ADELANTE
Capital Management

REIT *VIEW* – United States

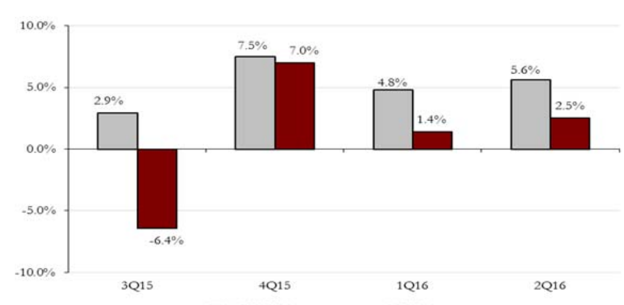
Second Quarter 2016

REITs outperform in a volatile quarter. Leading into the final round of the 2016 US Open, Dustin Johnson, the eventual champion, was asked about the disastrous three-putt on the final hole of last year's US Open which cost him that tournament, to which he replied with aplomb, "What happened last year?" If Dustin Johnson was asked about the global economy in Second Quarter, he might have answered, "What happened in the UK?"

Prior to the tumult surrounding the Brexit vote, the financial markets in the US were performing a delicate pas de deux with the Federal Open Markets Committee ("FOMC"). A good jobs report and Chairman Yellen would assuage the markets that the path to higher interest rates would be gradual; a bad jobs report and Chairman Yellen would say that growth was still on track and that she was ready to fight inflation. With the Brexit vote, the Kabuki theater starring the FOMC troupe closed for the year; the 10-Year Treasury Note yield collapsed from 1.786% to 1.488% during the quarter.

The Wilshire US REIT Index ("Index") delivered a total return of 5.6% in Second Quarter, outperforming both the S&P 500 and the Russell 2000 Indices which advanced 2.5% and 3.8%, respectively. The vast majority of the constituents in the Wilshire US REIT Index produced positive returns (87 out of the 116 constituents) but there was significant dispersion in total returns with the best performing REIT, NexPoint Residential Trust Inc., returning 40.9% compared to -22.7% for the worst, Felcor Lodging Trust Inc.

REITs vs. S&P 500 Index
Total Return



Source: Bloomberg and Wilshire Associates

Sector Performance of the Wilshire US REIT Index
Ranked by Second Quarter 2016 Performance

Sector	2Q 2016	Trailing 1-Year	Current Yield
Industrial	18.0%	40.1%	3.2%
Industrial-Mixed	16.4%	59.4%	3.3%
Mfd. Housing	13.8%	44.2%	2.3%
Health Care	12.7%	22.9%	5.0%
Office	8.5%	15.4%	2.8%
Factory Outlet	8.5%	32.1%	3.2%
Local Retail	8.1%	34.5%	3.2%
Diversified	6.3%	8.1%	2.6%
Wilshire US REIT	**5.6%**	**22.8%**	**3.5%**
Regional Retail	4.6%	22.6%	3.2%
Apartments	-1.0%	19.5%	3.1%
Hotel	-.3.3%	-13.9%	6.2%
Storage	-5.7%	41.6%	3.0%

Source: Wilshire Associates

Interest rate sensitive sectors outperform. Given the plunging 10-Year Treasury Note yield, it is not surprising that the interest rate sensitive sectors in the Index like Manufactured Housing, Health Care and Factory Outlet vastly outperformed the cyclical sectors like Apartments and Hotel during the quarter. Even within Office and Retail, Suburban outperformed CBD and Strips outperformed Malls. This type of dispersion between property types is very similar to what occurred in the fall of 2012/spring of 2013, the last time there was a sharp decline in interest rates in the US.

What is different this time around is the emergence of secular growth sectors: Self Storage, Data Centers and, lately, Industrial, all to greater or lesser extent stories of technological disruption. The latest iteration of that meme is the Industrial sector whose landlords are seeing significant uptick in demand for both first generation and second generation space by internet retailers. In a "lower for longer" world of interest rates and returns, shares in companies and property types that can demonstrate growth are being bought by investors at any price.

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Heads are rolling in REITland; "Qu'ils mangent de la brioche." On June 20, WP Glimcher announced the resignation of its eponymous CEO and Vice-Chairman; recall that Michael Glimcher sold his company to Washington Prime Group in early 2015. In the same press release, the company stated that it will take a charge related to (i) management changes and (ii) an "investigation of strategic alternatives," about which there were rumors circulating in the marketplace in the weeks prior. Most likely, the Board of Directors and the CEO reached an impasse about the future of the company and the CEO resigned. Given the background of the named interim CEO, Louis Conforti, whose resume is peppered with stints in private equity and investment banking, the likelihood of a renewed investigation of strategic alternatives is high despite his assertion that "during the next few months,… we'll be … concentrating on the basics of our business."

On July 11, DDR Corp announced the termination of David Oakes, its President and CEO. According to the press release, the termination "was not related to the Company's financial or operating results or to any disagreements or concerns regarding the Company's financial or reporting practices;" since (i) David Oakes and DDR recently consummated a new employment contract in May and (ii) there was no severance payment, most likely, the CEO was fired for cause. Replacing him is Thomas August, new to the shopping center business but long familiar to REIT investors; he was most recently CEO of Equity Office Property Trust under Blackstone and, back in the day, CEO of Prentiss Properties Trust. While some parallels may be drawn to management changes at WP Glimcher, the concurrent high profile hiring of Vincent Corno as EVP of Leasing and Development from DICK'S Sporting Goods suggests that in this instance, it really is business as usual.

On July 11, HCP announced that Michael McKee, Chairman, has assumed the role of interim President and CEO from Lauralee Martin, with the search for a permanent CEO expected to be completed in six months. Working off the excesses of an acquisition binge spearheaded by its former CEO, Jay Flaherty, HCP has recently underperformed its large-cap Health Care peers and has seen numerous changes in the C-Suite. With the spin-out of its troubled ManorCare skilled nursing portfolio in the works, perhaps the Board thought that a fresh start in management was due. Assuming the successful execution of its spin-out, HCP has a good enough portfolio to be viable, albeit in a sector with numerous headwinds. Like DDR, HCP has made some high profile hires in the past year; likely, the Board will stay the course for the foreseeable future.

Observations from the Field – Benjamin Yang

We attended the International Council of Shopping Centers (ICSC) "RECon" leasing convention in May, the annual gathering of landlords, retailers, investors and others associated with the retail real estate industry. Attendance was estimated to be over 37,000, slightly higher than last year but still below the peak 50,000+ that gathered in Las Vegas in 2007 when new development and store-opening decisions were, in hindsight, ruled by animal spirits.

RECon was particularly timely this year given the weak sales (blame the weather/stronger dollar) and steep share price declines experienced by many bricks and mortar retailers heading into the convention. Department stores continue to lose market share and relevancy with the consumer, compelling mall owners to adapt and seek alternative "anchors" to draw shoppers into their centers including dining, cinemas and other entertainment options.

Meanwhile, e-commerce continues to take larger slices of the spending pie. Omni-channel retailers are reporting more robust growth on-line than off, while new e-tailers seemingly pop up out of nowhere on a daily basis.

Amazon casts an increasingly larger shadow over the industry each year and is now the second largest clothing seller in the US. Past growth has come from basics and non-branded goods while future growth is expected to come from fashion apparel; Morgan Stanley estimates that Amazon will represent nearly 20% of all US apparel sales by 2020, up from 7% today. Amazon also plans to produce private label products and deliver perishable foods, with the higher gross margins of the former effectively subsidizing "the last mile" delivery costs of the latter – clearly not good news for grocers and owners of neighborhood shopping centers which have been more "internet-resistant" than other retail venues.

The outlook for retail real estate is challenged, yet proclamations surrounding the "death of bricks and mortar" may be premature. Successful e-tailers are opening physical stores, citing the merits of having a physical presence. Amazon opened its first bookstore in Seattle last year, with scuttle suggesting a goal to open upwards of 300 to 400 more. Ironically, Amazon's attendance at ICSC this year created positive buzz and excitement for an industry that hasn't had much to cheer about in a while.

Capital issuance is up slightly. According to NAREIT, $22.7 billion in capital was raised in Second Quarter 2016, more than the $15.1 billion raised in the prior quarter and the $18.3 billion raised a year ago in Second Quarter 2015. A little more than half of the activity comprised issuance of unsecured bonds; there were 25 offerings totaling $12.5 billion during the quarter, significantly more than the $8.0 billion issued in the prior quarter and the $10.0 billion issued a year ago. There were 24 secondary equity issuances totaling $7.6 billion and 13 offerings of preferred shares totaling $1.4 billion. There was one IPO in the REIT space, MGM's $1.2 billion spin-off of a portfolio of casino properties to triple-net investors.

Subsequent to the end of the quarter there was a handful of large secondary offering of equity. On July 5, Ventas, Inc. issued 9 million shares to fund a $1.5 billion purchase of a portfolio of life science properties from Blackstone. On July 6, Retail Opportunity Investments Corp. issued 5.7 million shares to pay down the line of credit which it had previously tapped to purchase shopping centers in Westlake and Monterey, CA. Also on July 6, Alexandria Real Estate Equities, Inc. issued 6.5 million shares to fund a $725 million purchase of One Kendall Square, a 650k sf lab space campus in Cambridge, MA. As long as there is a credible use of proceeds, REITs trading at premiums to NAV are finding a receptive audience for their equity to fund accretive acquisitions.

Fund flows are mixed. According to AMG Data Services, net flows out of dedicated domestic real estate funds, excluding ETFs, totaled $0.9 billion in Second Quarter 2016 compared to outflows of $1.6 billion in Second Quarter 2015. However, flows from US and Global mutual funds registered in Japan continue to be strong, estimated to be $6.0 billion in Second Quarter 2016 (it was $8.2 billion for all of 2015) compared to $1.6 billion in Second Quarter 2015.

Transaction activity backs up REIT valuations. According to Real Capital Analytics ("RCA"), preliminary figures for total sales of commercial properties were down 20% year-over-year for a second consecutive quarter. Transaction volumes were down for all property types except CBD Office and Apartment.

RCA does note that sales volumes accelerated in June and "preliminary estimates for the Moody's/RCA CPPI suggest that prices began to climb again in Q2 '16 after a bit of a pause in Q1 '16."

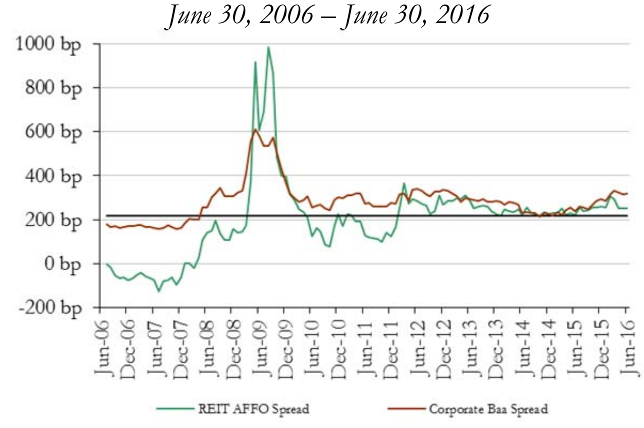
Premium/Discount to Net Asset Value
REIT Universe
June 30, 2006 – June 30, 2016

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 5.6% 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 276 bps to 293 bps (compared to the 10-year average of 217 bps) because the yield on the 10-Year Treasury Note Yield declined 30 bps during the quarter. As of June 30, there was still a healthy premium for taking the risk of owning commercial real estate via REITs.

The Corporate Baa spread compressed from 310bps to 283 bps at quarter-end; the Corporate Baa spread is now below the 10-year average of 291 bps.

Spread Comparison
REIT Cash Flow and Corporate Baa Yields vs.
10-Year Treasury Note Yield
June 30, 2006 – June 30, 2016



Source: Adelante Capital Management and Green Street Advisors

Outlook

Why has the rebound from the great financial crisis been so tepid, so modest? In short, there are demographic, technological and globalization trends below the surface that we papered over for a long time with global credit boom. Median income hasn't been good for a long time in the U.S., but we didn't notice it because we had access to progressively more credit. Our growth numbers seemed faster as a result, and we felt richer. But the underlying growth rate was deteriorating.

Under the surface several things were evolving. The baby boomers were getting older and less productive. The US labor force was barely growing. The effect of women coming into the labor force had maxed out. At the same time, China joined the WTO, and fresh flowers that once had to be locally sourced, could now, thanks to supply chain technology, be brought in from Ecuador overnight. Technology and globalization worked together to create, effectively, a huge supply shock to the US labor market, dampening our growth rate and wages. As a result, the lion's share of US growth accrued to those who controlled capital.

This—not the Fed, not Bush, not Clinton, not Obama—is the hidden reality the GFC laid bare. The global character of the phenomenon is why it's basically been the hidden reality in Europe and Japan too. Hard to pin it on your favorite US political target when the phenomenon is global. Worse, unless you want to try to roll back technology, there's not really all that much policy can do about it.

Mark Dow, Behavioral Macro, June 22, 2016

The stunning Brexit vote was the final nail in the coffin for any further intervention by the FOMC for the rest of 2016. In fact, many in the investment community believe that the FOMC tightening cycle is over, having effectively started with the exit from Quantitative Easing (remember the "Taper Tantrum?"); the current implied probabilities for a future rate hike does not cross 50% until November 1, 2017. With inflation figures stubbornly low, only a policy blunder by the hawkish members of the FOMC would upset the apple cart and that possibility seems remote with what is likely to be a volatile election in the US looming. If Donald Trump can call Pope Francis "disgraceful," the Washington Post "phony and dishonest" and claim that Chief Justice Ginsburg's mind is "shot," is there an estate of the realm that is safe from criticism?

With the denominator battened down for the foreseeable future, the numerator and expectations thereof are largely shaping investment returns. Domestic cash flows are better than global, longer lease terms are better than shorter and secular growth is gold.

In the land of the blind, the one-eyed man is king and REITs have reigned over investment alternatives since the end of the Great Financial Crisis, which outperformance seems sustainable. **Operating fundamentals for REITs are still solid.** Occupancy levels are almost 200 bps above the historical average of 93.2%, allowing landlords to push rents and improve margins. Same-store NOI is also well above the historical average of 2.9% for the group. Given the fact that REITs are required to pay out 90% of their taxable income, their earnings growth is not manufactured through wholesale share buybacks like some of the S&P 500 companies. It may be an indictment on the rest of the US companies, but, for better or worse, REITs are starting to populate the growth segments of the various indices.

Obviously, REITs have had a strong run and the multiples that investors are assigning to REIT cash flows are historically high so the margin of safety is not great. Supply continues to be the Achilles heel for the group. Almost every pocket of recent underperformance can be attributed to supply: New York City (Hotel, Office and Apartment), San Francisco (Office and Apartment) and Houston (Office). **While the overall level of new supply remains well below historical averages, there are areas of concern and investors should remain vigilant.**

Global Yield Comparison
Generic Government 10-Year Yields
January 2011 – June 2016

Source: Bloomberg