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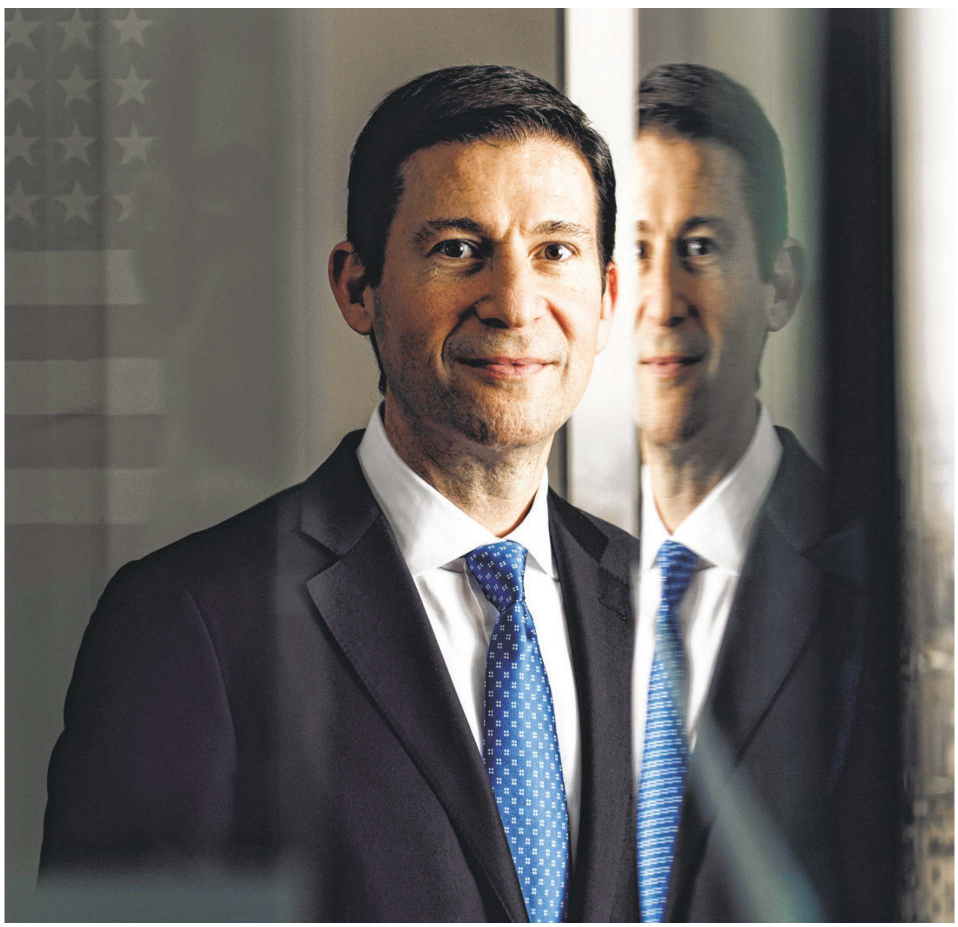
Real Estate Stock Woes Are a 'Gift' For Investors

BY SHAINA MISHKIN



Photographs by George Etheredge

With mortgage rates high and offices empty, investors have soured on real estate stocks. But not Jeffrey Kolitch, a portfolio manager at Baron Funds.

The market's aversion to all things real estate–related is "providing a gift for us—an opportunity to buy high-quality companies at attractive prices," says Kolitch, who oversees the $1.4 billion **Baron Real Estate** fund and the $80 million **Baron Real Estate Income** fund. With a gain of 13.2% this year through June 27, Baron Real Estate is No. 1 in its category, according to Morningstar, which rates the fund five stars. Its three-, five- and 10-year performance ranking is similarly impressive.

Kolitch has managed the fund since its 2009 inception, but his interest in real estate stretches back decades. "My father, who is my closest mentor and adviser, has been a private real estate developer and landlord for most of his professional career," says Kolitch.

The fund manager recalls being a teenager visiting a shopping center his father had developed, when he asked his father to explain what he did for a living. The answer—which touched upon the concepts of anchor stores, rent payments, and land appreciation—"sparked a curiosity" that led to a college major and, ultimately, a career.

Kolitch spoke with Barron's on June 20 about how investor jitters are creating attractive opportunities for real estate investors. An edited version of the conversation follows.

Barron's: **In your latest quarterly letter, you highlighted a number of real estate–related companies that you consider attractively valued. Why now, when so many investors are down on the sector?**

Jeffrey Kolitch: There is a fair amount of caution and concern regarding real estate investments because of the narrative out there: We could be on the cusp of a commercial real estate crisis, there are challenges in the housing market, and so forth. We disagree emphatically. The setup for real estate in the public markets is attractive.

For the past three and a half years, real estate–related stocks have faced a trifecta of headwinds. It started with the Covid pandemic, during which many real estate businesses were effectively shut down, which hurt the stocks. Then, real estate has been in the crosshairs of the most aggressive interest-rate tightening cycle in decades. Third, there are sensationalized—in our view—reports of a commercial real estate crisis on the horizon. As a result, many real estate stocks have lagged behind the broader market.

As we evaluate a larger swath of public real estate companies, two- to three-year return prospects look quite compelling.

Let's take a closer look at the case for office real estate, which has been plagued by vacancy concerns as more people work from home.

There is an assumption that the challenges facing lower-quality buildings are representative of all of commercial real estate. We couldn't disagree more. Most commercial real estate, and certain individual office buildings, are performing quite well. Yes, old and poorly located B and C office buildings are in both secular decline and perhaps what will be cyclical decline over the next couple of years. The new world, in which many employers are adopting more flexible work arrangements, will create demand pressures for occupancy and rent [issues] for lower-quality office buildings in the next few years.

When you layer on that the fact that in many cities there is an excess supply of older buildings, you have an unfavorable relationship between demand and supply. But what I am describing is a small percentage of the overall real estate landscape.

How does the rest of the market look?

At Baron, we believe that a commercial real estate crisis is highly unlikely. Very simply, business prospects for most commercial real estate operators are solid. There is little competitive new construction activity in the pipeline, as land costs, labor costs, and material costs have gone up. Debt profiles, generally speaking, are in pretty good shape.

After the failure of Silicon Valley Bank, there was concern about a major banking crisis. Sure, there perhaps will be additional challenges in the months ahead, but so far, it has been fairly contained. The loan defaults that you may read about will be largely isolated in the lower-quality B and C office space. This is an important point of clarification that is largely misrepresented.

We're leaning into this dislocation because we expect it to reward our investors in the next few years. We continue to emphasize four high-conviction investment themes: real estate investment trusts, non-REIT residential real estate, travel-related real estate, and the commercial real estate service firms and real estate alternative managers.

What is the outlook for residential real estate?

Sentiment has picked up quite a bit. May housing-start and permit data were encouraging. We are long-term bullish on the prospects for the U.S. housing market. There has been a multidecade structural underinvestment in U.S. housing.

Six months into 2023, we're seeing a meaningful uptick in demand in the housing market. Buyers are getting over the sticker shock that occurred last year, when mortgage rates went from a low of 3% up to 7% following a period of home-price appreciation of 30% to 40%.

There are several years of pent-up demand. Perhaps buyers are adjusting by purchasing a smaller home or choosing a different suburb, but this near-term dynamic has been one of the key pillars supporting the economy this year, and we think it will do so in the years ahead.

Which REITs look best to you now?

While certain REIT segments might face headwinds in the next few years, the setup for REITs in general is attractive over two to three years. Early in 2022, before the Federal Reserve's tightening cycle, REITs were trading for 25 times earnings. Now they are 17 times earnings.

We are focused on what we would call secular REITs, whose cash flows are less vulnerable to an economic slowdown. Think about industrial REITs such as **Prologis** or **Rexford Industrial Realty**, which are benefiting from the e-commerce trend and supply reconfigurations. Data-center REITs such as **Equinix** and **Digital Realty Trust** are benefiting from cloud adoption, an increase in internet use, and perhaps artificial intelligence.

Short lease-duration real estate, whose leases are shorter in nature, may have an opportunity to increase rents on a more frequent basis to off-set some of the inflationary pressures. Think single-family rental REITs such as **Invitation Homes** and **American Homes 4 Rent**; apartment REITs such as **AvalonBay Communities** and **Equity Residential**; or perhaps self-storage REITs such as **Public Storage**, **Extra Space Storage**, and **CubeSmart**.

One of the non-REIT companies highlighted in your letter to in-come-fund shareholders, Toll Brothers, is closely tied to the residential market. Why do you recommend it, and how do you view its valuation and stock fundamentals?

Toll Brothers is a best-in-class home-building company. It is led by a highly capable management team. Over the years, it has acquired and developed a valuable owned-land real estate portfolio in excellent markets. Much of it was purchased before the run-up in home prices during Covid, so there is very little risk to the book value.

Importantly, Toll focuses on luxury homes. Toll Brothers is more insulated from higher mortgage rates because about 25% of the buyers of Toll homes pay 100% in cash. The company has maintained a terrific balance sheet. There are approximately 132 million households in the U.S., of which about 25 million earn at least $150,000 a year annually. That's Toll's target audience.

There is a massive addressable market for Toll. With its pristine balance sheet, several billion dollars of liquidity, and superior capital sources, the company has a major opportunity to increase market share at the expense of its competitors over the next several years.

Toll has been a good stock this year. It is trading at just over our estimate of 2024 tangible book value. The stock historically has been valued at 1.4 to 1.5 times book value, and had a peak valuation of two times book value. If the company can just recover to its long-term average, we would have another 50% upside.

What other opportunities do you see in commercial real estate?
Shares of the largest commercial real estate service firm in the world, **CBRE Group**, have been pressured because the company got swept into the negative narrative. That has created a terrific opportunity to once again acquire a premier commercial company at a highly discounted price.

We are long-term bullish on the commercial real estate service industry. More companies are outsourcing their commercial real estate needs to service companies such as CBRE Group. The company has the leading global commercial real estate service brand. Its management team is led by CEO Bob Sulentic, who is exceptional.

After the shares performed well earlier this year, CBRE got hit by fears of a significant slowdown in bank lending and economic growth, which would negatively impact the company's leasing and property-sales businesses. We're fully aware that those businesses will be challenged this year, but that misses the forest for the trees. These businesses will come back in the years ahead.

Usually you have to pay a premium multiple for a premium company. This company historically has traded at a multiple of 16 to 17 times earnings and reached a peak multiple of 20 times earnings. Right now the shares are valued at about 13 times our estimate of next year's earnings. Management continues to believe that they can exceed the earnings generated last year in 2024, which would imply over 20% growth next year.

Our team sees a path where CBRE Group could generate more than $7 a share in earnings in 2025. That compares to about $5.40 a share in 2022. That assumes nothing for acquisitions, which could add another 50 cents a share.

Thanks, Jeffrey.

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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. Please read them carefully before investing.

Baron Real Estate Fund's annualized returns for the Institutional Shares as of June 30, 2023: 1- year, 16.17%; 5-years, 11.67%; 10-years, 10.82%; Since Inception (12/31/2009), 13.60%. Annual expense ratio for the Institutional Shares as of December 31, 2022, was 1.07%.

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 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 Fund 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 Fund invests 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.

As of 6/30/2023, the Morningstar Ratings™ were based on 230, 211, 151, and 230 share classes for the 3-year, 5-year, 10-year, and Overall periods, respectively. The Baron Real Estate Fund received 5 stars for each period. The Morningstar Ratings are for the Institutional Share Class only; other classes may have different performance characteristics. The Morningstar Ratings are based on the Morningstar Risk-Adjusted Return measures.

As of 6/30/2023, the Morningstar Real Estate Category consisted of 254, 230, 211, and 151 share classes for the 1-, 3-, 5-, and 10-year periods. Morningstar ranked Baron Real Estate Fund Institutional Share Class in the 1st, 1st, 1st, and 1st percentiles, respectively. On an absolute basis, Morningstar ranked Baron Real Estate Fund Institutional Share Class as the #3 for 3-year period, and the best performing share class in its Category, for the 1-, 5-, and 10-year periods, respectively.

As of 6/30/2023, Morningstar ranked Baron Real Estate Fund R6 Share Class in the 1st percentiles, for the 1-, 3-, and 5-year periods. On an absolute basis, Morningstar ranked Baron Real Estate Fund R6 Share Class as the 1st, 2nd, and 2nd best performing share class in its Category for the 1-, 3-, and 5-year periods, respectively.

Morningstar calculates the Morningstar Real Estate Category Average performance and rankings using its Fractional Weighting methodology. Morningstar rankings are based on total returns and do not include sales charges. Total returns do account for management, administrative, and 12b-1 fees and other costs automatically deducted from fund assets.

The **Morningstar Rating™** for funds, or "star rating", is calculated for managed products (including mutual funds, variable annuity and variable life subaccounts, exchange-traded funds, closed-end funds, and separate accounts) with at least a three-year history. Exchange-traded funds and open-ended mutual funds are considered a single population for comparative purposes. It is calculated based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a managed product's monthly excess performance, placing more emphasis on downward variations and rewarding consistent performance. The Morningstar Rating does not include any adjustment for sales loads. The top 10% of products in each product category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next

22.5% receive 2 stars, and the bottom 10% receive 1 star. The Overall Morningstar Rating for a managed product is derived from a weighted average of the performance figures associated with its three-, five-, and 10-year (if applicable) Morningstar Rating metrics. The weights are: 100% three-year rating for 36-59 months of total returns, 60% five-year rating/40% three-year rating for 60-119 months of total returns, and 50% 10-year rating/30% five-year rating/20% three-year rating for 120 or more months of total returns. While the 10-year overall star rating formula seems to give the most weight to the 10- year period, the most recent three-year period actually has the greatest impact because it is included in all three rating periods.

Portfolio holdings as a percentage of Baron Real Estate Fund's net assets as of June 30, 2023 for securities mentioned are as follows: **Digital Realty Trust, Inc.**,(1.7%); **Invitation Homes, Inc.**, (1.6%); **Public Storage Incorporated**, (2.4%); **Extra Space Storage Inc.**, (1.8%); **CBRE Group, Inc.**, (3.2%); **Rexford Industrial Realty, Inc.**, (2.9%).

As of June 30, 2023, Baron Real Estate Fund did not hold shares of **American Homes 4 Rent, AvalonBay Communities, Inc., Equity Residential,** and **CubeSmart.**

Top 10 Holdings

Baron Real Estate Fund **6/30/2023**

Holding	% Holding
Toll Brothers, Inc.	8.4
Brookfield Corporation	6.3
Prologis, Inc.	5.4
CoStar Group, Inc.	4.8
Lennar Corporation	4.6
Equinix, Inc.	4.4
D.R. Horton, Inc.	3.5
Wynn Resorts, Limited	3.4
MGM Resorts International	3.4
Blackstone Inc.	3.2
Total	47.3

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

The portfolio manager defines "**Best-in-class**" as well-managed, competitively advantaged, faster growing companies with higher margins and returns on invested capital and lower leverage that are leaders in their respective markets. Note that this statement represents the manager's opinion and is not based on a third-party ranking.

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