Jeff Kolitch: Reasons for optimism for Real Estate Equities

This is an edited version of a July 20, 2022, 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

- At this stage, we're optimistic as we look out over the next couple of years. We still believe that real estate should be part of a well-diversified investment portfolio.
- We do not believe we're headed toward a housing crash. The key reason is demand and supply.
- We think the investment case for REITs right now is strong. Business fundamentals in most cases are reasonably solid with some encouraging growth prospects. And they offer inflation protection characteristics, certainly for short-duration real estate: attractive dividend yields that are well covered by cash flow and growing.
- The conditions that typically foreshadow a major real estate correction aren't in place. Construction and inventory levels are modest for residential real estate and a good portion of commercial real estate. Job and demand growth are strong. Corporate balance sheets are liquid, lending practices are appropriate.

What is your key message for clients in this environment?

The key message is that we think there is reason to be optimistic. That's for several reasons.

1) We think a good portion of the bad news has been priced in at this stage. Many real estate companies have corrected 20-60%.
2) Fundamentals remain strong for most of the real estate-related companies we research and monitor. Corporate balance sheets are strong, and the credit markets are functioning well.
3) There's a tremendous amount of worry out there. Very often that is an indicator that better days are ahead.
4) The market is more reasonable from an evaluation perspective. The S&P 500 multiple contracted from 22x to 15x-16x in the first six months of this year. The equivalent REIT multiple contracted from 25x to 18x.

At this stage, we're optimistic as we look out over the next couple of years. We still believe that real estate should be part of a well-diversified investment portfolio.

Can you update us on your COVID-19 recovery theme?

That has been a theme for our team since the early days of the pandemic. For those that aren't familiar. When we refer to COVID-19 recovery beneficiaries, specific to real estate, there are several real estate businesses where the operations of the businesses are contingent on bringing people and businesses together. Think about hotels, casino gambling companies, apartment buildings in urban centers, or malls or shopping centers, or office buildings or senior housing facilities. During a pandemic, people stay away from them. Many of those stocks corrected very sharply in the first few months of 2020. We leaned into this aggressively and loaded up in those real estate categories.

Fast-forward to today: we have retired COVID-19 recovery beneficiaries as an investment theme. It's been a source of very strong returns for both of our Funds. Our analytics team ran the numbers through June 30th and found that our holdings in the category returned 156% since the early days of the pandemic. That's more than twice the return of the S&P, the REIT index, and our primary benchmark. Now, with most of the global economy reopened and business activities improved, we think it's the right time to retire that theme, even though we still own several companies.

Can you share your thoughts on travel-related companies?

At the beginning of 2022, we were notably bullish about the prospects for our travel-related real estate companies and their investment return potential. Our view was that two years of pent-up demand would be unleashed this year and, even though many of these stocks performed well over the last couple of years, they still had a way to go. We have tempered our enthusiasm for travel related investments a bit. Part of that is because of the slowdown in economic growth and how that might transpire in the months ahead, or perhaps even into next year.

This has been a major focus for our strategy, approaching about a third of our investible assets. We have cut that roughly by half, to somewhere between 15-18%. We still see tremendous value in some of these stocks. Many have corrected sharply and are discounting a much more severe outlook than what we think might unfold. And certainly travel-related businesses will be one of the first segments of the economy to rebound when economic strength re-emerges. Our team's bullish about the long-term spending priorities of the consumer. We think stocks are cheap and there's an arbitrage between the public and private market.

Given the spike in mortgage rates and home price, could we be heading towards a housing crash?

We don't believe so. The key reason is simple: demand and supply. A decade of underbuilding in our country has created a structural deficiency relative to long-term household demand. Let's go back to the housing crash in 2008. We were building too many homes. In 2004 and 2005, we were building 2 million homes per year, which was too much relative to the demographic need. Plus, mortgage underwriting standards were effectively non-existent. Then the economy started to slow down, demand dried up, people started losing jobs and forced to sell their homes. That produced a surplus of homes relative to demand, thus home prices crashed.

Those elements are not in place today. Instead, we have a structural deficiency of homes. We have a much larger population than we did 30, 40, 50 years ago, yet we're building fewer homes. There's tremendous pent-up demand to buy homes. Additionally, we have more appropriate lending standards; we have record homeowner equity and banks are in pretty good shape.

From an investing perspective, there's no question the housing market is going to slow in the months ahead. Home prices went up 30% over the last couple of years and mortgage rates have gone from 3% to 5.5-6% just this year. What we have right now is a buyer strike because they're experiencing affordability challenges right now.

Overall, we're near-term cautious/long-term bullish on the housing market. However, the stock market is a discounting mechanism. Home-building stocks and building-related stocks in the first six months of this year declined 30-60%, even though for the bulk of the last six months, business fundamentals for the most part remained strong.

Toll Brothers, Inc., a leading high-end luxury homebuilder, trades under 1x book value. That typically is a very good buy signal. It's been one of the best-performing stocks in a market inundated with news about negative data on housing – problems, crashes, stalls, etc. The stock closed the first quarter at around $47. It's been flat for four months, which is a sign that a good portion of the news related to the challenges in housing is already priced in the stock.

Lowe's Companies, Inc., one of the leading home center companies, trades at around 13x earnings. Its business may be a bit challenged in the months ahead. Yet, when a well-regarded Wall Street bank cut numbers on Home Depot and Lowe's, the stock went up, because it's not new news. The stock already corrected a fair amount. It's trading at 13x, but historically it's traded at 18x.

We cut our holdings in housing-related stocks by about half at the beginning of this year. In the last couple of months, we've started to reacquire shares because the stocks corrected so sharply that we think it has discounted a quite concerning scenario for the housing market. If we can pick up premier companies such as Toll, Lowe's, and a series of others at these multiples, we think our upside/downside over the next two to three years is quite attractive.

In your view, why haven't REITs performed better in 2022?

REITs returned 40% last year. It was the best year ever in the history for REITs. However, nothing's been spared in 2022 – equities, bonds, alternatives, REITs, have all declined sharply in the first six months.

In the first quarter, REITs held up reasonably well, better than most companies in the market. I think many investors found comfort in the inflation protection characteristics of REITs. In the second quarter, REITs corrected by almost 20%, just like the S&P 500. A spike in interest rates widened credit spreads, and some companies reported results that had moderated from some terrific results over prior quarters. That all contributed to year-to-date REIT returns largely in line with the S&P.

We think the investment case for REITs is strong. Business fundamentals are reasonably solid with some encouraging growth prospects. Balance sheets are in good shape. Inflation protection characteristics are offered certainly for short-duration real estate: attractive dividend yields that are well covered by cash flow and growing. Several REITs that have contracted cash flows and attractive dividend yields provide some appeal. Private equity has hundreds of billions of dollars yet to be deployed and is targeting real estate. With many REITs on sale relative to the private market, we're optimistic in that context as well.

Can you share your thoughts on the tower and data center on REITs?

We like them, and much more so today than we did 18 months ago. The stocks have corrected sharply. Valuations are more reasonable. Business prospects are improving. Our sense is that growth is likely to hold up better should economic activity continue to slow because growth for towers and data centers is more secular in nature rather than cyclical.

We took advantage of some sharp corrections in **American Tower Corp.** and **SBA Communications Corp.** on the tower side, and **Equinix, Inc.** and **Digital Realty Trust, Inc.** on the data center side. We've been largely on the sidelines with small allocations. We thought valuations were full, relative to other opportunities in real estate, and there were some company-specific considerations. All things considered, we're more optimistic today.

Our firm has a long history of investing in wireless towers. There are secular drivers in the form of strong mobile data growth, 5G adoption. These businesses generate 80+% cash flow margins. There are strong barriers to entry. They have stable, predictable cash flows, fixed costs, and high incremental margins.

We increased our positions in our data center REITs when valuations became more reasonable. We believe we're on the cusp of a positive inflection in business fundamentals, as it relates to leasing activity, booking activity, and pricing activity. The construction pipeline is slowing down because of elevated costs, which sets up a favorable demand/supply dynamic.

Would you mind sharing a few current examples of real estate companies you like?

- **Brookfield Asset Management Inc.** is one of the largest owners and operators of real estate and infrastructure assets in the world. The management team plans to spin out its asset management business at an $80 billion valuation. Brookfield's market cap today is around $75

billion. If you back out its non-asset management businesses, which is about a $50 billion public market value, the public market is valuing Brookfield's Asset Management business at around $25 billion. Yet Bruce Flatt, one of the most credible and amazing CEOs we've ever come across, tells us that he thinks the value of his asset management business is $80 billion, not $25 billion.

- We like **Jones Lang LaSalle Incorporated**, one of the leading commercial real estate service firms in the world. We're aware that segments of its business will likely slow in the months ahead. However, with the stock down about 30%, trading at 8.8x consensus earnings for this year, we think the stock is cheap. Maybe the market's telling us they don't believe the earnings. Just cutting earnings by a third, the stock's trading at 13x earnings, perhaps on trough earnings.
- **Las Vegas Sands Corporation** is at a price today that is effectively the 10-year low, and it has a pristine balance sheet. We believe the leading company in the gaming industry is going to recover business in Macao just as it came ripping back in Las Vegas. It's a question of when. Considering the upside and downside at this stage, and the ability to buy Las Vegas Sands effectively at its lowest price, we think the risk/reward over the next few years is compelling.
- **Vail Resorts, Inc.** is a relatively new travel-related addition to the portfolio. It owns some of the best ski resorts in the world. The stock peaked late last year at around $370. Now it's around $230, trading at 12x times cash flow. The long-term average has been 15-16x. We think we're buying amazing real estate on sale.
- **Invitation Homes, Inc.** is the largest single-family home rental company. Its homes are currently valued at around $350,000 in the public market, but it's buying homes in the private market at above $400,000. On a cap rate basis, it's trading at around a 5.2%.
- **Alexandria Real Estate Equities, Inc.** has been a Baron holding for years. It's the leading landlord and developer to the life science industry. Its real estate is valued in the public market at around $600 per square foot. We know that in the private markets they focus on — Cambridge, the San Francisco area, San Diego, and other segments of the country — their transactions occur at around $1,000 a square foot, upwards of $1,500 in some cases. This company is effectively selling at 60 cents on the dollar.
- We recently started acquiring shares of **Digital Realty Trust, Inc.** It trades at 20x cash flow. With Blackstone recently acquiring QTS Realty at 25x cash flow, American Tower acquiring CoreSite at 27x, and Switch, another data center REIT, announcing it is going to be acquired at 30x, we are happy to own what we believe to be one of the best companies in the bunch at 20x.

How much more downside do you see? Are you worried?

No promises on the downside, but I'll give you a few thoughts on our perspective. We don't have our head in the sand when I express optimism. There's a tsunami of reasons to be concerned, and we're well-aware of them. Nonetheless, I believe real estate's starting from a good place should conditions continue to worsen.

The conditions that typically foreshadow a major real estate correction aren't in place. Construction and inventory levels are modest for residential real estate and a good portion of commercial real estate. Job and demand growth are stubbornly strong. We're hearing from some companies that the consumer is still reasonably healthy. Corporate balance sheets are liquid and lending practices are appropriate.

Could you update us on Blackstone?

We think **Blackstone Inc**. is a great business. It's a premier brand with a global franchise and a loyal investor base. It's fast-growing with limited capital needs and is the largest real estate manager in the world with a very impressive investment track record. Around 60% of its fee-related earnings are derived from real estate and about 40% from assets under management. It trades at a similar multiple to the S&P, yet it'll grow much faster due to secular growth drivers. We remain long-term bullish.

Do you have any final thoughts you'd like to share?

We see reason for optimism in our public real estate companies and both of our Funds. I'm very optimistic about what our team has done over the last six months in terms of repositioning the portfolio. I feel good about the quality of the portfolio — best-in-class, competitively advantaged real estate companies with compelling long-term growth prospects and compelling share price appreciation potential.

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 June 30, 2022: 1- year, -24.21%; 5-years, 10.20%; 10-years, 12.29%; Since Inception (12/31/2009), 13.40%. 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 June 30, 2022: 1-year, -16.12%; 5-years, 5.71%; 10-years, 9.38%; Since Fund Inception (12/31/2009), 10.34%.

Baron Real Estate Income Fund's annualized returns for the Institutional Shares as of June 30, 2022: 1-year, -12.00%; 3-years, 12.42%; Since Inception (12/29/2017), 9.83%. Annual expense ratio for the Institutional Shares as of December 31, 2021, 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 June 30, 2022: 1-year, -7.32%; 3-years, 2.90%; Since Fund Inception (12/29/2017), 4.16%.

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, 2032, 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 ofthe 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 bychanges 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 June 30, 2022, for securities mentioned are as follows: - **Toll Brothers, Inc.** - Baron Real Estate Fund (1.5%); **Lowe's Companies, Inc.-** Baron Real Estate Fund (2.5%); **American Tower Corp.** – Baron Real Estate Fund (4.0%), Baron Real Estate Income Fund (6.8%); **SBA Communications Corp.**– Baron Real Estate Fund (1.0%), Baron Real Estate

Income Fund (1.6%); **Equinix, Inc.** – Baron Real Estate Fund (2.7%), Baron Real Estate Income Fund (6.1%); **Brookfield Asset Management, Inc.** - Baron Real Estate Fund (5.4%), Baron Real Estate Income Fund (2.7%); **Jones Lang LaSalle Incorporated -** Baron Real Estate Fund (4.0%); **Las Vegas Sands Corporation** – Baron Real Estate Fund (4.2%), Baron Real Estate Income Fund (3.3%); **Vail Resorts, Inc.** – Baron Real Estate Fund (2.5%), Baron Real Estate Income Fund (1.0%); **Invitation Homes, Inc.** – Baron Real Estate Fund (2.9%), Baron Real Estate Income Fund (4.2%); **Alexandria Real Estate Equities, Inc.**– Baron Real Estate Fund (0.9%), Baron Real Estate Income Fund (1.5%); **Blackstone Inc.**– Baron Real Estate Fund (3.4%,), Baron Real Estate Income Fund (1.4%).

Top 10 holdings as of June 30, 2022

Baron Real Estate Fund

Holding	% Assets
Brookfield Asset Management Inc.	5.4
Las Vegas Sands Corporation	4.2
CBRE Group, Inc.	4.2
Jones Lang LaSalle Incorporated	4.0
American Tower Corp.	4.0
CoStar Group, Inc	3.7
Blackstone Inc.	3.4
SiteOne Landscape Supply, Inc	2.9
Invitation Homes, Inc.	2.9
Public Storage Incorporated	2.7
Total	37.4

Baron Real Estate Income Fund

Holding	% Assets
American Tower Corp.	6.8
Equinix, Inc.	6.1
Public Storage Incorporated	5.9
Digital Realty Trust	5.2
Ventas, Inc.	4.7
Equity Residential	4.3
Duke Realty Corporation	4.3
Invitation Homes, Inc.	4.2
Brookfield Infrastructure Partners L.P.	4.2
Extra Space Storage Inc.	4.1
Total	49.8

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

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