to be trained on large data sets before they can be deployed into end-user facing applications. DC REITs such as Equinix (EQIX) and Digital Realty (DLR) performed well on the NVDA news, gaining 8% and 14%, respectively over 2 days. DLR gained more because they may benefit earlier in the AI adoption cycle. DLR's DCs act as the data processing "work horses" of cloud computing, where much of the AI model "training" mentioned above takes place. EQIX's business, on the other hand, is more focused on network connectivity.

Tower/fibre REITs did not benefit from the news, despite these technologies being an important pathway to data demand and networks in general. Demand for AI is currently cloud-driven, but tower company Crown Castle (CCI)'s management team believes that any technological advancement which increases data requirements is positive for providers of communication infrastructure. It is also worth noting that those applications of AI technology which sit closer to the end user (i.e. "edge computing") will provide less of a tailwind for DCs, and possibly more of a tailwind for tower/fibre REITs.

Certain sectors are also ripe to utilise AI. For example, Healthcare and specifically Welltower has been at the forefront of introducing AI improvements into its day-to-day pricing and offering improvements.

Balance sheet strength and debt availability

In nearly every meeting we participated in, the strength of the balance sheet along with upcoming debt maturities, cost of debt, and access to financing was discussed in detail. Most REITs reduced their leverage profiles following the GFC. Across sectors, net debt to EBITDA levels stand at a prudent c.6x.

Management teams acknowledged that higher interest rates and bank stress has led to a more difficult lending market across all property types. As the cost of debt has gone up, the appetite for external growth through development and acquisitions has slowed. Banks are enacting tighter lending standards by requiring higher loan to value levels for construction loans and becoming pickier about the real estate assets they lend against. Recent headlines about office owners handing back the keys for underperforming (and non-collateralized) office assets are surely making lenders think twice about new office originations.

Pause in CRE Transaction Markets

Bid-ask spreads between buyers and sellers are compressing but are still wide enough to cause a pause in transaction activity. Sellers are still anchored to asset values from 1-2 years ago while buyers are struggling to find attractively priced debt to make underwriting assumptions work. Cap rates have crept up across sectors, but acquisitions/disposition volume will not pick up until asset values fall more to reflect the new debt environment (likely), or the Fed begins to cut rates.

Conservative balance sheets equal competitive advantage

In the current debt environment REITs with lower leverage, long-dated maturities, investment grade (IG) ratings, and lower costs of capital are in an advantageous position.

First, REITs with stronger balance sheets and laddered maturities have less need to refinance or take on debt at the current punitive rates and can preserve their lower cost of capital.

Second, many REITs with strong balance sheets are patiently waiting for private and public peers with weak balance sheets to be forced to drop prices to close the bid-ask spread and sell assets cheaply to access badly needed capital sources. While this trend has yet to start, many experienced teams with conservative balance sheets across nearly every sector expressed a belief that this opportunity will inevitably arise.

Finally, REITs with strong balance sheets can maintain their dividends and reward their shareholders even in difficult times while demonstrating confidence to the market.

Corporate Governance/Board Insights

We met the board of directors of Four Corners Property Trust and interviewed their Chairman, John Moody. For context, meeting with board members is highly atypical for buy-side analysts and portfolio managers. We used this unique opportunity to ask tough questions about corporate governance and the difficulties investors face in properly evaluating the independence of boards. The board's voting track record and compensation policies provide some insight into the quality of the board and its independence from management. Overall, we were very impressed with the checks and balances in place at Four Corners.

At B&I, our philosophy is to evaluate CEO compensation vs. peers and share price performance. After evaluating the proxy statement in principle, we tend to vote in favor of (against) the compensation plan if the share price outperforms (underperforms) the market and its selective peers. However, we note if CEO compensation is exorbitant vs. REITs as a whole and we have historically voted against plans despite outperformance in these cases.

We continue to focus on and learn about this topic because we believe it helps the research process and provides us with a competitive advantage in stock picking.

Office Sector trade?

Considering the Office Sector is now only 3% (excluding Life Science) of the REIT index, it punches well above its weight in terms of news flow and read-through as to how bad the CRE sector's fundamentals must be in general. We believe this misconception has contributed to recent REIT relative share price weakness.

There was a lot of talk about whether now (not the first time we have heard this in the last couple of years) was the time to buy the Office REITs as they are at historically cheap levels, and we recognize those with both strong management as well as balance sheets. However, we are not ready to buy what could well be a value trap.

3. Sector Takeaways

Data Center (DC) and Telecom

We had positive meetings with DigitalBridge (DBRG) and four REITs from the DC and Telecom Infrastructure space: Equinix (EQIX), American Tower (AMT), Crown Castle (CCI), and Uniti (UNIT). The meetings were well attended, indicating significant interest from investors.

Key themes included: strong trends in end-user data demand, excitement about AI, and continued 5G deployment across markets. The tower businesses tend to have good visibility, with a large % of future bookings locked in. Tower REITs' forecasts for future growth were consistent with our expectations. AMT gave positive guidance on its international expansion into developed markets, such as Germany and Spain, but the company faces troubles in developing markets, like India and Mexico. This reaffirmed our positioning within the sector (underweight AMT, overweight SBAC).

While all management teams highlighted that the exact impacts of AI remain to be seen, they emphasized that AI is broadly positive for these sectors. We expect Digital Realty (DLR) to benefit more than EQIX or DBRG, because of DLR's focus on data processing over connectivity. However, this technology cycle is still in its early stages. Overall, we maintain a positive outlook on the DC and Tower REIT space.

Office

Office REITs are trading on average at a 50% discount to NAV. These valuations sparked investor interest at NAREIT, but the sector shows little reason for optimism. Office REITs are seeing declining occupancy, increasing tenant sublease space coming to market, flat or lower rents, sustained concessions, and office utilization on a good day at 60%. Most damning of all, many office REITs announced dividend cuts in Q1, signaling a clear lack of confidence in demand and balance sheets in the coming year. We will continue to monitor traditional office occupancy, utilization, and leasing volume closely but for now the sector screens as cheap for a reason.

We were most interested by our meetings with specialized office REITs such as Alexandria Real Estate (life science office) and Corporate Office Properties Trust (Defense and Cybersecurity assets). 90% of Corporate Office Properties Trust NOI is tied to priority defense and IT missions which is backed by the US Defense Department and necessitates specialized space for workers that must be in the office. Unlike most office REITs which have cut their dividends, OFC recently raised their dividend for the first time in 10 years and expects future dividend raises to match the 4% AFFO growth they are projecting.

Healthcare

We remain positive on the US Senior Housing Operating Portfolio (SHOP) REITs as occupancy continues to increase. Occupancy currently stands at 84.5% vs pandemic lows in the mid 70% range, and pre-pandemic of the high-80's. Welltower, the largest SHOP owner in the US is focused on pushing forward changes to an antiquated business model they believe is 30 years behind the technological and operational efficiencies the apartment REITs have implemented.

Welltower has put together a strong team to drive this transformation and believe there could be significant upside for shareholders if Welltower can execute and unlock the margin expansion they are forecasting. Currently, their operations team is focused on improving their CRM technology and process which they believe is the lowest hanging fruit in the transformation.

Residential

Single-family rental REITs are one of the best performing REIT sectors YTD. Millennials starting families and wanting more space as their families grow is driving demand. High interest rates and record high home prices necessitate large mortgage downpayments and has made it prohibitive for many younger Americans to buy homes.

A lack of single-family homes built following the GFC has created a shortage of 4m homes in the US and is driving SFR supply tailwinds. These factors are creating long-term momentum for SFR companies such as Tricon Residential, who we had an interesting meeting with at NAREIT.

One point that surprised us was the level of increases residential REITs are seeing to their insurance premiums. SFR companies saw 20% YoY increases, apartment REITs are seeing increases in the 20-35% range, and manufactured housing (MH) and RV REITs saw increases ranging from 60-80%. Significant portions of the MH/RV portfolios are in Florida and suffer from the risk of hurricanes. As weather events have become destructive 20-30% of insurance carriers for MH/RV have left the sector entirely. This is a significant expense increase affecting the bottom line and bears watching in the coming years.

Triple net

We met several triple net management teams that noted they are finding acquisition targets at more realistic prices. However, triple net REITs are selective in acquiring new assets while capital markets and lending issues remain challenging.

According to CEO Joey Agree, of Agree Realty, development risk remains high due to expensive financing costs despite a lack of real estate supply. The low supply theme was strong in the retail space and bodes well for higher rents.

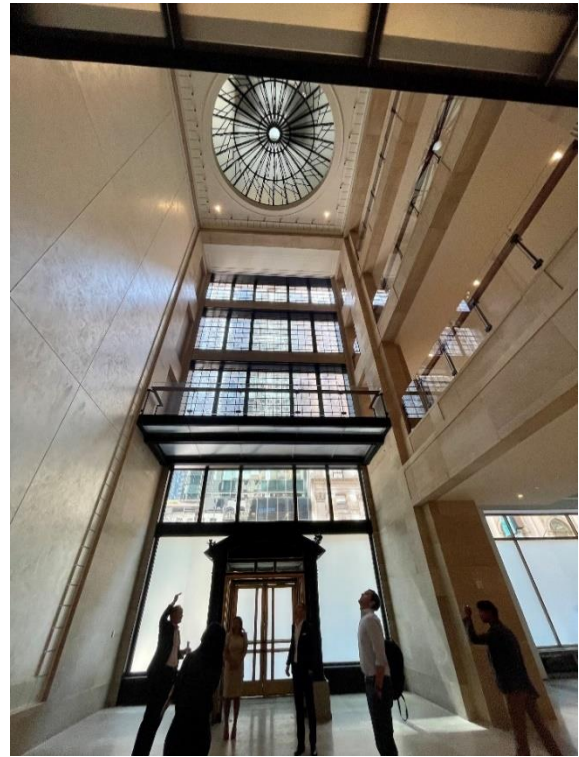
Retail

We spent time with several Retail REITs including open-air shopping centre REIT Brixmor (BRX) and Mall REIT Macerich (MAC). Both management teams reiterated they are seeing a lack of new supply, which bodes well for higher rents. Macerich's CFO highlighted the strength of their business since Covid ended and, for the second year in a row, reiterated how undervalued their stock price is. We acknowledge the undervaluation from a historical perspective (P/FFO at 6x today vs. 13x historical average); however, note that the balance sheet leverage remains high vs. its mall peer, Simon Property Group (SPG).

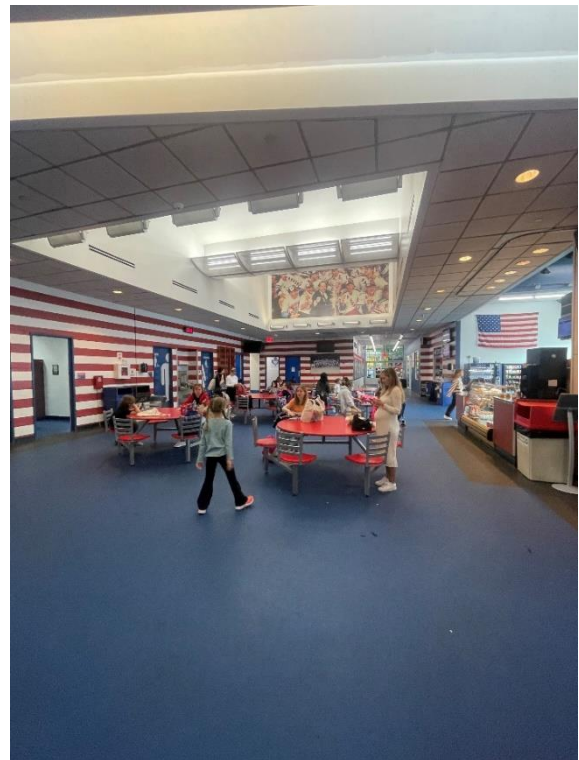
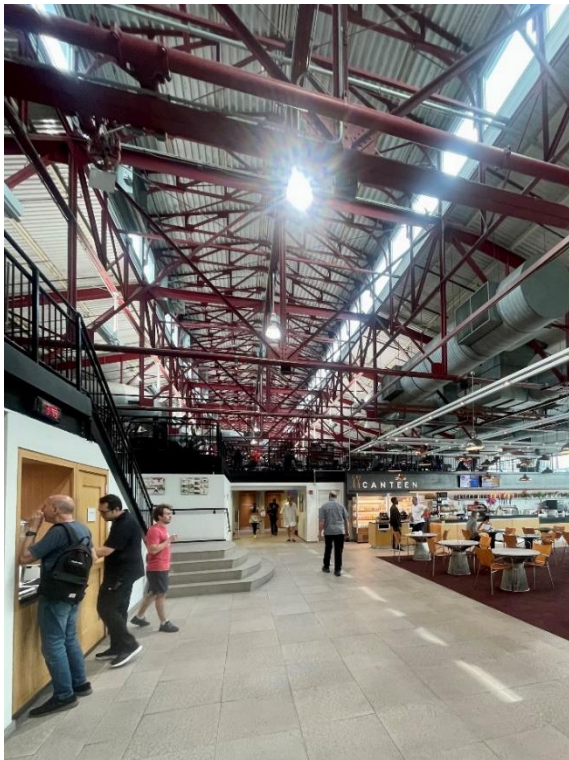
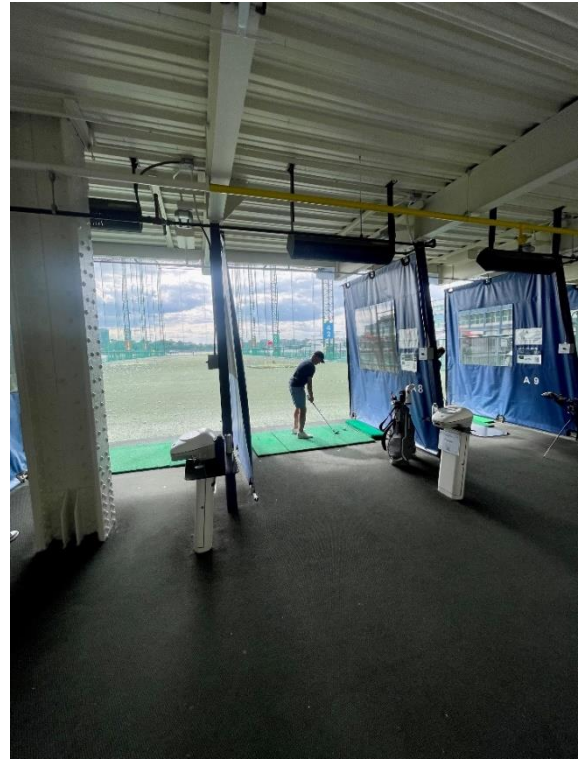
Brixmor CEO James Taylor felt that the lack of supply in open-air shopping centres helped their business but highlighted the REITs' low rents as the key to future growth. In general, low rent is easier to reprice and tenant retention is higher. Regarding ESG, Brixmor currently has 15% of their properties with EV charging stations, with a goal of 25% by 2025.

4. Asset Tour Pictures

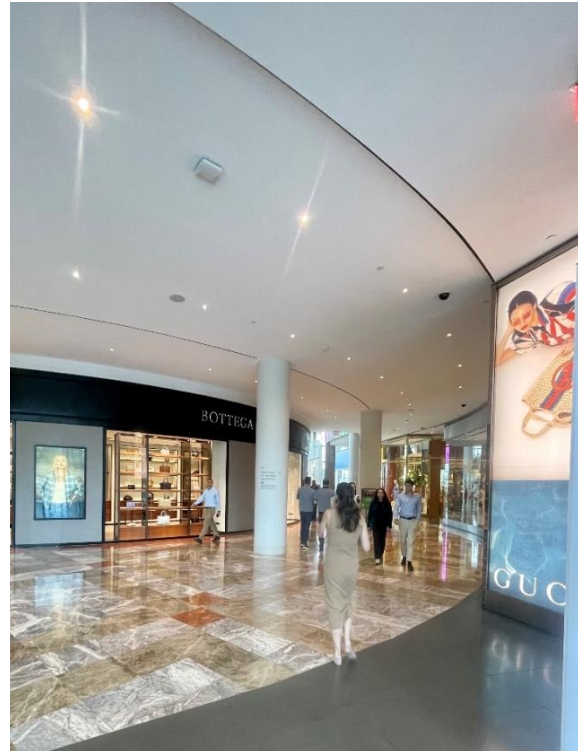
Paramount Group Inc. (PGRE) NYC Midtown Office Tours – 5 June 2023



Chelsea Piers Sports & Entertainment Complex – VICI REIT 1st mortgage lender – 5 June 2023



Westfield Shopping Center World Trade Center & Brookfield Place – 8 June 2023



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