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Inside Man: Cohen & Steers' Rich Hill Breaks Down the Listed REIT Marketplace

The 25-year CRE veteran explains why the public REIT space can anticipate private market recoveries and declines, and why the evolution of CRE investment products is a good thing

By Brian Pascus

Rich Hill is one of commercial real estate's top experts on the market of publicly traded real estate investment trusts (REITs). As head of Cohen & Steers' real estate strategy and research, he is responsible for advising on the investment activity of a public firm that has over 40 percent market share in actively managed mutual fund assets invested in the public REIT market, making it the world's largest active manager of listed REITs, as well as the two Cohen & Steers investment funds that deploy capital into private real estate assets.

At a time when listed REITs have seen unsecured bond issuance rise, credit spreads tighten, and net operating income grow, Hill's insider knowledge of the public market is critical for any real estate investment strategy. Commercial Observer sat down with him to discuss various trends, notably how the public market anticipates the private market.

CHELSEA MARRIN/FOR COMMERCIAL OBSERVER

Rich Hill at Cohen & Steers' 1166 Avenue of the Americas office on Oct. 21, 2024.

This conversation has been edited for length and clarity

Commercial Observer: You mentioned to me in an earlier conversation that your job is "connecting the horizontal and vertical in commercial real estate." What do you mean by that?

Rich Hill: When I think about the horizontal and vertical, it's this: Commercial real estate is a microcosm of the U.S. economy. The reason I say that is everyone has lived in an apartment building, or shopped in a retail property, and most people have worked in an office building, and almost everyone has gotten goods from an industrial warehouse facility when they buy them off Amazon. It is truly a microcosm.

But there's another aspect of commercial real estate that makes it different from other assets — it's an inherently levered asset class. When someone goes out and buys a property, nine times out of 10, they'll put some level of debt on it, they'll finance it. So we need to understand where we are in the economic cycle

and where we are in the lending cycle.

When people think about CRE, most people think about the buildings they see outside. But it's not so easy for people to go buy a building. Yeah, large institutional investors can buy a single building, but most people get exposure to CRE through listed REITs or a fund that owns commercial real estate. When we're trying to connect the horizontal and the vertical — the vertical is where you can invest across the capital stack, and the horizontal is what drives commercial real estate valuations.

So Cohen & Steers has over 40 percent market share of actively managed mutual fund assets investing in US REITs. Tell us about the funds you manage.

Cohen and Steers was founded in 1986 by Marty Cohen and Bob Steers. We're one of the grandparents of the modern listed REIT market because we developed mutual funds that could invest in listed REITs. They didn't really exist in scale prior to that. Our preliminary assets under management at the end of August was $88 billion. The vast majority of that AUM is listed real assets.

We started off focused on listed REITs, but we've expanded over the last several decades into other publicly traded real assets — things like infrastructure stocks, oil and gas, and we have a relatively big fixed-income business. But what is new to us is private real estate. We understand real estate very well because we're the largest active manager of listed REITS in the world, but we haven't invested in private real estate until now.

And what drove this move into private asset investment?

CRE is approximately a $20 trillion asset class in the U.S. and it's the second biggest asset class in the U.S. behind equities (stocks and bonds) and fixed income. Listed REITs are an important portion of that pie, but they're not the only portion of that pie. Private real estate is another feather of what we can offer to clients.

Often you can hear asset managers say "You should be 100 percent invested in private or 100 percent invested in listed REITs." We reject that premise. We think there is a role for both public and private within portfolios. There are times you should be overweight in terms of listed versus private and vice versa. And there are very important portfolio management goals that can be achieved by having both in your portfolio.

Why does active management work in listed REITS and not in other asset classes?

When you think about listed REITs, 10-year cycles generate plus-10 percent return on the index level, and we found we can consistently generate alpha 200 to 300 basis points on top of that through active management. Why does that work? It's pretty simple: People think about commercial real estate as a single asset class, but it's really 18 different sectors under one big broad umbrella, and sometimes those sectors work differently at different times.

Hotels, for instance — their rents are marked to market every night, every day; people can choose to rent a hotel each day, so it's more cyclical. There's other aspects of CRE that have 30-year triple-net leases and are bond-like proxies, so you have to understand how the different sectors perform. And, by the way, there are hundreds of listed REITs. You have to understand which ones are better managers than others, and we think we do a good job of that.

Your core thesis is, "Listed REITs are leading indicators of both downturns and recoveries." How does the listed REIT market anticipate the private market?

I emphasize the "and" [laughs]. Most people think listed REITs turn down before the private market does, but they turn up before the market does, as well. When you think about CRE cycles, this is how they typically play out: Listed REITs trough 12 to 18 months later than private valuations trough, and 12 to 24 months after that distress in the debt markets peaks. It's a delay. Why do listed markets lead? They can act quickly, people buy and sell listed REITs every single second of every single trading day, and the market is very quick to anticipate 12 to 24 months in advance.

Case in point: In 2022, listed REITs were down 25 percent, private market valuations were up. I think the bears that are concerned about CRE should've been screaming from mountaintops that a decline of valuations would come. Listed REITs didn't trough until October 2023, and they are up 40 percent since that time. Why is October 2023 important? Well, the peak for the private market occurred in Q3 2023, so private markets were peaking just as listed markets were troughing.

But isn't there a relationship to interest rates in that respect, because wasn't that the time Jerome Powell initiated the interest rate pause?

That's spot on. What was happening in most of 2022 and 2023 was the market was reacting to the higher interest rate environment. Higher interest rates have adverse implications for CRE because it's an inherently levered asset class. It took a long time for private markets to catch up to where the listed markets were. Listed markets instantaneously figured out that returns would be lower for real estate than they were in the prior decade due to the interest rate regime.

In October 2023, the public markets pivoted, and said, "The Fed is done hiking interest rates, the worst is behind us now," and as that occurs the market can begin to anticipate lower interest rates and price that into its forward projection for valuations.

And that's why you think the regime change in terms of interest rates is so favorable to listed REITs?

Completely.

So what's the catch?

I'll get a little wonky here. People often say, and we agree with this, that real estate is a hedge against inflation. And it is — except in one environment: stagflation. Stagnation was the environment we were dealing with throughout 2022 and most of 2023. Interest rates were high and growth was slowing: that's stagflation. The only time in my career, 25 years, that we ever dealt with stagflation was the first quarter in 2005. You have to go back to the 1970s to deal with a stagflationary environment.

Interest rates are really important for commercial real estate, but it's not the only thing driving CRE valuations. Given the shock we've had to interest rates for the past 24 months, it has had an outsized impact on valuations the listed REIT market has anticipated, well in advance, of the private markets.

Do listed REITs really outperform the stock market? Are they doing so today?

Believe it or not, a falling interest rate, and falling inflation regime — that we saw for most of the past 10 years — isn't very good for commercial real estate. Because it incentivizes investors to focus on asset classes with significant long-term growth even if they're not making money today. Why? Because you can put a low discount rate on that growth 20 or 30 years in the future. The S&P 500 has done well over the past several years, but in our opinion it's not really an index — there's only a handful of names driving most of those returns. But listed REITs are today performing in line with Nasdaq. Over the past five months, since year-to-date lows for listed REITs in April, they're the best-performing sector in the S&P by 600 basis points.

What's happening here is markets that were out of favor don't stay out of favor forever. They either become cheap enough, where there's a drop in the price and investors can step back in, or the macro backdrop changes, and we think it was a combination that is driving this outside rally in listed REITs.

Are there any historical parallels to this?

I think there are lots of parallels today with what occurred in the late 1990s for three reasons. Listed REITs had some of their worst years in 1998 and 1999? Why? Interest rates were spiking due to the Russian debt crisis. Second, the dot-com boom was all the rage. And, third, you had deregulation in telecom, which is usually considered a defensive sector so demand moved away from listed REITs into telecom.

Today, listed REITs had a challenging year in 2022, and while they were up in 2023, they still underperformed significantly on a relative basis. Why? Three reasons: Higher interest rates, the tech market has been doing exceptionally well, and utilities, another defensive sector, has caught on to the AI tailwinds and has done well for a while now. So listed REITs have underperformed, but they've cheapened enough, and there's a light at the end of the tunnel for listed REITs, and investors who are underweight are saying "Maybe I'm supposed to buy them."

How has the publicly listed REIT space evolved in your career?

Great question. The listed REIT market anticipates the private CRE market. That doesn't just mean valuations, it means what property types are important. People think about CRE as the old economy asset class — things like retail, multifamily, office, the big five. Guess what? That stuff is only 40 percent of the listed REIT market we have right now. Next-generation asset types — things like data centers, cell towers, single-family rentals — these are all asset classes that didn't exist 20 years ago, and are huge portions of the listed REIT space, which the private market is just beginning to realize.

ODCE Funds, which are open-ended funds that own core commercial real estate — for a long time you had to sort of invest in these five main food groups. But now you're allowed expansion into alternative asset classes like self-storage, data centers and single-family rentals. It's pretty exciting because 25 years ago the commercial real estate market was just about malls and office properties.

Do you expect to continue to evolve?

Necessity is the mother of all inventions. The public markets allow new asset types to tap the IPO market. Case in point, the largest IPO of the year was a cold-storage REIT [Lineage, for $5.1 billion in July 2024]. I think that the market will continue to expand.

I think there will be an intersection between infrastructure and real estate. At some point, investors that have owned infrastructure assets will want a tax-efficient vehicle to dump those things into.

Do I think green energy will be huge in the REIT space? Yes, but here's the most tangible: solar power we talk about all the time. You know what asset class has the greatest ability to produce solar power? Industrial rooftops, data center rooftops. So there's a possibility that some REITs could theoretically generate more revenue selling solar power than renting their own space. To put a bow on this: The CRE market is always evolving, and the listed REIT space is on the cutting edge of it.

Last question on this subject: Considering all the dislocation right now, what are the most favorable trends for listed REITs today?

One of the benefits of investing in listed REITs is they learned some really hard lessons from the Global Financial Crisis. Heading into GFC, they had leverage of north of 50 percent, and it was approaching closer to 60 percent in some cases. Today they have leverage around 35 percent. That meant listed REITs were not the best buyer for private CRE over the past 10 years because they weren't levered up. And as the past 10 to 15 years incentivized the levered buyer, they were actually net sellers of assets. The public markets forced them to play it safe because they gave them

a cheap cost of capital in early cycle environments like today to buy assets and gave them an expensive cost of capital as the cycle matured. Management teams were being cautious on balance sheets, and the public markets forced this additional disciple on them.

But what most people miss about listed REITs is they not only have lower leverage, but they have diversified access to debt capital. A big portion of that is the senior unsecured bond market. Private investors have to have a bond rating, generally investment grade, to access the senior unsecured bond market. Not many private investors have that, so listed REITs have been aggressively tapping into the senior unsecured bond market — i.e. corporate bonds — as interest rates have fallen and spreads have come in, and it's given them an attractive cost of capital to buy private commercial real estate with widening cap rates.

These are public companies. They have wide access to diverse sources of capital, and they're constantly figuring out what's the most accretive.

Let's switch gears and talk about lending conditions. I've heard it's now "a new golden age" for alternative lenders and private credit. How does that impact the REIT space?

Why is it a so-called golden era? Because banks are pulling back from lending to CRE. But I think "pulling back" is the wrong term. Their share of CRE lending is normalizing back to where it has historically been. Small banks made a huge push into CRE over the past decade. The reason is because Dodd-Frank regulation made it difficult for banks to lend on residential real estate, and so they started to move into commercial real estate at a time it was doing very well.

As for the bank pullback, that void has to be filled someplace, somewhere. Enter CRE debt funds. They're able to lend at really wide spreads — i.e. really high financing costs — in a market with very limited competition. Basically, it means you can get really attractive risk-adjusted returns. You're getting equity-like returns for debt like risk. Debt is inherently higher in the capital structure. It's good in theory, but there are a lot of debt funds competing for a smaller pie than what people think. I don't believe debt fund market share, alternative lender market share will ever go to 50 percent. Could it go to 20 percent to 25 percent? Maybe it could.

What's the relationship between Cohen & Steers and debt funds? Because you're managing assets, purchasing shares into REITs, but you're also buying private real estate and you're raising money.

Theoretically, we're not competing against debt funds in our normal businesses. They are actually a theoretical source of capital for us, especially in the private side of the business. When we go out to buy a property, and look to put leverage on it — particularly in our real estate opportunity funds — debt funds who do shorter-term, non-stabilized asset financing might compete for our business.

But when we are raising funds for our various strategies, investors can look at REITs, they can look at core private funds, they can look at value-add and opportunistic funds, and they can look at debt funds. There's a wide spectrum of strategies and vehicle types. There's no magic bullet strategy. Debt funds do well sometimes, sometimes they don't. We think you should have a diversified mix of these different strategies, and we think listed REITs are a really good strategy for owning core real estate, and then value-add and opportunistic are supposed to be satellites and debt sometimes works. Sometimes it doesn't. I'd just push back on the idea you're supposed to be loaded up on one versus the other.

So do you believe this is actually a golden opportunity for CRE investment?

I like to lead with facts and let you decide whether it's a golden opportunity or not. It's not very often that CRE valuations reset 20 to 30 percent lower. It's only happened two times previously in the modern era of CRE: in the early 1990s, post-Savings and Loan Crisis, and post-GFC in 2009.

Typically, in the aftermath of events like today, the very best vintage returns occur. We think this is setting up to be very similar to prior downturns. I don't want to give you the impression there will be a V-shaped recovery like post-GFC, because we don't anticipate much government intervention. But a market where we can go back to old school fundamentals, instead of financially engineering returns, that's really healthy for CRE and it's really healthy for an active manager like ourselves because we can pick good quality properties with good fundamentals and manage the properties appropriately.

So I think we're going back to an environment where you can have good, solid CRE returns, because then people can use CRE as a diversifier for their portfolio. I don't think people like the idea that CRE valuations could be up 30 percent or down 30 percent, because that's not what CRE is. What it is, is a stable, income-producing asset class that diversifies your portfolio because it typically does well when the broader equity markets do well.

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