REITS
A MUCH MORE POSITIVE OUTLOOK

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Table of contents

Executive summary

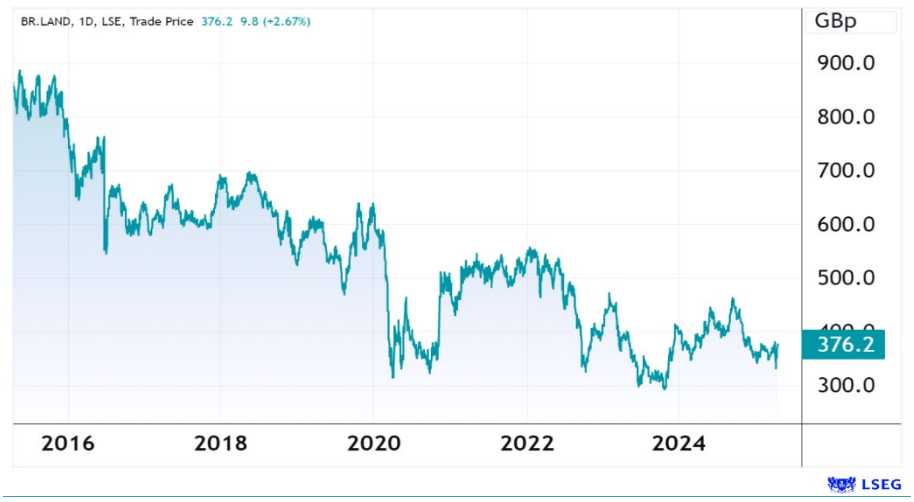
Hardman & Co has carried out several assessments of the REITs sector in the past; in 2024, we looked at whether they represented fair value in terms of their share prices compared with the average discount to NAV at which share prices traded over several historical cycles. We concluded, at that point, that REITs were trading at very close to the historical, long-run average but that the macroeconomic momentum was not strong enough to encourage us to view prospects for REIT share price performance positively. Since then, the share prices of many REITs have fallen in absolute and relative terms.

The trigger to our change in stance to a significantly more positive one is the recent turmoil in markets – particularly the sharp moves in US Treasury (bonds) in the immediate wake of President Trump's global trade tariffs announcement.

We conclude that the likely lower degree of confidence in the US economy's prospects allied to the US President's public statement that he had some concerns around avoiding a sharp rise in US Treasury yields both point to accelerating interest rate cuts. Rate cuts will be seen both in the US but particularly in the UK, where the inflation effects from US tariff impositions should prove muted. As this document references UK REITs specifically, we see the reversal of the sustained share price declines, in the past few days, as symptomatic of more positive moves to come.

One factor boosting our confidence is the bottoming out of valuations across virtually all UK commercial real estate sectors since earlier in 2024, which is evidenced by rents, occupancy and valuations. Indeed, there are also outside factors helping, not confined to the tariff-related global shocks. One significant factor is the UK Government's drive to Net Zero, with particular relevance to the EPC (Environmental Performance Certificate) C mandate for 2027 onwards.

British Land Company 10-year chart



Source: LSEG, 16/04/25

Segro 10-year chart

Source: LSEG, 16/04/25

UK REITs – macro drivers to outperformance

In our view, UK REITs' asset values are underpinned by the positive tenant demand across the piece; see our segment *UK commercial real estate market*. In addition, we see a much firmer base for reducing capitalisation rates (rising asset values) as a result of the imminent downturn in the global economy. US manufacturing and US housing prospects look bleak. This cuts the demand for, and cost of, money.

US tariff announcement

The prompt to our more positive share price outlook has come courtesy of the US President. What we saw was the "Bessent Put." US politicians blinked in the face of a panic-driven flight to safety. That flight, though, was not to US Treasuries, nor even the US dollar. It was to gold mining stocks – and when *mining stocks* are seen as safe havens, something is seriously wrong.

There is a maximum level of pain that US Treasuries can be allowed to take. This is especially pressing since recent US Quantitative Tightening shortened the maturity profile of US debt — exacerbating refinancing rate risk. That "Bessent Put" has prompted our much more positive outlook for UK REITs.

There has been a remorseless flow of news from the US this year — politics, consumer confidence, the housing market. This newsflow has depressed UK REIT prices, despite it having nothing to do with them.

US housing market cautions for lower interest rates

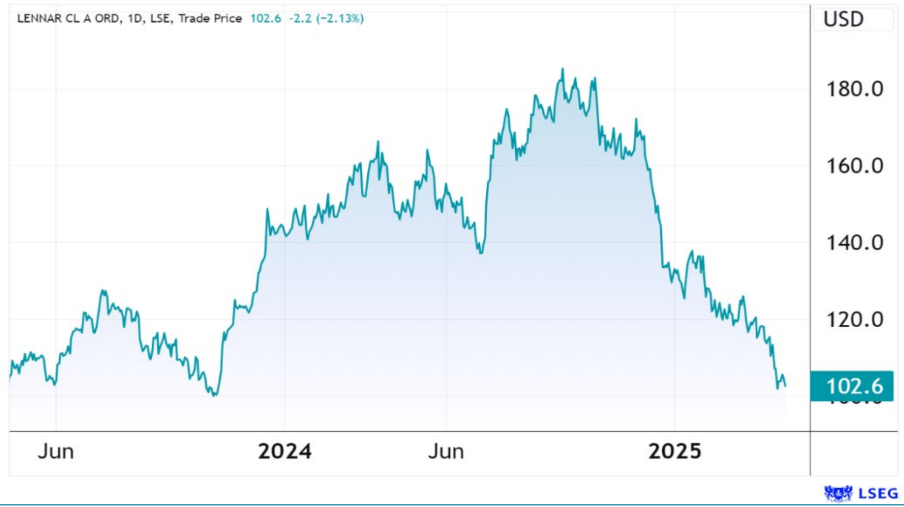
We will touch on the decline in consumer confidence in the next section. The "canary in the coalmine", however, is housing, and particularly the Florida market, which has many "discretionary" purchases of second homes and is where the 2006 market downturn hit early. In the two years to August 2022, Florida house prices increased at 24% annually. Since then, they have gone sideways.

Lennar released its *first quarter 2025 results* (to end-February 2025) on 21 March 2025. They showed net earnings per diluted share of $1.96, but the company also reported a decrease in the average sales price of homes delivered.

On balance, analysts lowered their earnings estimates post the announcement, The consensus earnings estimate for fiscal 2025 was reduced, as were those for fiscal 2026.

However, as long as confidence in the REITs' own assets is not dented, we see bad news here as positive for UK REITs' prices because it leads to falling cost of debt and hence falling capitalisation ratios. We demonstrate this in our segment *UK commercial real estate market*. Nevertheless, the share price of Lennar – one of the world's largest housebuilders – demonstrates the pain and concern.

Lennar 2-year chart ($)



Source: LSEG, 16/04/25

Consumer and purchasing managers' mixed messages

US consumer confidence has taken a sudden shift downwards with consumer sentiment deteriorating sharply in April (released 11 April 2025). Furthermore, 12-month inflation expectations surged to the highest level since 1981 after unease over escalating trade tensions. The University of Michigan Surveys of Consumers took place between 25 March and 8 April. The index dropped to 50.8 from 57.0 in March. Economists, polled by Reuters, had forecast a fall to 54.5, so the deterioration is sharp. We conclude that the outlook for US, and knocking-on to UK, interest rates is lowered. Raised UK inflation expectations are now unlikely, leaving a clearer path in the UK to a falling cost of debt, which, in itself, is a positive factor for UK REIT share prices. Of course, this has to be taken in conjunction with share prices relative to NAV historical comparisons, to which we referred earlier, and to the increasing signs of health – a bottoming, not a boom – in the underlying commercial real estate markets in the UK.

The downwards shift among purchasing managers has been less clear. The S&P Global Flash US Manufacturing PMI fell in March, but the allied Composite reading actually rose to 53.5, a three-month high. Similarly, the UK Purchasing Managers' Index data for March 2025 has the Composite PMI, tracking both services and manufacturing, rising to 52.0, the highest since August last year. However, the manufacturing PMI fell to 44.9, the lowest since October 2023. Like the US, there seems to be robust services sector confidence but contraction in the not so large manufacturing sector.

Depressing effects of Quantitative Tightening now eased

This easing stems from the above and is the most directly relevant factor contributing to our positive thesis. Two years ago, we had financial market euphoria, but that has since been washed out. Central banks, including the Federal Reserve and the Bank of England, responded to the strength by tightening monetary policy – ostensibly from rising price inflation. However, it is worth noting that the global central banks are nervous about the effects of previous boosts to money supply – and what that does to inflation in both consumer prices and asset values. That response from central banks included interest rates, but, pertinently, it comprised Quantitative Tightening. Real estate doesn't like that — nor do other real assets like gold. Gold has been strong since Quantitative Tightening ended but was suppressed by Quantitative Tightening being applied. For timing, see the US Treasury reverse repurchases chart below.

Gold 10-year chart ($)

Source: Source: LSEG, 17/04/25

Now, though, Quantitative Tightening has come and gone. Gold has rocketed. And, crucially, UK commercial property rents and values have bottomed — even if US housing may still be wobbling. In the context of the outlook that we have enumerated above, and adding further elements of our macroeconomic argument below, we do not expect Quantitative Tightening to return for some time.

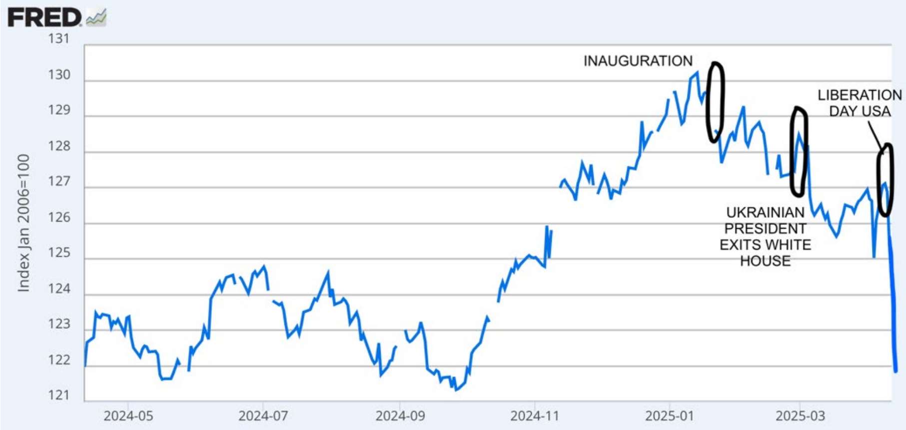
The chart below shows the 2022/2023 tightening, subsequently unwound, thus ending the restrictive stance.

US Treasury reverse repurchases (quantitative tightening)

Note shaded area is recession. Source: Federal Reserve Bank of New York

Added to the situation is the weakness of the $, which makes it difficult for the US to lower interest rates – as does the flight from US Treasuries. Mathematically, however, this means a strengthening Euro, Yen, and crucially here, Sterling as well. The $ weakness is ingrained now, and so constitutes a tailwind for reductions in UK interest rates, as does the increased likelihood of a worldwide recession. These factors add to the optimistic view we take of the downward trend of UK interest rates, which acts as a tailwind to commercial property valuations.

$ weighted index



Source: Federal Reserve Bank

$ weakness has been present for four months, but the situation has turned to crisis. This hastens UK interest rate cuts.

Suddenly, there is extreme caution; one evidence of this being the sharp rise of $ credit spreads.

$ credit spreads

Source: Source: Ice Data Indices, LLC via Fred®, 2025

So, if we demonstrate the robustness of the UK commercial market, we believe we are at a true turning point.

UK commercial real estate market

Rents and valuations bottomed in 2024

We begin with retail — once the weakest. After a long decline between 2018 and 2023, retail rental values started to rise in 2022. Retail parks have been climbing steadily — up 2.3% in the year to February 2025. High street rents bottomed in May 2023.

Office downsizing has run its course, bar London Docklands. The RICS UK Commercial Property Survey showed +3% on office demand in 4Q'24, down from +7% in 2Q'24, still positive nonetheless. London office rents are ticking up slightly, more so in agents' new lettings experience, as noted in the *Financial Times*, 20 February 2025.

MSCI data indicates regional office rents are up 2.6% YoY to February 2025.

Industrial is more nuanced. Occupier demand has moderated — +7% vs. +49% in 2Q'22. Demand for larger sheds is weaker, but last-mile urban logistics continues to have shrinking supply.

Valuations and investment

The CBRE Monthly Index shows that December 2024 had a total return of 1.1% — the highest recorded month in 2024.

For the full year, 2024 returned 7.7% — better than 2023 and 2022, and better than the 7.2% average since 2000. Capital values were up 1.8%, rental values 2.9%. In December alone, retail capital values rose 0.7%.

All segments saw positive returns in capital and rental values. Investment volumes hit £54bn in 2024, up from £45bn in 2023. Of that amount, £13.6bn came from the US — more than double the previous year. January through March 2025 also posted solid returns, albeit modest — around 0.6%–0.8% monthly.

New supply has been moderated

Large logistics continue to see some development. Offices — almost none. Retail? Only the brave are building.

Student housing is limited outside London. Hotels are strong with very good REVPAR. Overall, development is below trend. Interestingly, the UK's Build to Rent boom is fading, except where housebuilders are selling stock to US hedge funds for rental.

In London, CBRE data shows that, historically, 74% of new office space was new builds, 26% refurbishments. The current pipeline is only 58% new builds. With the April 2027 EPC C deadline approaching, two-thirds of existing stock is obsolete. Only a third of leases expiring between 2023 and 2027 have an EPC of C or better.

Conclusion

The global economy seems to have been weakening since late 2024 and slowing further so far in 2025. President Trump's April announcements of tariffs have exacerbated the situation.

The demand/supply balance in the UK commercial real estate market turned much more positive early in 2024. To us, this indicates that a weakening macroeconomy, overall, will have limited negative effects.

We believe the reverse is true for REITs, in that a bit of bad macroeconomic news keeps Quantitative Tightening away, lowers interest rates and means, therefore, that conservatively managed REITs generating strong investment returns provide a safe haven.

Risks

Given that the economic outlook remains uncertain and potentially darkening, UK commercial real estate has enough tailwinds to obviate the need for much gearing of REITs' balance sheets to enhance returns. In a dangerous world, where lenders' appetites are set to become more constrictive, the ideal REIT balance sheet still has modest gearing — ideally under 30%. Happily, most do.

We are of the strong view that Quantitative Tightening has a significant effect on asset values. Balance sheets of the central banks continue to hold far more government debt than historical norms – even recent history. Were the option to reinstate Quantitative Tightening to open up again, it might be adopted, thereby providing a headwind to asset valuations. More realistic in the immediate term is the restrictive attitude of "risk off" commercial bank lending. Turbulence is built into the system; however, we believe a major, long-term corner has been turned, and REITs are much more attractive not only for their evident cashflow generation but, indeed, as relatively safe havens.

About the author

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Mike Foster is an equity analyst at Hardman & Co, and covers a wide range of clients in the Support Services, Building and Property sectors.

He spent his early career working in fund management with British Rail Pension Fund and Eagle Star Investment Management. He then spent two decades in sell-side research at several firms, including Peel Hunt and Credit Lyonnais. He has covered sectors including Construction, Support Services and Real Estate. In his fund management career, he was responsible for both bond and equity portfolios.

Mike was part of the group of investors that acquired Hardman & Co in late 2012. He holds a BA (Hons) in Geography from the University of Cambridge.

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