



## Jeff Kolitch: Reasons for optimism for real estate equities

This is an edited version of a January 18, 2023, Q&A with Jeff Kolitch, Portfolio Manager of Baron Real Estate Fund and Baron Real Estate Income Fund. To access the full recording, please visit [our website](#).

### Executive Summary

- Ongoing volatility in the marketplace notwithstanding, 2023 may shape up to be a positive year where we can generate solid returns.
- Many of the headwinds that weighed on the market last year may reverse course this year and become tailwinds and vice versa.
- From our perspective, the setup for REITs this year is attractive.
- We remain long-term bullish on the housing market, and we've been incrementally bullish on housing stocks.

### Introduction

Jeff Kolitch manages Baron Real Estate Fund and Baron Real Estate Income Fund. Jeff has 31 years of investment experience. Before joining Baron in 2005, Jeff spent 10 years at Goldman Sachs, starting as a research analyst and moving to managing director in 2002. He launched Baron Real Estate Fund, which invests in REITs and other real estate-related companies, in 2009; and Baron Real Estate Income Fund, which emphasizes REITs and other dividend-yielding real estate companies, in 2017.

### *Can you give us your perspective on 2022, your thoughts about the year ahead, and the prospects for real estate?*

**Jeff Kolitch:** At this time last year, we expressed a cautious outlook. We had a premonition that 2022 would be a difficult year, although we didn't anticipate the tsunami of headwinds that weighed on the market environment — the war in Ukraine, multi-decade high inflation, extremely aggressive central bank Fed tightening, the slowdown in economic growth, and the prospect of recession. That confluence of headwinds weighed on all financial assets.

We talk about the three pillars of total return: growth, dividends, and change in valuation. For real estate in 2022, broadly speaking, growth was a reasonable 8%-10%. Dividend yields were around 3%-4%. Together, that delivered low double-digit returns that was offset by compression in the valuation multiple, which in real estate went from 25x earnings at the beginning of the year to 17x later in the year. That's a 35% compression in the multiple. That change in valuation more than offset dividend growth. Ultimately, we had a year where real estate was down in the public markets by 25%-30%, and, in some cases, more than that.

Today, there are several reasons to remain cautious about macroeconomic considerations, geopolitical considerations, and micro considerations for various companies. The most prominent, in our view, is the potential of the Fed tightening period - resulting in a recession.

Ongoing volatility in the marketplace notwithstanding, we think 2023 may shape up to be a positive year where we can generate solid returns. Last year's headwinds — multi-decade high inflation, a spike in interest rates, credit spreads blowing out — may begin to reverse course in 2023, ultimately resulting in valuation expansion rather than compression. We believe the long-term case for real estate remains intact.

### *What is your outlook specifically for REITs in 2023?*

**Jeff Kolitch:** REITs were one of the categories in the crosshairs of Fed tightening since they're more

interest-rate sensitive. than many other categories in the economy or the public markets.

From our perspective, there are three reasons the setup for REITs this year is attractive:

1. While growth rates will likely moderate, we believe the shares of many REITs have repriced for the higher cost of capital and expectations of slowing growth. Let's not forget that REITs corrected sharply last year, on average by about 25%.
2. We think the prospects for a rebound in 2023 are compelling. Since the turn of the century, there have been six years in which REITs declined. In five of those six times, they rebounded the following year. The exception was 2008 during the global financial crisis. We had a credit crisis, too much leverage, and excess inventory. Notwithstanding some isolated situations, those factors aren't in place right now.
3. REITs are more attractively valued. We started last year at 25x earnings. Now, we're 16x–17x earnings. We started last year at 4% cap rates; now, we're at 6%. That's a 50% expansion. Early last year, we were trading at premiums to liquidation value or net asset value. Now, we're at discounts to net asset value.

Real estate tends to run into trouble following periods of strong economic growth when two things happen. The first is excessive leverage where individuals, companies, sovereign wealth funds, and private equity funds borrow money to start building at the wrong time. Too much leverage combined with excess inventory leads to a sharp correction. That's what happened in the 1980s, when too much leverage led to a terrible recession in the 1990s. Too many homes were built in this country with excessive leverage and loose underwriting standards. We had the worst housing crash on record. Today is nothing like that.

That is a foundation for our optimism. Most of the companies that we're evaluating are levered at about 5x in the commercial real estate space. That compares to 8x during the global financial crisis. Balance sheets are better, with staggered debt maturities, more fixed-rate debt, and appropriate leverage relative to cash flow. The expectation for a buildout of excess inventory at this stage is rather modest. That also gives us comfort.

Across all real estate categories right now, we're starting from a great spot. In almost every category, except for office space, occupancies are 95%-97%. With high occupancy, very little new construction, and relatively low leverage, we think any further downturn in real estate should be relatively modest. When we put this all together, we think the backdrop for REITs in 2023 in the public markets is constructive.

### *Do you find any REIT subsectors particularly attractive?*

**Jeff Kolitch:** We're focused on two key themes right now.

1. **Secular growth real estate companies.** These are companies with enduring cash flow growth that is likely less sensitive to the economic cycle. Think about wireless tower companies, data center companies, industrial logistics companies, and life science companies. That's about 50% of Baron Real Estate Income Fund, and north of 20% of Baron Real Estate Fund.
2. **Short-lease duration real estate.** These companies have the ability to reprice on a more regular basis to offset some of the inflationary headwinds. Think hotels and casinos which reprice daily, self-storage facilities which reprice every 30 days, manufactured housing facilities which can reprice, and apartments or single-family homes.

Here are two examples:

1. The largest REIT in the public markets and, coincidentally, the largest investment in Baron Real Estate Income Fund and one of the largest in Baron Real Estate Fund, is **Prologis, Inc.** This is an industrial logistics REIT, a secular growth company with solid results and a very strong outlook. This company is forecasting 10% earnings growth, and in-place rents in its portfolio are 65% (or more) below current market rents. As those rents expire and tenants sign or extend their leases, the company has an opportunity to increase rents by 65% just to align with the market. That's 65% growth over the next five years. I don't think many companies in the public market have a line of sight into such robust growth on a multi-year period. The company also has a \$39-\$40 billion land bank as another source of growth. We think this is going to be a strong investment on a multi-year

basis.

2. As for short-lease duration, we're bullish on manufactured housing. This is a niche category that we expect to continue benefiting from favorable demand-supply dynamics. Think about budget-conscious home buyers, such as retirees or Millennials looking for affordable housing. There's negligible inventory. There are very few capital expenditure requirements. Historically, this category has held up very well during recessions or economic slowdowns. In fact, during the global financial crisis cash flow never turned negative for manufactured housing.

### *What are your thoughts on the housing market and its multi-year prospect?*

**Jeff Kolitch:** We remain cautious about near-term fundamentals and business prospects for housing-related companies, for-sale companies. The reason for our caution is simple: affordability. When home prices go up 30%-40% over a three- to four-year period on top of mortgage rates going from 3%-7%, homes suddenly aren't affordable. Individuals are paying about 35% of their monthly income on mortgage payments, interest, and principal. That compares to a long-term average in the low to mid-20s. Homes are expensive. That's why we're near-term cautious on business prospects.

We remain long-term bullish on the housing market, and we've been incrementally bullish on housing stocks, which we've been buying for the last six months or so. We've talked previously about the multi-decade structural underinvestment in housing in our country. Demographic needs require shelter. You either own or rent. And everything in real estate comes down to the economics of demand relative to supply. We have a shortage of inventory relative to the demographic need.

What does it mean for the stocks? The public market is often a discounting mechanism. It moves ahead of business fundamentals. This time last year, home-building stocks were one of the worst-performing categories of the public market. During the first quarter of 2022, these companies corrected 30%-40% even though the housing market was performing well. That's what we mean by a discounting mechanism. The stock market anticipates the correction in the housing market.

Now, we're in a housing recession. Stocks are cheap, they've already corrected. Typically, this is the time to start acquiring shares based on the two- to three-year outlook. You don't want to wait for the all-clear signal, when the press announces, "We're out of the housing crisis or the housing recession." When that happens, the stocks will have already gone up 50%. That's the way the stock market works. We try to get in front of that. We're identifying a lot of value in housing-related securities, home builders, land developers, and residential building product and service companies. This is a key focus for us in both of our strategies.

### *Toll Brothers is one of the largest positions in your portfolios. Could you share some thoughts there?*

**Jeff Kolitch:** **Toll Brothers Inc.** is a leading luxury home builder in the US. It's led by a highly capable management team; we think the CEO, Doug Yearley and his senior management team are fantastic. The company has a large, valuable real estate portfolio in excellent geographic markets with strong long-term demographics. Unlike many home builders, it owns a four-year supply of land largely purchased prior to the run-up in home prices during the pandemic. We see very little impairment or book value risk. Toll Brothers is also more insulated than many of its peers from elevated mortgage rates because 20% of the company's customers are all-cash buyers. They tend to be wealthier people with some excess savings who don't necessarily require a mortgage to purchase a home. That's a key positive in this environment.

In general, our firm has a long history of investing in Toll Brothers, Inc. We believe it is a best-in-class home builder that is on sale. In the fourth quarter of 2022, we increased Baron Real Estate Fund's exposure to residential-related companies. We increased our exposure to home-building companies and some building product and service companies.

### *Could you update us on Brookfield?*

**Jeff Kolitch:** We have a long history with **Brookfield Corporation** as well. In fact, this was the first company we purchased when we launched Baron Real Estate Fund. It was our largest position 13 years ago, and it's still a top-five position. This company is a leading global owner and operator of real assets like real estate and infrastructure. It has global reach, a substantial amount of capital, and an impressive management team led by CEO Bruce Flatt, who has been referred to as the Warren Buffett of Canada. We think Bruce and his team are amazing allocators of capital. They are benefiting from the growing allocation of capital to alternative vehicles and continue to gain market share.

Brookfield recently spun out 25% of its asset management business, **Brookfield Asset Management, Inc.** It is a pure-play asset management business that we believe is positioned to grow its fees by about 15%-25% per year. It pays a 4% dividend yield, with \$3 billion of cash and zero debt. We now own that as well.

Brookfield Corporation closed today [January 18, 2022] at just over \$35 a share. Management believes that the spot value of its business is double that. Brookfield is reasonably easy to value because it has several publicly listed entities including **Brookfield Infrastructure Partners L.P.** and **Brookfield Renewable Energy Partners L.P.** The current aggregate value of the company's public investments is about \$30 a share. Its privately held businesses represent another \$30-plus per share. This is why we believe it is a very cheap stock, and a great company benefiting from secular tailwinds.

***Travel-related real estate has been a focus in your Funds. Could you share your current thoughts on that industry?***

**Jeff Kolitch:** This time last year (prior to the war in Ukraine), we were quite bullish on travel based on more than two years of pandemic-related pent-up demand. That largely played out in 2022 and it appears to be continuing. We did temper our enthusiasm a bit and reduced our exposure to travel-related real estate companies in anticipation of a possible economic slowdown. Having said that, this continues to be a key focus area for us. We think about travel as a secular growth opportunity. The Millennial generation, about 70 million people, prefers spending on services over goods. This cohort has more disposable income than prior generations, some of which is being used for travel. In addition, the work-from-home phenomenon creates more flexible job arrangements, which supports more flexibility to travel.

We're focused on companies with healthy balance sheets. And let's not forget that this is a key focus area for private equity companies sitting on billions of dollars that they're looking to invest. Given some of the value that we're identifying in the public markets, we anticipate that private equity will step in as in the past.

***Do you have any concluding thoughts you want to share?***

**Jeff Kolitch:** I would go back to what I said at the beginning. Notwithstanding the expectation of ongoing volatility, we think the recalibration that occurred last year in the market wiped away a lot of the froth in valuations. That has set the stage for a more favorable risk-reward proposition for public real estate. We think there's going to be an opportunity to generate some strong returns on a multi-year basis from here.

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*Investors should consider the investment objectives, risks, and charges and expenses of the investment carefully before investing. The prospectus and summary prospectuses contain this and other information about the Funds. You may obtain them from the Funds' distributor, Baron Capital, Inc., by calling 1-800-99BARON or visiting [www.BaronFunds.com](http://www.BaronFunds.com). Please read them carefully before investing.*

**Baron Real Estate Fund's** annualized returns for the Institutional Shares as of December 31, 2022: 1-year, -28.44%; 3-years, 8.69%; 5-years, 7.65%; 10-years, 10.28%; Since Inception (12/31/2009), 12.94%. Annual expense ratio for the Institutional Shares as of December 31, 2021, was 1.05%. The **MSCI USA IMI Extended Real Estate Index's** annualized returns as of December 31, 2022: 1-year, -23.84%; 3-years, 2.72%; 5-years, 4.73%; 10-years, 8.59%; Since Fund Inception (12/31/2009), 10.20%.

**Baron Real Estate Income Fund's** annualized returns for the Institutional Shares as of December 31, 2022: 1-year, -27.47%; 3-years, 4.75%; 5-years, 6.91%; Since Inception (12/29/2017), 6.91%. Annual expense ratio for the Institutional Shares as of December 31, 2022, was 1.08%, but the net annual expense ratio was 0.80% (net of the Adviser's fee waivers). The **MSCI US REIT Index's** annualized returns as of December 31, 2022: 1-year, -25.37%; 3-years, -1.16%; 5-years, 2.48%; Since Fund Inception (12/29/2017), 2.48%.

*The performance data quoted represents past performance. Past performance is no guarantee of future results. The investment return and principal value of an investment will fluctuate; an investor's shares, when redeemed, may be worth more or less than their original cost. The Adviser reimburses certain Baron Fund expenses pursuant to a contract expiring on August 29, 2033, unless renewed for another 11-year term and the Fund's transfer agency expenses may be reduced by expense offsets from an unaffiliated transfer agent, without which performance would have been lower. Current performance may be lower or higher than the performance data quoted. For performance information current to the most recent month*

end, visit [www.BaronFunds.com](http://www.BaronFunds.com) or call 1-800-99BARON.

**Risks:** In addition to general market conditions, the value of the Funds will be affected by the strength of the real estate markets as well as by interest rate fluctuations, credit risk, environmental issues and economic conditions. The Baron Real Estate Income Fund invests in debt securities which are affected by changes in prevailing interest rates and the perceived credit quality of the issuer. The Funds invest in companies of all sizes, including small and medium sized companies whose securities may be thinly traded and more difficult to sell during market downturns.

The discussion of market trends is not intended as advice to any person regarding the advisability of investing in any particular security. The views expressed in this document reflect those of the respective writer. Some of our comments are based on management expectations and are considered “forward-looking statements.” Actual future results, however, may prove to be different from our expectations. Our views are a reflection of our best judgment at the time and are subject to change at any time based on market and other conditions and Baron has no obligation to update them.

**Portfolio holdings for both funds as a percentage of net assets as of December 31, 2022, for securities mentioned are as follows:** - **Prologis, Inc.** - Baron Real Estate Fund (5.2%), Baron Real Estate Income Fund (13.8%); **Toll Brothers, Inc.** - Baron Real Estate Fund (4.9%); **Brookfield Corporation** - Baron Real Estate Fund (4.6%), Baron Real Estate Income Fund (2.7%); **Brookfield Asset Management, Inc.** – Baron Real Estate Fund (1.2%), Baron Real Estate Income Fund (1.8%); **Brookfield Infrastructure Corporation** - Baron Real Estate Income Fund (2.9%).

Neither Fund owned shares of **Brookfield Renewable Partners L.P.** as of December 31, 2022.

### Top 10 holdings as of December 31, 2022

#### Baron Real Estate Fund

Holding	% Assets
CoStar Group, Inc	5.3
Prologis, Inc.	5.2
Toll Brothers, Inc.	4.9
Brookfield Corporation	4.6
American Tower Corp.	4.3
Equinix, Inc.	3.9
CBRE Group, Inc.	3.8
Lennar Corporation	3.7
D.R. Horton, Inc.	3.1
SiteOne Landscape Supply, Inc	3.1
Total	41.9

#### Baron Real Estate Income Fund

Holding	% Assets
Prologis, Inc.	13.8
American Tower Corp.	10.4
Equinix, Inc.	7.3
Public Storage Incorporated	6.0
SBA Communication Corp.	5.3
Simon Property Group, Inc.	4.9
Sun Communications, Inc.	4.9
EastGroup Properties, Inc.	4.1
Extra Space Storage Inc.	3.3
Rexford Industrial Realty, Inc.	3.3
Total	63.4

**Portfolio holdings are subject to change. Current and future portfolio holdings are subject to risk.**

The **MSCI USA IMI Extended Real Estate Index** is a custom index calculated by MSCI for, and as requested by, BAMCO, Inc. The index includes real estate and real estate-related GICS classification securities. The **MSCI US REIT Index** is an unmanaged free float-adjusted market capitalization index that measures the performance of all equity REITs in the US equity market, except for specialty equity REITs that do not generate a majority of their revenue and income from real estate rental and leasing operations. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed or produced by MSCI. MSCI is the source and owner of the trademarks, service marks and copyrights related to the MSCI Indexes. The indexes and the Funds include reinvestment of interest, capital gains and dividends, which positively impact the performance results. The indexes are unmanaged. Index performance is not fund performance. Investors cannot invest directly in an index.

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