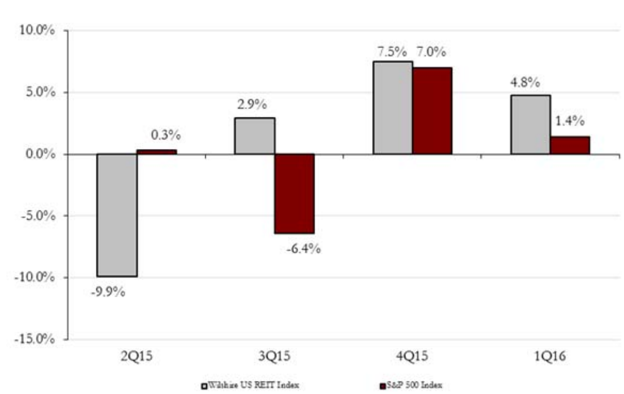
REITs outperform in a volatile quarter. After a violently flat 2015 in the US equity markets, the action became just plain violent into the New Year as volatility was imported from China along with t-shirts and housewares. Small signs of economic weakness (e.g. 157,000 jobs added in January vs. expectations of 185,000) blossomed into full-blown recession fears amid a growing chorus of Monday morning quarterbacks questioning the decision by the FOMC to raise the federal funds rate by 25 bps in December 2015. After the S&P 500 Index dropped more than 10% through mid-February, share prices began to recover, led first by bargain hunting and short covering and joined later by corporations buying back stocks after earnings were reported. Diminishing prospects of another rate hike in the near term, a weakening dollar and stabilizing oil prices helped turn sentiment.

The Wilshire US REIT Index ("Index") delivered a total return of 5.2% in First Quarter, handily outperforming both the S&P 500 Index which advanced 1.4% and the Russell 2000 Index which declined 1.5%. The vast majority of the constituents in the Wilshire US REIT Index produced positive returns (94 out of the 117 constituents) but there was significant dispersion in total returns with the best performing REIT, DuPont Fabros Technology, Inc., returning 29.0% compared to -19.2% for the worst, First Potomac Realty Trust.

REITs vs. S&P 500 Index

Total Return



Source: Bloomberg and Wilshire Associates

Sector Performance of the Wilshire US REIT Index

Ranked by First Quarter 2016 Performance

Sector	1Q 2016	Trailing 1-Year	Current Yield
Factory Outlet	12.3%	7.7%	3.1%
Storage	10.8%	42.6%	2.5%
Industrial	10.5%	7.1%	3.8%
Local Retail	7.9%	8.1%	3.4%
Industrial-Mixed	6.8%	23.4%	3.9%
Hotel	6.1%	-16.1%	5.9%
Regional Retail	5.7%	4.3%	3.3%
Wilshire US REIT	**5.2%**	**4.8%**	**3.6%**
Mfd. Housing	4.7%	25.3%	2.6%
Apartments	4.5%	13.1%	3.0%
Health Care	3.2%	-6.8%	5.6%
Office	-0.2%	-6.3%	3.0%
Diversified	-1.7%	-9.1%	2.8%

Source: Wilshire Associates

Cross-currents. Outperforming sectors in the Index in First Quarter were a mixed bag. Some of the REIT equivalent to the FANG (Facebook, Amazon, Netflix and Google) stocks which did well in 2015 continued their outperformance: most notably, Storage and Data Centers - offering secular growth in a global economy bereft of cyclical growth. Some of the economically sensitive sectors which did poorly in 2015 had a rebound in First Quarter: Industrial and Hotel as bottom-fishing kicked in with the turn of the calendar.

The laggards generally had difficult earnings calls during the quarter: Apartments (decelerating rent growth), Health Care (terrible operating fundamentals) and Office (new supply in key markets).

Despite some of the reversion to the mean that we witnessed in First Quarter, there still exists a huge disparity in valuations between the "haves" and the "have nots" in the Index. For example, Storage stocks, on average, still trade at 40% premiums to Net Asset Values ("NAV") compared to Hotel and Office stocks which trade at 15% discounts. Hotel stocks are offering 337 bps additional yield in dividends than Storage stocks.

Sun takes advantage of its cost of capital. On March 22, Sun Communities, one of two public pure-play operators of manufactured home and recreational vehicle communities in the Index, expanded its portfolio by 103 properties through the acquisition of Carefree Communities from private equity sponsor Centerbridge Partners for $1.7 billion. The transaction highlights Sun's ability to quickly mobilize opportunistic capital at a scale that would be difficult for a private company to duplicate as they were able to leverage existing capacity on their balance sheet and raise $385 million in net proceeds though a secondary issuance of equity (at a roughly 15% premium to NAV).

For Sun, the transaction is earnings accretive given the arbitrage between public and private pricing, but it is also another step in a multi-year process to upgrade its portfolio quality. The profile of assets in this acquisition is very attractive with the majority of sites in retirement states California and Florida, about half of which is age-restricted (generally regarded as an indicator of quality). Through the transaction, Sun has expanded its portfolio size by over 30% while raising its proportionate exposure to age-restricted communities from 25% to 33%. The acquisition is a nice extension of a portfolio repositioning story that has seen Sun grow its sites by 84% ($2.6 billion) since 2011.

Brookfield goes "All In" on Rouse. On January 19, global asset manager Brookfield Asset Management announced an offer to acquire all outstanding shares of Rouse Properties for $17.00 per share in cash, a 26% premium to the REIT's share price but still nearly a 15% discount to NAV. Brookfield and Rouse subsequently agreed on an improved $18.25 per share cash offer on February 25, a 35% premium to the unaffected share price, valuing the retail REIT at $2.8 billion; the deal is expected to close sometime this summer.

Having inherited its 33% ownership in Rouse from a January 2012 spin-off from General Growth Properties, Brookfield faced the unenviable choice of selling down its position in Rouse Properties at a steep discount to break-up value or go "all in" with the unconventional belief that B-mall fundamentals will improve over time against the headwinds of deteriorating department store fundamentals and the continued market share gain of e-commerce. It is unclear whether Brookfield has made the appropriate choice for its investors but the asset manager should be comforted by the increased fees that will be generated from managing the remaining 67% of Rouse.

Observations from the Field – Elvis Rodriguez

Over a couple of rainy days, we traveled through Seattle and Bellevue visiting REIT office properties. Behind Austin and Denver, Seattle was the third fastest growing city in 2015. Obviously, technology has been the driver of population and job growth in the last five years. The office market giants are Amazon and Microsoft; while their real estate strategies have been different, a centralized campus for Amazon in Seattle's South Lake Union vs. offices for Microsoft spread through Redmond and Bellevue, both have had been a leading force in office demand and growth. Amazon now accounts for 8 million of Seattle's 60 million sq. ft. and Microsoft comprises approximately 2 million of Bellevue's 8 million sq. ft.

Lately, Amazon and Microsoft have been joined by Apple, Facebook, etc. who have begun to establish a presence in the MSA to recruit talent for their growing operations. Venture activity is also strong in the region; VC funding to technology companies was up 228% in Third Quarter 2015 vs. Third Quarter 2014, as reported by Dow Jones Venture Source, for a total investment of $80.2 million. The MSA's home grown startups include Redfin and Bungie (spun off from Microsoft in 2007) headquartered in Seattle and Bellevue, respectively. Kilroy Realty, the leading office REIT in the area, derives 18% of its rental income from Seattle and Bellevue. Prominent tenants include Adobe in Seattle and Expedia in Bellevue. Kilroy is 95.1% leased in the region.

Similar to other centers of the knowledge economy like San Francisco and Cambridge, life science tenants are flourishing alongside tech; Bristol-Myers Squibb, Celgene and Gilead, to name a few, have a footprint in the area, anchored by the Fred Hutchinson Cancer Research Center and the Gates Foundation. Alexandria Real Estate Equities, the only public lab space REIT, derives 5% of its rental income from Seattle. Prominent tenants include Juno Therapeutics and ZymoGenetics. Alexandria is 99.6% leased in Seattle.

All good things in commercial real estate must, if not come to an end, at least face the adversity of new supply. Property developers are taking advantage of the strength in population and job growth with speculative development; over the next 18 months, approximately 2 million sq. ft. and 1 million sq. ft. of new supply will be introduced to Seattle and Bellevue, respectively.

Capital issuance is up slightly. According to NAREIT, $15.1 billion in capital was raised in First Quarter, more than the $10.2 billion raised in the prior quarter but slightly less than the $22.1 billion raised a year ago in First Quarter 2015. A little more than half of the activity comprised issuance of unsecured bonds; there were 14 offerings totaling $8.0 billion during the quarter, on par with the $6.9 billion issued in the prior quarter and the $8.6 billion issued a year ago. There were 20 secondary equity issuances totaling $6.6 billion and four offerings of preferred shares totaling $0.5 billion. There were no IPOs during the quarter.

Simon Property Group started the New Year with the sale of two senior notes due July 15, 2021 ($550 million) and January 15, 2026 ($800 million); the coupon on the two notes were 2.5% and 3.3%, respectively. As a point of comparison, Unibail-Rodamco, a European regional mall company, placed two bonds totaling €1.0 billion; the coupon was 1.125% on the 11-year maturity and 2.0% on the 20-year maturity (the longest maturity ever for a real estate company in the Euro market). According to the company, "these issuances attracted more than €5.0 billion in demand in less than 2 hours." A race to the bottom is in full force among lenders across the globe.

Fund flows are mixed. According to AMG Data Services, net flows out of dedicated domestic real estate funds, excluding ETFs, totaled $2.1 billion in First Quarter 2016 compared to inflows of $1.4 billion in First Quarter 2015. However, flows from US and Global mutual funds registered in Japan strengthened, estimated to be $5.3 billion in First Quarter 2016 (it was $8.2 billion for all of 2015) compared to $1.9 billion in First Quarter 2015.

Transaction activity backs up REIT valuations. According to Real Capital Analytics ("RCA"), total sales of commercial properties were $111 billion in First Quarter 2016, down 20% year-over-year. Transaction volumes were down for all property types except Apartment, which saw elevated levels of portfolio activity.

RCA noted that (i) volumes declined the most in the six "Major Metros" and (ii) there was uncertainty and widening spreads in the CMBS market. Clearly, correlation does not imply causation as the purchase/sale of high quality assets in top markets are the least dependent on CMBS financing. More likely, buyers became reluctant paying peak prices at what is likely late innings in the commercial real estate recovery.

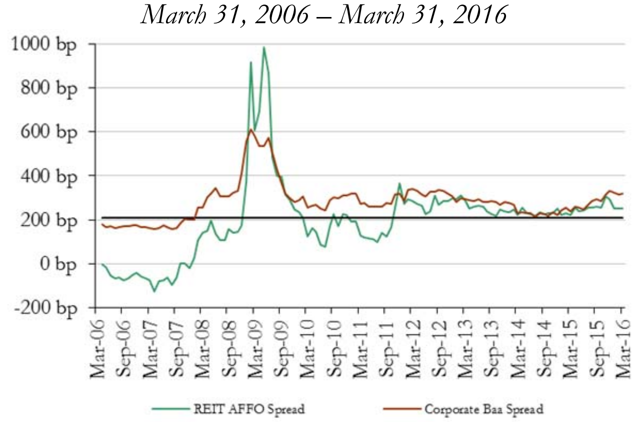
Premium/Discount to Net Asset Value
REIT Universe
March 31, 2006 – March 31, 2016

Source: Adelante Capital Management and Green Street Advisors

Risk premium remains above the ten-year average. The risk premium for owning commercial real estate, as represented by the spread between REIT cash flow yields and the riskless rate of return, still trades well above the 10-year average. Despite the 5.2% advance in the Wilshire US REIT Index during the quarter, the spread between REIT cash flow yields and the 10-Year Treasury Note yield actually widened from 253 bps to 276 bps (compared to the 10-year average of 209 bps) because the yield on the 10-Year Treasury Note Yield declined 48 bps during the quarter. As of March 31, there was still a healthy premium for taking the risk of owning commercial real estate via REITs.

The Corporate Baa spread compressed from 321 bps to 310 bps at quarter-end; the Corporate Baa spread is still above the 10-year average of 288 bps.

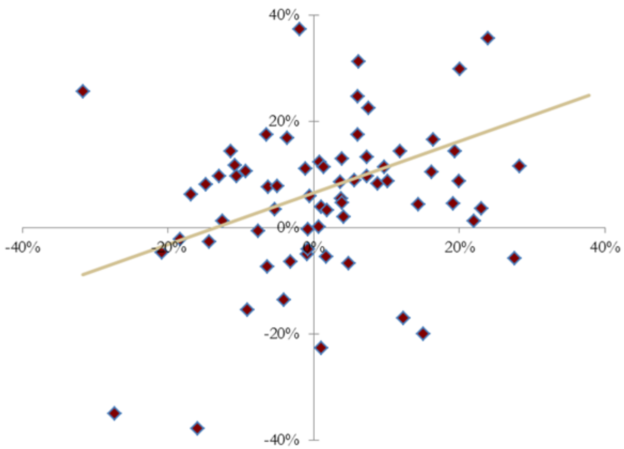
Spread Comparison
REIT Cash Flow and Corporate Baa Yields vs.
10-Year Treasury Note Yield
March 31, 2006 – March 31, 2016



Source: Adelante Capital Management and Green Street Advisors

Outlook

Premium/Discount to Net Asset Value
Vs Total Return
REIT Universe
March 31, 2015 – March 31, 2016



Source: Adelante Capital Management and Green Street Advisors

For the past two quarters, we've written about the outperformance of growth/momentum over value. Above is a scatter gram with the x-axis representing premiums or discounts to Green Street Advisor's NAV estimates at the end of First Quarter 2015 and the y-axis representing total returns for the year ending First Quarter 2016. As you can see, there has been a demonstrable correlation (negative) between value and performance. Disaggregated into quartiles, the cheapest REITs (14.3% discounts to NAV on average) produced total returns of 0.6% for the year compared to 4.8% for the Index. The second and third quartiles produced total returns of 6.0% and 10.1%, respectively. The most expensive quartile (20.8% premiums to NAV) produced average total returns of 15.3%!

Last quarter, we offered one potential explanation for the underperformance of the value names – that REIT investors were anticipating slower growth in the near to intermediate future and were willing to pay almost any price for companies and property types offering secular growth, not too dissimilar to what was happening in the broader equity market. The momentum/growth stocks in the REIT space have been the Storage, Manufactured Housing and Data Center companies. Conversely, with heightened concerns about a near-term recession, investors were willing to sell Hotel and Regional Mall companies (especially owners of B/C malls) at any price; the prospect for technological disruption in those two sectors via Airbnb and Amazon certainly did not embolden potential investors.

A second possible explanation for the divergence in performance is that there is growing consensus that we are late in the commercial real estate cycle. At the latest Citi Global Property CEO Conference held in March this year, results of an informal poll showed that 70% of the attendees thought that we were in the 7th or 8th innings in terms of operating fundamentals and 8th or 9th innings in terms of valuation. Obviously, the slope (shallow) of the recovery subsequent to the Great Recession offers hope for extra innings but trees don't grow to the sky, however slowly. If we are in the late innings, there is a strong possibility that NAV estimates are overly optimistic, especially for property types like Hotel and CBD Office whose constituents currently trade at the biggest discounts to NAV.

Finally, with the pending promotion of real estate as a stand-alone sector under the Global Industry Classification Standard (GICS) structure, there may have been a steady influx of non-dedicated REIT money coming into the sector given how underinvested generalist funds are in REITs; in a recent report, JP Morgan estimated that equity managers would have to allocate $125 billion to $150 billion to the new sector to get to benchmark weight. With outflows from dedicated real estate funds, the marginal buyer of REIT shares is not the dedicated REIT investor who looks to NAV to guide their purchases but rather generalist investors who look to earnings and dividend yield. Dedicated REIT investors who have refused to pay up for non-core assets and property types because of inferior real estate quality may have been replaced by the equity investors who see only potential for spread compression in commercial real estate of marginal provenance.

As we mentioned in our previous REITview, if the recession fears are excessive, there could be real value in some of the beaten up cyclical REITs. Additionally, given that the vast majority of commercial real estate rests in private hands, capital flows should correct dislocations in value over time. However, given the level of uncertainty about the economy and the future path for interest rates and the influx of non-dedicated investors into the insular REIT community, investors should expect more of the unexpected for the foreseeable future.