Industry Outlook

Real Estate

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Summary

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Regardless of the economic and environmental uncertainty that is taking place all around the world which caused home sales in the spring of 2020 to drastically decrease, the real estate industry has made a phenomenal recovery and continues to grow strong as of now.

Real estate refers to physical property such as land, buildings, natural resources and-suchlike. There are 4 main categories of real estate which are land, residential, commercial, and industrial. Furthermore, the real estate industry's major firms and jobs are mainly related to brokerages, property management, development, sales, and marketing. These categories are the main components that this billion-dollar industry consists of.

In this industry outlook, we aim to provide a balanced evaluation of this ever-growing industry which may have much potential for further upside even with the ongoing pandemic.

Environmental Analysis

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Political

	Political	
	Corporate Tax	**Trade Restrictions**
Duration of Impact	Medium Term	Long Term
Type of change	Negative	Positive/Negative
The factor`s rate	Increasing	Increasing
Importance	Important	Important

In the USA a new democratic administration has brought some interesting changes to the business world. One of the biggest promised changes is the increase in corporate taxes. Real estate is going to be affected both directly and indirectly by this change. The increase in taxes can be targeted at REIT corporations, having thus a direct effect on their bottom lines. On the other hand, lower profit for corporate lessors means more difficulty paying off their rent, having an indirect effect on the bottom-line of capital-intensive businesses.

Globalization, despite the slowdown during the pandemic, is still one of the main impact factors for any business. Industrial companies can easily move their production to other, cheaper places, and thus vacating the space, leaving industrial REITs with less income. On the other hand, the trade war with China may be a hidden benefit since industrial companies are incentivized to stay in the USA. A recent attempt by the Biden administration to reinforce the supply chain in areas such as semiconductors is a clear example of just that.

Economic

	Economic			
	Pandemic	**Unemployment**	**Monetary Policy**	**Interest Rates**
Duration of Impact	Medium Term	Medium Term	Short Term	Short Term
Type of change	Negative	Negative	Positive	Positive
The factor`s rate	Decreasing	Decreasing	Increasing	Decreasing
Importance	Critical	Important	Critical	Important

The pandemic had a great impact on Real Estate. When everyone was ordered to stay at home, the closing of infrastructure that depends on "regular life", such as hotels and theaters, had an especially big effect on REITs that operate in this niche. The prospect of recovery is still very uncertain. Some Real Estate will be less affected than others. In the case of Retail, the impact is likely to be reduced. The land can be reused for other purposes. For example, many malls in the USA can be used as distribution centers without much investment. Other sectors, such as leisure can find themselves in a much more precarious situation (more on that below).

In the past year, unemployment has risen significantly across the world. Less disposable income means less spending on leisure activities and in some extreme cases inability to afford rent, both harming some sectors of Real Estate.

However, this was largely offset by large intervention from the governments with huge monetary spending all around the world. This has significantly reduced the effects of the pandemic while increased the concerns for high inflation. Additionally, this has shown that central banks are not afraid to use all the tools necessary to keep the economy growing. In either case real estate wins since it gains value in inflationary situations and can benefit from a growing economy.

Additionally, all-time low-interest rates have made landing very affordable and as result acquisitions, construction, and debt servicing, in general, have become a lot easier for REITs.

Social

	Social	
	Home Ownership	**Demand for Physical Space**
Duration of Impact	Long Term	Long Term
Type of change	Positive	Positive/Negative
The factor`s rate	Increasing	Increasing
Importance	Important	Critical

According to The Economist, the ownership of a home is on a steady decline all around the world. On the surface the increase in the number of renters does seem to come with the problem of rent control, however, overall the corporate landlords seem to be able to make rent lower due to economies of scale. This is a beneficial factor for REITs moving forward all around the world.

In the leisure sector, there is still much uncertainty when it comes to demand. Pandemic seems to have permanently altered consumer behavior to be more digital. Yet, there are defenders of the opposite side of the debate affirming that demand will return bigger and stronger than ever. While not the only reason, the Great Influenza pandemic in 1918 had a great effect on how people acted, in part responsible for the boom of the roaring '20s. The world has changed much since then and yet this is still a very real possibility.

Technological

	Technology	
	Digitalization	**Industrial Efficiency**
Duration of Impact	Long Term	Medium Term
Type of change	Positive/Negative	Positive/Negative
The factor`s rate	Increasing	Increasing
Importance	Important	Important

Despite the concerns of a fully digital economy, real estate has always been the backbone of any innovation.

Digitalization has been a real blessing for some sectors of real estate such as Data Centers. An increase in cloud usage is powering this trend and it will likely continue so in the future. According to Statistica cloud services are projected to grow at 17% over the next few years. Public infrastructure such as 5G towers has also been on the rise, boosting the returns of REITs in this sector. With technologies such as Augmented Reality needing fast internet connections, this is another area of high growth.

Additionally, the industrial sector has made many improvements to the industrial process over the years making it faster and less capital intensive decreasing the usage of real estate, while increasing profitability.

Legal

	LEGAL	
	Minimum Wage	**Unionization**
Duration of Impact	Long Term	Long Term
Type of change	Positive/Negative	negative
The factor`s rate	Increasing	Increasing
Importance	Important	Important

Labor laws have been getting more and more strict over the last decades all over the world. The current US administration has been in talks to make a 15$ per hour minimum wage. Additionally, more employees are pushing for unionization, increasing the pressure on public companies for better conditions and more benefits. Both can impact Real Estate positively and negatively. More income means more spending, yet higher wages also mean less profit for enterprises. However, the impact will differ depending on the sector of real estate.

Environmental

	Environment	
	Green Infrastructure	**Natural Disasters**
Duration of Impact	Long Term	Long Term
Type of change	Positive/Negative	Negative
The factor`s rate	Increasing	Increasing
Importance	Critical	Critical

Ever-increasing concern by the government around the world for the environment has produced incentive programs that promote many different green infrastructures. Incentives for the production of Renewable Natural Gas are a clear example of this. Without them, the building of processing factories has no economic benefit. Natural gas is simply cheaper. This means that these programs are essential to incentivize companies to invest. These incentives make green infrastructure profitable and as a result make the whole sector grow. Many REITs have benefited from these incentives by providing the infrastructure necessary.

On the topic of environmental hazards, these are happening more and more often. This will most certainly impact Real Estate more frequently than ever. Leisure infrastructure is especially vulnerable to these natural disasters.

Industry Competitiveness

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Porter’s 5 Forces

The Threat of New Entrants

- **Moderately strong competitive force**
- This industry requires a high initial investment to construct buildings to later sell. Even if companies buy already built buildings, they always have to make high investments, which decreases the number of companies interested in this industry. Also, governments set laws and norms for the construction of buildings

which increases prices of construction due to taxes and additional costs to legalize the construction, making it even harder to enter this industry.

Threat of Substitution

- **Strong competitive force**
- There is no direct substitute in this industry. There could be some indirect substitutes if the real estate industry is divided into different segments according to the different areas where companies are located. In this case, one area could be the substitute for the other. Also, an indirect substitute could be renting instead of buying. This problem could be overcome by having businesses in different areas and offering several options to clients such as buying, renting, or leasing.

Buyer Power

- **Moderately low competitive force**
- This is an industry where buyers usually think and analyze alternatives before deciding, so their decisions are conscious and informed. Also, in this industry companies fight for prices and margins, so the prices tend to be similar. Because of this, consumers' bargaining power increases since they can evaluate alternatives, present counteroffers to lower prices and if needed can choose another company.

Supplier Power

- **Moderately low competitive force**
- In the real estate industry, the suppliers are the ones that provide the materials and equipment to do the construction and the owners of the land where the construction is going to be done. As there are several suppliers of equipment, they lose bargaining power since the companies can change easily from one supplier to another. The land suppliers can be either private owners or the government. These suppliers have more power since the offer is limited and ruled by laws.

Competitive Rivalry

- **Low competitive force**
- This industry has a lot of different companies that operate in the same areas and fight for market share by reducing prices and consequently margins and revenues.

SWOT Analysis

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SWOT Analysis

Strengths	Weaknesses
S1: Strong hedge against inflation S2: Possibility of Capital Appreciation S3: Owner has full rights	W1: Need large startup capital W2: Real estate assets are illiquid W3: Risk of capital depreciation
Opportunities	**Threats**
O1: Growing industry O2: Global Demand present O3: Federal Reserve buying mortgage backed securities O4: Growing population O5: Access to financing	T1: COVID-19 rescission T2: Fluctuations in demand T3: Competition from other investment asset classes

Cross-SWOT:

S1 & T1:

With the current recession caused by COVID-19 taking place, many central banks and governments have taken the approach of conducting quantitative easing, giving out trillions in stimulus packages to citizens, and unprecedented monetary policy actions. This in turn has caused many investors to fear the potential inflation which may take place to fiat currency. With that in mind, many have looked to real estate assets as a hedge against inflation to keep their value protected.

W1 & O5:

One of the most prominent barriers to entry in this industry is start-up investment capital. In order to operate efficiently, huge capital is required since acquiring valuable assets can be quite costly, this may be a challenge for many investors.

However, a solution to this can be seen through financing. If an investor has a good balance sheet many lending and financing institutions are willing to provide financing if the investor qualifies. This opportunity can greatly aid to pass the barrier of large initial capital in this industry.

S2 & T2:

The real estate industry tends to be correlated with the economy and therefore is an industry that faces different cycles. Within these cycles fluctuation in demand can be seen, low or high demand takes place depending on which part of the cycle the industry. These fluctuations may be seen as a threat to investors since low demand may decrease the value of assets that may be in their possession. However, in the long-run capital appreciation is very likely due to the fact that real estate asset supply is limited therefore the price is prone to increase as demand increases over time.

The Big Players

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American Tower Corporation

Description

American Tower Corporation is one of the largest global REIT, with a 23/77 division between the US and ROTW, at the moment of writing, in terms of properties portfolio. It's headquartered in Boston.

It is part of the SPX 500, with a 414th position in the Fortune 500.

American Tower Corp. was founded back in 1995 as a unit of American Radio Systems. Tom Barlett is the current CEO.

Strategy

American Tower makes money by leasing space on towers that it owns or manages. The majority (57%) of its revenue comes from the 23% US part, with AT&T, T-Mobile, and Verizon, their biggest clients, amounting to 51% of American Tower's revenue.

American Tower is looking to invest in 5G, with a recent long-term deal with T-Mobile focused on that.

Financials

American Tower's revenue has been growing non-stop since its creation. In recent years (2006-2020), the average quarterly revenue growth was 2.53% (from $1.28B to 2.21B), a value that puts it a little bit above the mean compared to the top competitors. Analysts' consensus is that for 2021, American Tower will grow around 7.8% in annual revenue, from $8.04B to $8.87B.

The ROA has increased 35.71% since Q4 2015, from 2.8% to 3.8%. However, it has declined over the course of 2020, from 5.1% in Q4 2019. The ROE, on the contrary, grew even in 2020, only decreasing from Q3 2020 to Q4 2020. The last 4 years have shown a 191.3% increase in ROE, from 12,7% to 37%.

Liquidity-wise, American Tower shows a Quick Ratio of 0.7x, a much lower value than the sector's 1.2x. The D/E Ratio represents a value of 896.8%, a very high value compared to the 99.6% of the Real Estate Sector.

American Tower's stock closed today (9th March 2020) with a value of 202.69 USD per share, close to the lowest value of Year-to-Date, which was one day before, at 198.66 USD. The highest value YTD was 236.15 USD. Forecasts point to a maximum value at the end of 2021 of 247.103 and a minimum value of 223.126, for 31st December of 2021, meaning that, at today's prices, it should, at least, grow 10%, making it a good buy.

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Prologis, Inc.

Description

Prologis, Inc. is an American real estate investment trust company that was founded in 1991 with its headquarters in San Francisco, California. The company mainly focuses on Real Estate Operations and Strategic Capital. The Real Estate Operations segment activities include ownership and development of logistic properties and also rental operations. The Strategic Capital segment consists of asset management services, including the management of unconsolidated co-investment ventures.

This company is currently one of the global leaders in the logistics real estate business, with current holdings and investments in development projects, co-investment ventures, and properties totaling over 91 million square meters in more than 15 different countries.

Strategy

Prologis, Inc. mainly uses a business-to-business model, providing established brands such as Lidl, DHL, and Samsung their services. Their main sources of revenue streams from their strategic and rental capital. Revenue is generated when the company leases the logistic properties that they own to other businesses to use long-term on a contractual basis. This is very lucrative for Prologis, Inc. since they both wholly and partially own (co-investment) logistic real estate assets which all add up to over $148 billion. The company also manages several public and privately traded real estate investment funds, generating $2 billion of adjusted funds from operations in 2019.

Considering that many industrial real estate investment companies only invest in the U.S market, Prologis, Inc. has a unique selling proposition since they have a global diversification, and they have co-investment ventures in different countries around the world.

Financials

In terms of financials, the company's revenues have been on a steady increase annually. Revenues went from $2,618,134 in 2017 to $4,438,735 by the end of 2020, an increase of 69.53%. This continuous increase in revenues is quite impressive since it reflects that the demand for the company's services remains continual, even when there was much uncertainty in the market with the pandemic.

From the 3rd quarter of 2016 to the third quarter of 2018, the ROA was mainly roaming around 3.90%-6.33%, however, by the end of 2020 the ROA had decreased down to 2.65%. Even though this ratio has decreased lower than it has ever been in the past 4 years, it continues to perform above the industry average of 1.87%. The company's ROE also followed a similar route, going from 10.2% in the 3rd quarter of 2018 and dropping down to 4.02% by the end of 2020. However, this ratio also continues to operate above the industry average of 3.62. Both the ROA and ROE have declined compared to previous years but both ratios continue to operate above their industry's mean.

Concerning liquidity, Prologis, Inc.'s current ratio was mainly fluctuating from 0.32-0.5 from 2017 to the beginning of 2019. Then the ratio increased over 300% to 1.55 by the end of 2019 and is now operating at 1.54 which is above the industry average of 1.13. Also, the company currently has a quick ratio of 1.52, indicating that Prologis, Inc. has good short-term financial strength.

The debt to equity ratio (D/E) is currently at 0.54. Since 2018 this ratio has been fluctuating 0.43-0.54. The company's D/E currently is under the industry's average of .80.

The stock (PLD) price has grown over 60% from the crash in March of 2020. Currently, the price is at $102.18 (18/03/2021), this year's stock high was $109 in February and its low was $93 at the beginning of January. Price is currently in consolidation with not much price action on the yearly chart.

ITIC

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Realty Income Corp. (O)

Description

Realty Income Corp (0), founded in 1969, is a REIT that invests in single-tenant commercial properties located in the USA, United Kingdom, and Puerto Rico. It also belongs to the list of Dividend Aristocrats. This means that they have been increasing their payments to shareholders for the last 25 years. In 2020 they had a dividend yield of 4.5% as well as having monthly payments to shareholders.

Almost all of their revenues come from the retail sector, representing 84% of total collected rent. While massively exposed to this sector the actual constitution of this portfolio of properties is well diversified with the biggest sub-sector – convenience stores – representing only 12% of the total rent.

Despite having tenants that were hit hard by the pandemic, they were able to maintain the occupancy rate - how many properties are rented - at 97.9% with 140 vacant properties out of 6,592 total properties by the end of 2020. This represents a slight increase from 94 vacant properties in 2019.

Strategy

Their strategy is based on actively operating a portfolio of commercial real estate. Like any other fund that manages assets, its main goal is diversification and acquisition. Being a REIT makes later much more difficult. Distributing at least 90% of taxable income means no cash accumulation. As a result, their main liquidity source is the issuance of new stock. Only in January 2021, they raised close to $700 million this way.

Main risk management is done by assessing the sustainability of their clients. Of the top 15 clients, 8 are an investment-grade enterprise. This is a large improvement from only 1 back in 2009. Also, their lease agreements are long-term and spread throughout the years. As a result, no single year has more than 8% of leases expiring.

Their diversification does not end there. They are also working on keeping a balanced geographical distribution. While 95% of real estate under control is in the USA, no single state is responsible for more than 10% of total revenues.

Financials

Despite going through some really difficult circumstances in 2020, Realty Income was able to increase its revenues by 10% in 2020, from $1,491 million to $1,651 million.

Funds From Operations (FFO) - a measure that does not include depreciation and thus more accurately indicates net income - has increased by 10% in 2020 in comparison to 2019.

Additionally, the company was able to maintain an impressive 90%+ gross margin, and 24% net margin despite a challenging year. The average gross margin for the real estate industry is 65%. The dividend payment represents 82% of all FFO and as discussed previously have constantly increased over the last 25 years.

While financing is done mainly by issuing new stock, the company does have $8,9 Billion in outstanding debt. This represents a debt-to-equity ratio of 0.82. Interest expense has increased by more than 6% and yet the average interest rate of debt climbed down from 3.89% in 2019 to 3.48% in 2020 due to liquidations of some high yield debt.

When it comes to rentability metrics in the past 12 months, the company has registered an ROE of 3.8% and an ROA of 2%. In both cases, their metrics are above the industry average of 1.9% ROE and 0.9% ROA.

Looking at the liquidity, the company has a Current Ratio of 3.37. However, this number is an outlier. The average Current Ratio for Realty Income over the last 10 years is at 0.36. The average Current Ratio of the real estate sector at the end of 2020 was also 0.36.

All of this presents a picture of a solid and actively expanding company. Yet what is the valuation and is it a good investment?

While there are certain risks when it comes to the future of retail, strong diversification, active and prudent management and general uncertainty make it an interesting case for great undervalued security. At the current price of $61, the consensus is that its intrinsic value is somewhere around $69. We tend to agree with that assessment.

Conclusion

Despite the current pandemic, many companies within the real estate industry, such as the ones mentioned in the report, continue to stay antifragile in the midst of the uncertainty that surrounds the environment. Many companies in the space reported revenue increases over the past year. With that said, there is still much potential for growth in the long run for investors to take advantage as home sales recover and demand begins to increase much more, with many experts stating that they expect many more home buyers to enter the market in the next few months.

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Our Club

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