Jeff Kolitch: Opportunities in real estate equities

This is an edited version of an April 24, 2023, update with Jeff Kolitch, Portfolio Manager of Baron Real Estate Fund and Baron Real Estate Income Fund. To access the full video, please visit our website.

Executive Summary

- We remain optimistic about the prospects for public real estate. Notwithstanding expectations for ongoing volatility, we see attractive opportunity for investors with a two- to three-year view in light of the risk/reward for both REIT and non-REIT real estate stocks.
- We believe most of the repricing of real estate equities has already occurred. In our view, stocks are essentially on sale. Rarely do we identify opportunities to buy what we view as best-in-class, high-quality companies at discounted prices. This is one of those times.
- When we examine demand, construction, balance sheets, banking systems, loan defaults, et cetera, we think it is a gross misrepresentation to suggest a commercial real estate crisis is on the horizon. Our research and conversations with company management teams affirm that business trends and prospects are generally positive for most categories of real estate and for most of the companies we are evaluating.
- We are coming to the end of a Fed tightening cycle, which often is a positive for real estate stocks.

Introduction

Jeff Kolitch 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 has been the portfolio manager of Baron Real Estate Fund, which invests in REITs and other real estate-related companies, since its 2009 launch; and Baron Real Estate Income Fund, which emphasizes REITs and other dividend-yielding real estate companies, since its 2017 launch.

Q&A with Jeff Kolitch

What is your overall view of today's real estate investment landscape?

We remain optimistic about the prospects for public real estate. Notwithstanding expectations for ongoing volatility in the short term and our understanding of reasons to be cautious, we see the potential for strong returns. We believe growth, which was a tailwind last year, is likely to slow this year. However, we also see that multi-decade high inflation and the Federal Reserve Board's most aggressive tightening cycle on record are starting to reverse course, which should be supportive of valuation multiples. We believe multiple expansion will more than offset any slowdown in growth.

Consensus narrative is that a commercial real estate crisis is imminent. Our team views such reports as sensationalized and misplaced. We do not believe a commercial real estate crisis is on the horizon.

We believe most of the repricing of real estate in the public markets has already occurred. In our view, public real estate stocks are essentially on sale. Rarely do we identify opportunities to purchase what we deem to be best-in-class, high-quality companies at discounted prices. This is one of those times.

Why do you believe a commercial real estate crisis is unlikely?

In our 1Q 2023 Baron Real Estate Fund letter we discuss our views in detail and dispel the notion that we may be headed for significant commercial real estate (CRE) distress. We think it's a big mistake, and a missed opportunity, to paint the entire CRE industry with one brush.

What would cause a commercial real estate crisis?

- **Demand destruction.** The prospects for most categories of CRE continue to be positive.
- **Excess inventory.** New construction activity over the next few years is quite muted, because it's not economical given the rise in land, material, and labor costs.
- **Balance sheets.** Many of the companies, developers, individuals, and institutions focused on real estate learned from the Great Financial Crisis and other challenging periods. Overall, debt profiles — debt relative to cash flow, fixed vs. floating, debt maturity schedules — are solid, in our view.
- **The banking system.** Our sense, from the work we've done and conversations with management teams, is that the banking system overall is in a strong capital position.
- **Loan defaults.** We think any loan defaults will be largely isolated to old B and C office buildings, which could face insufficient new loan proceeds for refinancing. Most real estate is appropriately capitalized. Values have gone up. They will be able to refinance, should that occur.

In summary, when we examine demand, construction, balance sheets, banking systems, loan defaults, etc., we think it is a gross misrepresentation to suggest a crisis in CRE is on the horizon.

What are you hearing from management teams?

We speak to management teams throughout the quarter. Strong relationships and access to management, in our view, contribute to our competitive edge over many of our peers.

Recent conversations affirm that business trends and prospects are generally positive for most categories of real estate, and for most of the companies we are evaluating. For example, we spoke with **D.R. Horton, Inc.,** the largest home builder in the U.S. Business is strong, the outlook is encouraging. We spent four hours with the management team at **Toll Brothers, Inc.,** the leading luxury homebuilder in this country. Business activity has stabilized. The chairman of **Lennar Corporation,** the second-largest homebuilder tells us business activity has picked up. The CEO of **Hilton Worldwide Holdings Inc.** sees no sign of a global slowdown in travel. The largest industrial REIT in the country, **Prologis**, **Inc.,** a large position in both of our real estate funds, reported that business is strong. In-place rents are more than 70% below market rents, so the company has visibility into 70% growth over the next four to five years. Casino company **Caesars Entertainment, Inc.** reports that business activity is good. **Las Vegas Sands Corporation**, another casino company and a top holding, tells us business is rebounding much faster than it expected in its focus markets of Singapore and Macau. Finally, a private data center company with which our firm has a long history tells us that it expects much stronger demand in the next 10 years compared to the prior 10 years, driven by the growing need for computing power and massive data storage required by artificial intelligence (AI) and autonomous vehicles.

What are some current investment ideas?

We're bullish on four primary themes as we look out over the next couple years.

1. **REITs**. We think the setup for REITS over the next two to three years is attractive. Stocks are down,

valuations are reasonable, business fundamentals are generally solid, balance sheets are in good shape, and dividend yields are well covered. We focus on REITs whose cash flow should be more durable during a downturn — industrial, data center, and tower. We also focus on short-duration lease REITs, where the landlord can increase rents to partially offset expense headwinds. Self-storage REITs, for example, reprice every 30 days; single-family rental REITs reprice once a year.

2. **Residential real estate.** Our long-term optimism for the housing market is based on a multi-decade structural underinvestment in housing relative to demographic needs. Our research indicates a meaningful uptick in demand and that buyers are adjusting to the sticker shock of higher prices and higher mortgage rates. Remember, during 2005 and 2006, the most robust housing market on record, mortgage rates were around 6.5%.
3. **Travel-related real estate.** We think the trend of reprioritization or redirecting some discretionary dollars away from goods toward experiences, namely travel, will persist. We see this among several age cohorts. When you layer on the return of the international traveler and business travel rebounding faster than consensus expectations, the demographic trends are positive.
4. **Commercial real estate service firms.** We believe this industry will be consolidated by two leading players: **CBRE Group, Inc.** and **Jones Lang LaSalle Incorporated.** These stocks are trading at massive discounts to historical levels, and we are delighted to buy them with a two- to three-year view. We see significant multiple expansion and growth over the next three years.

Blackstone continues to be in the news. Do you see any reason for concern?

We hold **Blackstone Inc.** in high regard. From our perspective, the company has world-class talent, a leading brand, a strong investment track record, a strong and liquid balance sheet, and loyal long-term clients. Blackstone received some unfavorable press in recent months for its non-traded REIT. The view is that the valuations don't currently reflect market values because they're based on appraised values.

Blackstone announced it has raised $30 billion from sophisticated capital -- institutions, endowments, pension funds, and others -- to create the largest private real estate fund ever. With leverage, that represents $80 to $100 billion of buying power, likely to target public real estate, perhaps some companies that we own. The president has said he sees the best opportunities in real estate in the public markets.

We think certain public real estate stocks or mutual funds may outperform non-traded REITs because the public market has already repriced. We believe our strategies will do quite well over the next few years.

Any concluding thoughts you'd like to share?

From our perspective, this is an opportune time to lean into real estate. Most stocks have already repriced. We're approaching the end of the Federal Reserve's tightening cycle, which often is a positive for real estate stocks.

We made some of our best buys when real estate was out of favor. During the Great Financial Crisis, while many investors stayed away, our team leaned in and made some successful investments. In the early pandemic days, we saw opportunity after the sharp correction. Here we are again: We see opportunity for those with a two- to three-year view and consider the risk/reward for both REIT and non-REIT stocks.

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. Please read them carefully before investing.

Baron Real Estate Fund's annualized returns for the Institutional Shares as of March 31, 2023: 1-year, (14.15)%; 3-year, 19.71%; 5-year, 10.35%; 10-year, 9.66%; Since Inception (12/31/2009), 13.26%. Annual expense ratio for the Institutional Shares as of December 31, 2022, was 1.07%.

The **MSCI USA IMI Extended Real Estate Index**'s annualized returns as of March 31, 2023: 1-year, (10.34)%; 3-year, 16.81%; 5-year, 6.85%; 10-year, 8.00%; Since Fund Inception (12/31/2009), 10.38%.

Baron Real Estate Income Fund's annualized returns for the Institutional Shares as of March 31, 2023: 1-year, (21.78)%; 3-year, 12.63%; 5-year, 9.24%; Since Inception (12/29/2017), 7.51%. Annual expense ratio for the Institutional Shares as of December 31, 2022, was 0.96%, 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 March 31, 2023: 1-year, (20.17)%; 3-year, 10.76%; 5-year, 4.79%; Since Fund Inception (12/29/2017), 2.83%.

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 or may reimburse certain 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 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 March 31, 2023, for securities mentioned are as follows: D.R. Horton, Inc. - Baron Real Estate Fund, 2.9%; **Toll Brothers, Inc.** - Baron Real Estate Income Fund, 2.7%; **Hilton Worldwide Holdings Inc.**- Baron Real Estate Fund, 1.5%; **Caesars Entertainment, Inc.** - Baron Real Estate Fund, 2.8%; **Las Vegas Sands Corporation** - Baron Real Estate Fund, 3.0%; **CBRE Group, Inc.** - Baron Real Estate Fund, 2.5%; **Jones Lang LaSalle Incorporated** - Baron Real Estate Fund, 2.4%; **Blackstone, Inc.** - Baron Real Estate Fund, 3.0%.

Top 10 holdings as of March 31, 2023

Baron Real Estate Fund

Holding	% Assets
Toll Brothers, Inc.	6.8
Prologis, Inc.	6.5
Brookfield Corporation	6.3
CoStar Group, Inc.	4.0
Lennar Corporation	3.7
Rexford Industrial Realty, Inc.	3.6
Equinix, Inc.	3.4
MGM Resorts International	3.3
Wynn Resorts, Limited	3.2
Public Storage Incorporated	3.1
Total	43.9

Baron Real Estate Income Fund

Baron Real Estate Income Fund

Holding	% Assets
Prologis, Inc.	11.7
Equinix, Inc.	6.9
Welltower Inc.	6.0
Public Storage Incorporated	5.8
Extra Space Storage Inc.	4.9
Brookfield Corporation	4.8
Rexford Industrial Realty, Inc.	4.7
Equity Residential	4.7
EastGroup Properties, Inc.	4.6
American Tower Corp.	4.5
Total	58.7

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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