E-commerce: The REIT sector beneficiaries

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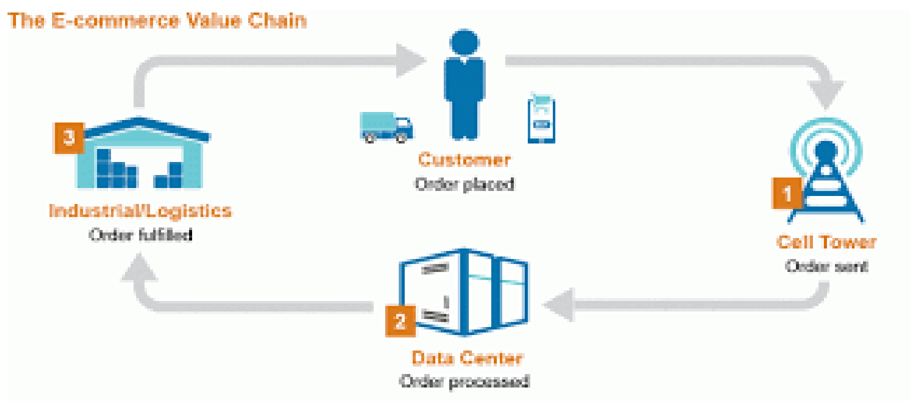
Retail has been the bearer of much scrutiny over the past few months as E-commerce becomes a more evident reality. Store closures are increasing, affecting some of the biggest names in the sector, with retail trade slowing down.

What does this hold for the REIT market?

Globally there are 17 REIT sectors, of which 13 will not be affected and three stand to benefit.

In this article, we focus on these three REIT sectors; towers, data centres and industrials. Below is a graphic illustrating how these REITs are involved in different stages of the value chain, starting from the client placing the electronic order.

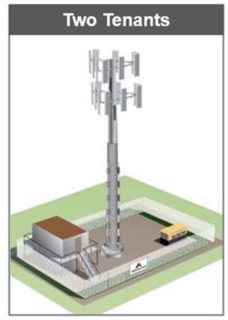


Courtesy of: Cohen & Steers

Tower REITs

The Real Estate

Towers are typically a steel structure (tower) or rooftop structure and the ground space below it. Multiple tenants, such as wireless and broadband service providers, lease the vertical space. The picture below illustrates the usage of the real estate when one to three tenants are sharing this space.



In the past, wireless providers used to build and maintain their own towers, which is a very costly matter. Tower REITs have taken ownership of this real estate, allowing the onus of the initial investment costs of building a tower to be taken off the provider.

REIT Examples

- American Tower, fast becoming the world's largest REIT with a $56 billion market capitalisation. Currently the world's largest REIT is Simon Property Group.
- SBA Communications, the oldest tower company, gaining REIT status in 2016.
- Crown Castle International, the largest provider of wireless infrastructure with 40 000 towers across the U.S.

The Tenants

- **Wireless carriers** such as AT&T, Sprint, Verizon, MTN
- **Government agencies** such as emergency medical services and the police
- **Broadband data providers/cable companies**

The Growth Drivers

There is a continuous need for wireless carriers to improve their data coverage and networks. Tower companies must keep up with the burgeoning growth in cell phone usage and this translates into the need for building new structures or the renewal of existing leases.

The Lease Structure

Contracts are typically five to 10 years and have historically had a 98 to 99% renewal rate upon expiration. There are annual escalations built into most contracts and these are generally linked to inflation. This translates into highly predictable cashflows.

The Supply Cycle

Towers are simple structures and easy to build, albeit expensive. Based on this, tower REITs are easily able to meet the rising demand. Several thousand towers are built by companies every year. Incumbent tower owners do however enjoy significant barriers to new competition. This is based on strict zoning laws, limited suitable locations as well as the network effect and scale their towers provide to end users.

Data Centre REITs

The Real Estate

Data centres are hives of optical cables, equipment racks, cooling units and backup generators, where organizations rent space for data storage, networking and communications hardware. Every time a video or image is downloaded, an online transaction takes place, or employees are connected through a virtual network, data centres are providing this critical support.

REIT examples

- CyrusOne, with more than 30 centres around the world.
- Digital Reality, one of the largest US REITs owing 156 data centres in 32 global markets.
- Equinix, the largest data centre REIT

The Tenants

- **Cloud services** such as Amazon, IBM, Microsoft
- **Internet** such as eBay, Facebook, Google, Netflix
- **Financial services** such as JPMorgan, Morgan Stanley
- **Communications** such as AT&T, NTT communications

The Growth Drivers

Globally there is an insatiable demand for data storage and computing power due to accelerating adoption of cloud services, E-commerce and digital media. In addition to this companies are now more likely to be outsourcing IT infrastructure as well as business continuity/disaster recovery planning.

The Lease Structure

Leases are based on electricity usage rather than square meterage as data centres consume huge amounts of power.

Larger tenants generally have seven to 10-year contracts while smaller tenants often have less than five-year contracts.

Historically, high customer retention has led to stable cash flows and annual escalations are normally in-line with inflation.

The Supply Cycle

The shell of the data center is erected relatively quickly, often in less than a year. The inside is more complex containing generators, coolers and raised flooring. This requires large amounts of upfront capital.

New development has been a key driver for growth in this REIT sector.

Industrial REITs

The Real Estate

Industrial REITs own warehouses that house goods that are ultimately delivered directly to an end user. In the past, these properties have been located close to transportation hubs but due to E-commerce, the logistics for parcel delivery is structurally changing. Facilities are now being built closer to population centres where consumers and workers live, decreasing the costs and time involved to deliver the goods to them. Warehouses are increasing the automation capacity with robots working more and more alongside humans for retrieval.

REIT examples

- Prologis, the largest Industrial REIT with a sizeable presence in Europe and Asia, but based in the US
- Duke Realty, which has recently shifted its focus to industrial properties, so has relatively new assets.

The Tenants

- **Online retailers** such as Amazon which is currently the largest user of industrial real estate
- **Third-party logistics** such as FedEx, UPS and Nippon Express
- **Traditional retail** such as Walmart, Home Depot and Pepsi
- **Manufacturing**

The Growth Drivers

There is Increased personal consumption via E-commerce worldwide. This along with a growth of the middle class in emerging markets is a significant growth driver. There is a modernization of the supply chain to support improved logistics efficiency and global trade has increased due to increased container volume.

The Lease Structure

There is a shift from traditional large out-of-town warehouses where leases are five to 15 years, to locations closer to the public where demand is strongest. Here leases are only two to five years.

The Supply Cycle

Supply tends to track demand more easily for industrial properties than for the more complex property types such as hotels or offices. This is because the construction times are shorter. With the rise in E-commerce, properties are now being built closer to more highly dense population areas, driven by the desire to meet the faster delivery times demanded by online purchasers.

Redefining Listed Property Investing

Conclusion

The three companies/sectors we have discussed are largely de-coupled from the economy in that their growth drivers are also powerful secular drivers and may help counter the shorter-term market fluctuations.

At Reitway Global we have a thematic approach to investing, taking the entire REIT universe and all its sectors into account. When the significance of one sector declines, we may decrease our exposure to this sector and enter or increase another holding in a different sector, such as we have done with retail versus industrial, towers and data centres. The advantage to our benchmark agnostic approach is that we can make these changes as soon as we need to, underpinned by our GARP (Growth at a reasonable price) bottom-up approach.

For more information about Reitway Global Property Funds, please visit our website at www.reitwayglobal.com or contact us on 021 551 3688.

References:

www.reit.com

www.cohenandsteers.com