Adelante Capital Management

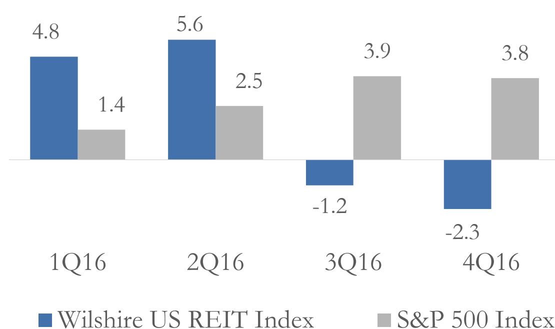
REIT VIEW - DOMESTIC

Fourth Quarter 2016

A Huge Win for the Donald. 2016 has turned out to be *annus horribilis* for establishment politics and politicians as well as pollsters who have repeatedly underestimated global populist discontent, which discontent found an unlikely champion in the US in a billionaire prone to tweeting late into the night. Perhaps even more unexpected than the election result was the reaction of the capital markets subsequent; huge losses in the futures markets were quickly reversed and all facets of a "reflation" trade came on display: small caps, cyclicals and financials up, bond yields up and the dollar up. While the President-elect would probably like to take all the credit for the animal spirits awakened, in reality, the US economy was already showing signs of life and, at close to full employment, wage/inflation pressures were being felt even before the election. With the FOMC at the forefront of tighter monetary policy, not only was the yield on the 10-year Treasury Note rising but the yield differential to global counterparts meant that the dollar was strengthening. Only the equity markets seemed uncertain about the balance between a stronger economy and the deleterious effects of rising rates; when Trump won the election, the promise of pro-business policies of deregulation, tax cuts and fiscal stimulus was like gasoline poured on tinder and equities were off to the races.

The Wilshire US REIT Index ("Index") delivered a total return of -2.3% in Fourth Quarter, underperforming both the S&P 500 and Russell 2000 Indices which advanced 3.8% and 8.8%, respectively. For the year, the Index delivered total returns of 7.3% compared to 12.0% and 21.3% for the S&P 500 and Russell 2000 Indices. Since the GFC, this is only the second calendar year that the Index has underperformed its equity counterparts.

REITs vs. S&P 500 Index (%)
Total Return



Source: Bloomberg and Wilshire Associates.

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

Sector	4Q16	2016	Current Yield
Hotel	19.7%	23.5%	5.0%
Diversified	2.6	8.3	2.4
Apartments	1.7	3.8	3.2
Industrial	1.0	31.1	3.4
Industrial-Mixed	0.3	28.7	3.3
Storage	0.2	-8.2	3.8
Office	0.1	12.2	2.9
Wilshire US REIT	**-2.3**	**7.3**	**3.7**
Mfd. Housing	-3.6	28.8	2.3
Factory Outlet	-7.3	16.3	3.6
Local Retail	-9.0	2.2	3.8
Health Care	-10.3	6.8	5.4
Regional Retail	-11.5	-5.0	3.9

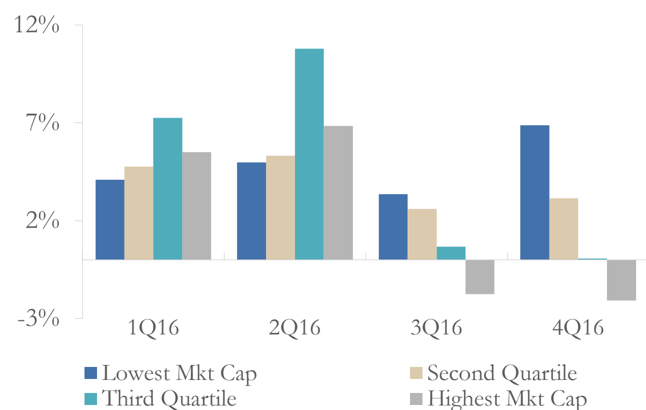
Source: Wilshire Associates.

Not All REITs are Created Equal in a Reflationary World. The duration of the lease term was the most important variable in determining Fourth Quarter relative performance by property type. Hotels were the clear winners as investors bid up the stocks despite deteriorating fundamentals reported during Third Quarter earnings and problems in two of the major REIT markets for 2017: New York City (supply) and San Francisco (renovation at the Moscone Center). Conversely, Health Care and Net Lease woefully underperformed during the quarter as investors fled interest rate sensitivity.

Interestingly, Retail continues to suffer in performance. Historically, Retail landlords were thought to be beneficiaries of a better economy and higher retail sales: Regional Malls (lower occupancy costs and higher percentage rents), Power Centers (better credit profile for the tenants) and grocery-anchored Neighborhood Centers (higher rents from in-line tenants) generally have outperformed during periods of good GDP growth but fears of a secular decline vis a vis internet retail and obsolescence of the anchor store, as exemplified by problems at Sears and the pulled Neiman Marcus IPO, have scared buyers away. With Retail landlords trading at meaningful discounts to Net Asset Values, investors may be underestimating prospects for bricks and mortar, especially at the higher end of sales productivity.

Large cap REITs underperform. Since the financial crisis, large market cap REITs have underperformed within the Index as they have generally lagged the smaller, more speculative companies during the recovery. With the real estate cycle perhaps approaching maturity, the performance gap was closed somewhat in calendar year 2015 before the large caps resumed their underperforming ways in 2016. Assuming quarterly compounding and rebalancing between the four quartiles, $1,000 invested in an equal weighted basket of the largest market capitalization stocks at the end of 2015 would have been worth $1,084 a year later; in comparison, the same $1,000 invested in a basket of the next three market capitalization quartiles would have been worth $1,197, $1,168 and $1,207, respectively.

Total Returns by Market Capitalization Quartile (%)
Wilshire US REIT Index
December 31, 2015 to December 31, 2016



Source: Wilshire Associates.

Interestingly the role of passive money and index inclusion may have had a significant role in the underperformance of the large caps; returns for REITs in the Russell 2000 Index were 19.8% on average compared to 4.3% for those REITs in the S&P 500 Index. Unfortunately, the S&P 500 Index is populated by blue-chip REITs with high quality commercial real estate in supply constrained markets managed by the most competent management teams, all traits favored by active REIT dedicated portfolio managers and their investment teams who have historically outperformed benchmark indices. As Mike Kirby, co-founder of Green Street Advisors, points out, "In recent years, however, the dedicated REIT community has generally underperformed at the same time that large sums of AUM flowed out of their hands and into passively managed vehicles. Conventional wisdom holds that the weak performance was the cause of the negative funds flow, which is surely the case. But that is only half the story, as it appears that the inverse is also true: negative fund flows was likely a cause of weak performance."

Observations from the Field – Suzanne Sorkin, CFA

We attended REITWorld in Phoenix, AZ in November; this semi-annual conference sponsored by NAREIT is usually a great opportunity for investors to get one-on-one time with management teams and hear their perspective on everything from recent operating trends to capital allocation and balance sheet management. This November's REITWorld was especially insightful from a big picture perspective as it occurred one week after Donald Trump became the President-elect. If sentiment could be summarized into one word, it would be uncertainty – uncertainty around economic growth, interest/cap rates, transaction activity, capital flows and tax reform.

Top of mind was tax reform – how will the potential for the full expensing of capital investments (immediate depreciation of improvements) and the elimination of interest deductibility affect real estate values? Would these changes increase taxable net income for REITs and, as such, would payouts/dividends be higher for REITs? Will the 1031 exchange rule (which allows investors to defer capital gains) be eliminated and what impact will this have on net lease REITs as 1031 buyers are most active in that space? Time will tell how all of this unfolds but, in the near-term, it appears that transaction activity will be muted.

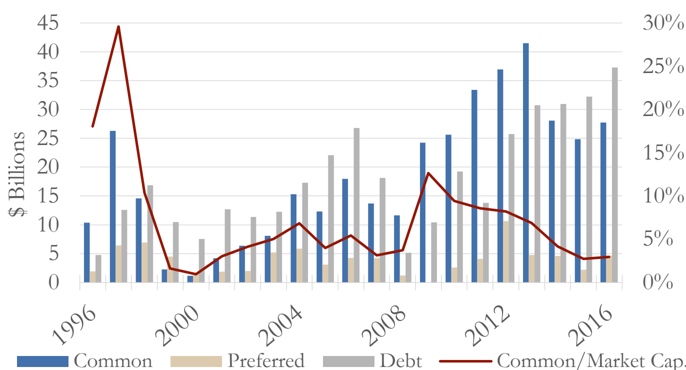
There was also much chatter on the future of the GSEs (Fannie Mae and Freddie Mac) under the Trump administration. Would they continue to exist and, if not, what would happen to apartment values given that GSEs currently represent 40% of the multifamily mortgage market? Most REITs do not employ GSE financing so their balance sheets would not be affected but any change is likely to disrupt apartment values, at least in the short-term; even the initial discussions of GSE reform led to a 3% drop for the apartment REITs on the first day of the conference. Longer-term, GSE reform might actually benefit the REITs given their access to alternative forms of debt and equity capital should dislocation arise in the market.

The potential repeal of the Affordable Care Act ("ACA") and the resulting effect on the healthcare REITs was also a conversation topic. Given that most of the health care REITs have limited exposure to hospitals (which have been major beneficiaries of the ACA) and most are focused on private-pay senior housing facilities, consensus was that the impact would be negligible. There was also much talk about changes to trade regulations and a destination-based tax system and the potential fall-out (negative) on industrial REITs. If investors came to Phoenix looking for answers, most likely they left disappointed.

Capital issuance is up slightly. According to NAREIT, $10.5 billion in capital was raised in Fourth Quarter 2016, significantly less than the $21.3 billion raised in the prior quarter but on par with the $10.2 billion raised a year ago in Fourth Quarter 2015. The capital activity took place primarily in the issuance of unsecured bonds (there were 13 offerings totaling $6.1 billion during the quarter, about half the $10.9 billion issued in the prior quarter and on par with the $6.9 billion issued a year ago); additional issuances include one small IPO totaling $77 million, 11 offerings of secondary equity totaling $2.9 billion and 8 offerings of preferred equity totaling $1.5 billion.

Historical Offering of Securities

1996 – 2016



Source: NAREIT.

Fund flows are mixed. According to AMG Data Services, net flows out of dedicated real estate funds, excluding ETFs, totaled $5.5 billion in 2016 compared to outflows of $6.1 billion in 2015 and net inflows of $5.3 and $3.8 billion in 2014 and 2013, respectively. Flows from US and Global mutual funds registered in Japan more than compensated, estimated to be $17.9 billion in 2016 compared to $8.2, $18.1 and $11.8 billion in 2015, 2014 and 2013, respectively. However, most of the inflows came during the first three quarters of the year; highly publicized reductions in distributions stemmed the tide from Japan in Fourth Quarter.

Transactions are down. According to Real Capital Analytics ("RCA"), total sales of commercial properties were down 11% year-over-year; however, negative comparisons were the worst in Fourth Quarter, down 21%, as investors took to the sidelines in front of the election; in terms of property types, apartments were the outlier with volumes up 3% year-over-year. On a preliminary basis, RCA is projecting "ongoing price growth through Fourth Quarter 2016," however, they do note that single tenant lease properties saw sequential widening of cap rates of 20 to 40 bps from Third Quarter to Fourth Quarter 2016.

Premium/Discount to Net Asset Value

REIT Universe

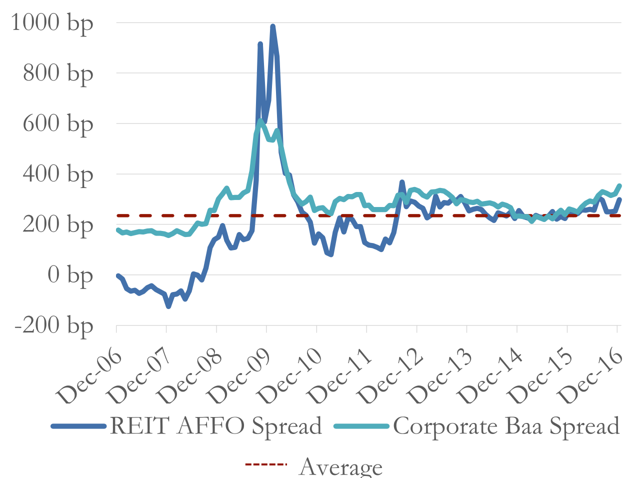
December 31, 2006 to December 31, 2016

Source: Adelante Capital Management and Green Street Advisors.

Risk premium is in-line with 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, now trades on par with the 10-year average of 234 bps. With the 2.3% retreat in the Wilshire US REIT Index and some organic growth, the cash flow yield for REITs improved from 4.63% to 4.80%; however, the yield on the 10-Year Treasury Note shot up from 1.61% to 2.45% and, as a consequence, the spread between REIT cash flow yields and the 10-Year Treasury Note yield narrowed from 302 bps to 235 bps. As of December 31, there was still a healthy yield premium for taking the risk of owning commercial real estate via REITs. With the sharp sell-off in bonds, the Corporate Baa spread actually widened from 268 bps to 304 bps at quarter-end; the 10-year average is 297 bps.

Spread Comparison

REIT Cash Flow and Corporate Baa Yields vs.
10-Year Treasury Note Yield
December 31, 2006 to December 31, 2016



Source: Adelante Capital Management and Green Street Advisors.

Outlook

The staff's forecast for real GDP growth over the next several years was slightly higher, on balance, largely reflecting the effects of the staff's provisional assumption that fiscal policy would be more expansionary in the coming years. These effects were substantially counterbalanced by the restraint from the higher assumed paths for longer-term interest rates and the foreign exchange value of the dollar. The staff projected that real GDP would expand at a modestly faster pace than potential output in 2017 through 2019. The unemployment rate was forecast to edge down gradually, on net, and to continue to run below the staff's estimate of its longer-run natural rate through the end of 2019; the path for the unemployment rate was a little lower than in the previous projection.

The near-term forecast for consumer price inflation was somewhat higher than in the previous projection, reflecting recent increases in energy prices. Beyond the near term, the inflation forecast was little revised. The staff continued to project that inflation would edge up over the next several years, as food and energy prices along with the prices of non-energy imports were expected to begin steadily rising in 2017. However, inflation was projected to be marginally below the Committee's longer-run objective of 2 percent in 2019

Minutes of the Federal Open Market Committee, December 13-14, 2016

Reviewing the returns of the various property types in the Index subsequent to the election, it is clear that the duration of the lease term was the most important factor in determining the relative winners and losers. However, there is a ceiling to the reflation trade for even the most ardent fan of President Trump and a unified Republican Congress; otherwise, active REIT managers can just shorten the duration of their portfolios and outperform for 2017 and beyond. A number of mitigating factors come to mind: "monetary offset," global yield differentials and the possibility that Trumpflation may disappoint in actuality.

It is interesting to note that for the FOMC staff, the risk to their projections for real GDP growth (which they characterize as "similar to the 20-year average") is actually to the downside since "monetary policy appears to be better positioned to offset large positive shocks than substantial adverse one." The Staff seems to be espousing the concept of monetary offset, defined in a recent Bloomberg article as "an effort by a central bank, which guides monetary policy, to use an increase in interest rates to tamp down economic growth spurred by spend or tax cuts, the fiscal policy of its government."

If the FOMC's mandate is "maximum employment, stable prices, and moderate long-term rates (*Federal Reserve Act of 1977),"* and if its members believe that we are already at full employment, then don't they have to sterilize the excesses of future fiscal stimulus? Moreover, with yields on sovereign bonds of comparable credit quality hovering near zero, how much higher can the US 10-Year Treasury Note yield go given global capital flows? Finally, what are the chances that a first-term President (with disruptive tendencies) can deliver all the tax reform, deregulation and fiscal stimulus that an 8.8% move in the Russell 2000 Index implies? After all, Ladbrokes, the British-based gambling company, is offering 11 to 10 odds that Donald Trump will "leave via impeachment or resignation in the first term." As with the Affordable Care Act, it may be easier to tear something down than to build something up.

At the end of the day, there are limits to hopium and there will be demand for the durable cash flow characteristic of commercial real estate as represented by REITs, even those with long-duration leases, and relative performance in the long run will be determined by fundamentals and the law of supply and demand. However, the valuation band between REITs trading at discounts and premiums to Net Asset Values have been stretched recently beyond historical norms by the influx of passive money and generalist investors (who seem to be more thematic in nature than dedicated REIT investors) so… to quote Jean-Jacques Rousseau, "patience is bitter but its fruit is sweet."

Relative Performance (REITs vs S&P 500) vs. 10-Year Treasury Note Yield
December 31, 2015 to December 31, 2016

Source: Bloomberg and Wilshire Associates.