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REIT Resilience in a Time of Uncertainty

How resilient are REIT revenues to the pandemic caused by COVID-19? In prior economic downturns, revenues and cash flows across the REIT industry proved more resilient than broader corporate America. Yet it is imperative to acknowledge this crisis is unlike anything we have experienced before. While the contractual nature of REITs' revenue streams typically supports reliable cash flow and dividend growth over time, REITs are not immune to negative changes in the economic cycle. In fact, some REIT property sectors like Retail and Lodging have suffered disproportionately due to shelter-in-place requirements. At the same time, other sectors have benefited from a boost to their secular tailwinds, including Data Centers, Cell Tower REITs, and Logistics. With REITs in the U.S. trading at significant discounts, should REITS still be viewed in the same manner as they have in the past?

Supply and pricing power of each REIT property sector varies by market. Heading into the Global Pandemic Crisis, pricing power was strongest for Logistics and continues to be strong as online shopping has increased the need to store inventory closer to the customer. In some Data Center markets serving hyper-scale users, supply had become elevated, leading to competitive pricing. Yet, in recent months, Data Centers have benefited from accelerated video and data traffic as a result of workplace, school, and university closures. Pre-crisis, there was too much existing space in Retail, as measured in square feet per capita. In terms of new development, Senior Housing, Lodging, and Self Storage were also facing greater levels of new supply, leading to pressure on organic growth as a result of elevated deliveries in recent years. The Self Storage and Residential sectors (Single Family Rental, Manufactured Home Communities and Apartments) have historically fared better in economic downturns due to relatively greater tenant retention. We are beginning to see the pattern of increased tenant retention emerge once again. Uncertainty exists around whether COVID-19 will move us toward an ongoing remote work environment. If so, what could that mean for the Office sector or where employees choose to live? We will continue to monitor these trends.

To the degree possible, investors are seeking predictable levels of cash flow. Year-to-date, the market has rewarded those property sectors with more reliable cash flows driven by the type of property they own and operate. Are the highest-performing properties immune from tenants requesting deferment of rental payments? Certainly not. Over the last few months, we have seen owners of listed real estate offer to work with tenants, including in the Residential sectors. Most commonly, rent deferral has been granted within the current lease period across a number of property sectors. In more limited cases, outright rent relief has been offered. Similarly, we have seen REITs set up assistance programs for the most vulnerable tenants. The Residential sectors have historically performed relatively well in recessionary environments as they offer affordable, geographically diverse places to live, and generate predictable levels of cash flow. As economic recovery unfolds, these companies should experience increased cash flow driven by both employment and population growth. We have seen new construction and new competitive supply slow across real estate, an important factor in delivering predicable cash flows.

As it pertains to Retail REITs, the immediate hit to revenue will depend on the underlying tenant exposure to essential (i.e. grocery stores, pharmacies, home improvement, etc.) versus non-essential services (dine-in restaurants, cinemas, gyms, dry cleaners, etc., which may remain closed depending on state requirements), as well as to what degree non-essential tenants have been able to access aid to pay rent. Such aid includes loans and grants from the CARES Act and lending facilities established by the U.S. Federal Reserve. Additionally, the pool of potential Retail tenants post-crisis will

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likely be smaller to pick from, even for owners of well-located real estate. Supply (in terms of retail square feet per capita) was already in surplus pre-crisis and is only being exacerbated by closings and bankruptcies, along with the acceleration in online shopping. Based on earnings season operating updates given by companies across Retail, the level of rent collections for the month of April into May has ranged from 15-30%— for companies that own malls, megaplex theaters, and entertainment-oriented retail properties— to 60%+— for REITs that own grocery anchored shopping centers.

We eagerly await advancements in treatments, therapies, and vaccines to address COVID-19. Furthermore, we recognize much of this work is being conducted in optimally-located Life Science real estate owned by REITs. Whether Life Science real estate is owned by Office REITs like Alexandria Real Estate or Health Care REITs like Healthpeak Properties, we recognize Life Science should also be noted among the better performing property sectors such as Data Centers, Cell Towers, Logistics, Self Storage, and Residential (Manufactured Homes, Single Family Rental and Apartments).

From a balance sheet perspective, during the Global Financial Crisis of '08-'09, we saw the market quickly turn to liabilities to assess fortitude and liquidity, as well as pending debt maturities and the ability to address them. Collectively, the currently outperforming property sectors (Data Centers, Cell Towers, Logistics, Self Storage, Single Family Rental, Manufactured Home Communities, and Apartments) are in a sound financial position when assessing the right side of the balance sheet.

With the arrival of COVID-19 and the Global Pandemic Crisis, the asset side of the balance sheet has gained equal prominence given the immediate pressure on tenant revenues impacted by shelter-in-place requirements. As a result, Retail landlords have seen the market shoot first and ask questions later in terms of their negotiations with tenants, whether they are a closed store, restaurant, or theater. As for Lodging companies, the revenue decline was more rapid than they have ever witnessed, leaving them the most eager among landlords to reopen. However, how and when reopening is rolled out across the country will vary, likely leading to a slower recovery for many in these property sectors.

Looking forward, investors can expect continued variance in the global economic picture. REIT investors may be rewarded for their patience in this crisis by reaping the benefits of strong sector fundamentals, reliable cash flow, and continued growth in some property sectors. Duff & Phelps' Global Real Estate Securities team will continue to employ active management and favor strong balance sheets while we gain a clearer picture of how and when growth will resume. Our thorough investment process and focus on high quality owner-operators aims to anchor our portfolios through these uncertain times.

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Geoffrey P. Dybas, Executive Managing Director, heads the Duff & Phelps' Global Real Estate Securities team. He is Senior Portfolio Manager and co-founder of all dedicated REIT strategies managed by Duff & Phelps, including the Virtus Duff & Phelps Real Estate Securities Fund; the Virtus Duff & Phelps International Real Estate Securities Fund; the Virtus Duff & Phelps Global Real Estate Securities Fund; the Virtus Duff & Phelps Real Estate Securities Series, a series of the Virtus Variable Insurance Trust; the REIT portfolio within the DNP Select Income Fund Inc., a closed-end fund; and separate institutional accounts. He joined Duff & Phelps in 1995. Mr. Dybas was a corporate banker for Bank One and began his investment career in 1989. He holds a BS degree, cum laude, from Marquette University and an MBA from the Kellogg School of Management at Northwestern University.

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