The ‘new’ real estate for a post-COVID world

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WisdomTree has a platform of different thematic strategies and many of these themes have their own infrastructure requirements. Information technology megatrends (like cloud computing, 5G connectivity, the Internet-of-Things and artificial intelligence) may not appear to need infrastructure in the same way as those involved in making more physical things, but they do.

For example, a lot of these megatrends could not function without cell phone towers and data centres.

New economy real estate vs. old economy real estate

2022 has been defined by the macroeconomic landscape, and inflation is at the top of that list. During a high inflation environment, real estate is an interesting asset class. First of all, we’ve seen how the markets have emphasised cash flows over the concept of possible profits in the future. Many types of real estate investments are known for their capability to generate cash flows. Secondly, there is the fact that, in typical inflationary environments, one should focus more on real assets—assets where the value should increase at least in line with inflation. The value of real estate has been known to do this well over time, even if we could never guarantee it always would in the future.

But, since the Covid-19 pandemic, are we equally excited by shopping malls and old-style office buildings as we once were?

In our view, ‘new economy’ real estate is defined by the physical infrastructure that needs to exist for different megatrends to continue to scale. Two of the most important focal points of megatrend infrastructure are:

- Cell phone towers
- Data centres

Cell phone towers

When considering cell phone tower real estate in 2022, the primary attributes would be incredible visibility into business cash flows and, also, very little economic variability. These companies tend to deal in very long-dated contracts, and they also tend to operate in the investment-grade end of the credit spectrum1.

In 2022, if we think beyond the difficulties of the macro picture, we can see that we are in the earlier stages of the global 5G deployment. One could think that the primary activities to upgrade global networks began in 2021, and while we can’t know for sure how long the upgrade cycle will take, it could be somewhere in the range of 5 to 7 years as a reasonable prediction. With these upgrades, there tends to be both software and hardware-oriented elements2.

The business model of cell phone towers is fairly simple - the entities that want to use the hardware (like telecommunications companies) will pay regular fees to do so. If we think of 'data as the new oil', it's similar to how energy producers pay the pipeline companies to use the infrastructure. It's notable to consider the difference between US and non-US companies with respect to how they tend to deal with inflation:

US companies have tended to sign deals with longer, multi-year terms and 3% annual, fixed escalators. In past years, this was excellent. In years when inflation is at or near double-digit levels, of course it is less ideal3. Non-US companies tend to see deals where there are uncapped escalators that are indexed to various measures of consumer price inflation4.

Investors may be curious to understand the difference between focusing more directly on the companies that, for instance, provide the 5G services, as opposed to the companies that provide the infrastructure that allows for the data to be transferred more efficiently. We'd note that, if one is thinking about telecommunications companies in particular, the rates that they can charge consumers are very regulated. Additionally, these companies are forced to make huge capital expenditures to be able to say they can at least match the best network capabilities. Cell phone towers may not have the same visibility, but we return to our original note about the visibility of cash flows and the limited variability of cash flows. Remember, it's more about the fact that the pipes are needed than exactly what is flowing through them.

Data centres

If readers take away one point about data centres from this piece, it should be this: data centres are all about scale. If one is thinking about Equinix and Digital Realty Trust today, one should be recognising that these are unrivalled global platforms. Operating a new data centre today at low scale would be a horrible business. Equinix data centres, spread across many of the world's countries, function as the backbone of the internet.

Some might think, 'why can't the world's largest companies like Microsoft, Amazon and Alphabet just build their own data centres? Why do they need to pay Equinix or Digital Realty Trust?' We can agree that the negotiating power of data centre providers against these companies has not been high historically but, in 2022, it has been interesting that a few things are changing:

- Internet traffic has been increasing
- The supply of the right types of semiconductors to use in data centres has still been tight
- It is not necessarily a simple matter to increase the capacity of existing data centres or to build new data centres in the right locations, at least with enough speed to match the demand

Like commodities, if the supply of data centres is tightening and the demand is stable to increasing, then the price should tend to increase. It's possible that we will see some of the biggest growth in pricing power of data centres in 2022 that we've seen in recent history5.

We'd also note an interesting practice that we have seen from Equinix, again, one of the largest players in the space. Equinix actually hedges roughly 2 years of its forecasted energy demand. This means that customers will not have to pay the full cost of energy price increases. At a time when energy prices have risen significantly, this is a very interesting policy to consider6.

Conclusion: real estate could have a place within a thematic strategy

Thematic equities are frequently equated with growth equities, and with good reason. However, for those thematic investors that might, for example, prefer to see cash flow generation as a primary attribute, new economy real estate is an interesting consideration. A data centre real estate investment trust (REIT) will exhibit a totally different look and feel of an income statement than a Software-as-a-Service (SaaS) cloud company. Maybe in 2022's macro environment the correlation between these two is a bit higher but, once the fundamentals of the underlying businesses come to the fore, we think the two should exhibit significant differences in risk and return.

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1 Source: hoyacapital.com/cell-tower-reits

2 Source: statista.com/chart/23194/5g-networks-deployment-world-map/

3 Source: dgtinfra.com/cell-tower-lease-rates-agreements

4 Source: dgtinfra.com/cell-tower-lease-rates-agreements

5 Source: Ryan, Carol. "Data Centres Are Unpopular. All the Better for Their Stocks." Wall Street Journal. 30 August 2022.

6 Source: Maurer et al. "Hedges Give Companies Temporary Relief from Surging Energy Prices." Wall Street Journal. 14 March 2022.

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