

PUBLIC NOTE

REITs are not Real Estate, Part Two

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In [this January note](#), I explained the structural decline of the public REIT sector. We looked at various bad incentive structures that have facilitated this decline, and the most intractable was the infamous “illiquidity premium”:

Let’s move on to the excuse that all these public market players can agree on: we can’t beat the private market on fundraising, even with better risk-adjusted returns. The agency problems that drive capital into illiquid alternatives are simply too strong.

When you hear this from generalists, it’s usually about (corporate) private equity, or late-stage VC, or the current private credit boom... [but] real estate was the OG case of this problem. [And] in retrospect, maybe it was naive to expect REITs to earn a liquidity premium, in an asset class where illiquidity is the #1 selling point.

In other words, it’s not only that the stock market doesn’t like real estate; it’s also that real estate doesn’t like the stock market.

I stressed that the most successful REITs with the best long-term track records have created much of that value through other means than passive ownership — which of course implies that the most successful REIT funds have found ways to be less NAV-centric. But there’s no single or systemic answer to what they’re doing instead, or how investors without a REIT benchmark should be approaching the sector. So that’s what I was doing in part one.

Now we’re going deeper, and I’ll start with that hard problem above. In theory, liquidity and transparency are the best reasons for public REITs to exist. In practice, many investors treat them as a negative — all the way from institutional

allocators who are solving for their own career risk, down to the yield-seeking retail investors that they often look down on.

Again, this problem is not specific to real estate, and others have described it in more general terms. (Start with [Cliff Asness](#), who I quoted in that first note.) But if we just take these “irrational” biases as a given... what’s an alternate foundational advantage for public REITs that is (1) still grounded in sound investment principles, but (2) more aligned with how financial markets actually work?

Well, the one that I keep coming back to is permanent equity. In a fee-driven business like CRE, with strong incentives to transact and churn, the most powerful advantage of public REITs is that they can hold their investments indefinitely, and use them to build stable and valuable platforms. So in practical terms, what does this permanent equity rule tell us to look for in a well-run REIT?

1. MINIMAL DISPOSITIONS

If your core competitive advantage is holding assets forever, the most direct way to squander that advantage is by selling them. In fact, there are only two compelling reasons for a healthy REIT to sell anything:

- an unsolicited offer they can’t refuse (i.e. well above their internal valuation)
- using the proceeds to buy back stock at a material NAV discount (i.e. arbitraging their internal valuations)

In reality, this describes only a small minority of REIT dispositions. For the most part, REITs sell assets for other reasons:

- because they’re dilutive to near-term internal growth
- or in an out-of-favor location or property type
- or they need a lot of defensive capex
- or to “match fund” something they want to buy

These reasons overlap heavily, and we could often describe them as a single mindset. For example, your office building in a Midwestern metro has a lot of near-term lease roll, but if you sell it at an 9% cap rate, and buy Sun Belt multi-family at 6%...

For many readers, it will be obvious that this is NAV-destructive, not just earnings dilutive. You’re a price-taker on both sides, you’re incurring all these frictional costs, you’re solving for near-term non-cash (or non-per share) KPIs... of *course* you’re trading off real shareholder value. What else could you be trading off?

Well, in REITland, it's common to pretend that this kind of portfolio churn is "NAV neutral," or close enough, and the only tradeoff we have to model is lower current earnings for higher growth in a couple of years.

I wrote another [wonky public note](#) trying to unpack this flawed logic, and I could write five more if I thought there was an audience for it. But the appeal of "match funding" runs pretty deep — for investors as well as management, if we're being honest — and as a result, I've found heavy portfolio churn to be a remarkably persistent long-term sell signal.

More specifically, I apply a 5% test; when a REIT is selling less than 5% of their portfolio per year, we can give management the benefit of the doubt. There are some edge cases I haven't covered (like a higher use, or tenant option exercise) and sometimes a problem asset just isn't worth the internal distraction.

Maybe your number is 7%, or 10%. But once you get above that, and they're not buying back stock in size, it's time to look much more closely at the math. And conversely, some of the "sleepy" REITs that never sell much at all have been long-term outperformers. Just minimizing churn goes a long way.

2. LESS GREEDY ON INTERNAL GROWTH

This varies by property type, but it's a common sentiment in private real estate that REIT assets are a bit under-optimized — e.g. they're prioritizing occupancy over rate, or they could run leaner on expenses, or squeeze their tenants with more ancillary fees.

On the public side, this is reflected in mind-numbing modeling wars over quarterly same-store metrics — with just as much attention on a 50bp spread to peers as you'd get with a 500bp spread at a retailer.

Now, on the one hand, it's important for REITs to be efficient operators, and that's part of the long-term platform value that we're trying to solve for. It's important to have enough disclosure for investors to measure this, and appropriate for them to question it.

On the other hand, when there's too much focus on optimizing near-term comp metrics, it can easily turn into a kind of homeostatic zero-sum game. For example, if investors successfully pressure a residential REIT into pushing too hard on renewal spreads, it can show up in higher turnover and capex... which in turn become the next "weak points" vs. peers, and are never really attributed to the "catch up" on renewals. Then you address these other problems by shifting the pressure to another part of the growth algorithm, and so on. If they become concentrated in certain assets or markets, they'll get tagged as "non-core," and it will feed back into the portfolio churn problem above.

As with that problem, there is no perfect way to avoid this trap, but a simple rule of thumb can go a long way. For example, I introduced one in [this prior note](#) on multifamily yield management: if your renewal spreads exceed your new leasing

spreads by 5%+ for more than a few quarters, you should assume that's too good to be true, and you'll give back the excess returns in other ways.

Again, the specific number here is not the point; some REITs and investors would argue that a pre-Covid 5% threshold should now be a bit higher, and that's partly what that prior note was about. The point is that many CRE investors on the private side would not have much use for a rule at all, because they're always trying to optimize for an exit price or refi. It's a *privilege* of permanent equity that you don't have to participate in this cycle of maxing out / dressing up assets every few years. And in a well-functioning market, these public and private incentive structures can be complementary.

3. MORE GREEDY ON EXTERNAL GROWTH

Ground-up development and third-party asset management were somewhat suspect activities in the old NAV framework, and they contributed to a few high-profile meltdowns during the GFC. But there was some overcorrection in the pre-Covid cycle, with a keep-it-simple mindset that left real value on the table.

And again, if you start by asking where you can get an edge over peers from permanent equity — and access to the bond market, and other structural advantages of public REITs — then development and asset management start to look a lot more attractive.

For example, one knock on development was the excess overhead, funding a team that's only active in half of each cycle; I've come to see this as a very limited perspective. For one thing, longer time horizons and deeper liquidity can allow public REITs to be active across more of the development cycle than their private peers. Being an active developer can also make you a better operator, and keep you in front of a wider set of tenants and LPs. And if all it does is upgrade your portfolio quality and same-store trends without match-funded portfolio turnover, that's worth a lot too.

CONCLUSION

You can see how these three strategies reinforce each other, and work better together than apart; that's one sign of a true alternate framework, rather than just a list of ideas. But it also doesn't preclude the most valuable parts of an NAV- or earnings-first framework, and it doesn't have to replace them entirely.

We know there's also some very real positive feedback from growing a portfolio, and it's not just about economies of scale or other quantifiable factors. Many public market investors are appropriately wary of "growth for growth's sake" or empire-building M&A, and we're obviously not just talking about REITs here. But this is another case where the conventional wisdom in REITland may have overcorrected, and that may have something to do with the REIT structure or the return profile of CRE assets.

In any case, there are many things that just seem to work better in a growing organization, starting with comp and retention vs. private market career tracks. And of course, there are many things that would work better in a growing public REIT sector, rather than a shrinking one.

Prior Drawing Board notes referenced above:

REITs are not Real Estate (January 2025)

The B2C Premium (October 2022)

The Dead Zone (March 2022)

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