

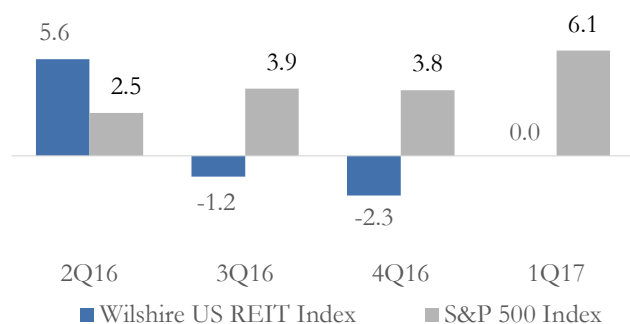
Glass Half Full. Not surprisingly, politics dominated the start to the New Year. The optimism that permeated the investment/corporate community after the election of Donald Trump somehow managed to survive in First Quarter (i) an ill-fated immigration ban, (ii) a half-hearted attempt to “repeal and replace” the Affordable Care Act and (iii) a never-ending investigation into the potential collusion between members of the victorious Trump campaign and Russia.

As mentioned in the previous *REITView*, readings of economic data in the US had been steadily improving leading up to the election and this improvement continued in First Quarter. As a result, implied probabilities of an increase in the federal funds rate steadily climbed intra-quarter; when the Bureau of Labor Statistics reported an addition of 235,000 in February non-farm payroll employment compared to estimates of 200,000, the first rate hike of 2017 became all but a formality. Surprisingly, despite all the hoopla leading up to the March 14/15th Fed meeting, the yield on the 10-Year Treasury Note actually fell from 2.446% to 2.396% during the quarter; most of the decline took place after the rate hike – buy the rumor, sell the news apparently.

The Wilshire US REIT Index (“Index”) was essentially unchanged in First Quarter, underperforming both the S&P 500 and Russell 2000 Indices which advanced 6.1% and 2.5%, respectively. The majority of the constituents in the Index produced negative returns (70 out of the 118 constituents) and there was significant dispersion in total returns with the best performing REIT, Silver Bay Realty Trust, returning 26.0% compared to -22.5% for the worst, Cedar 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 2017 Performance

Sector	1Q17	Trailing 1-Year	Current Yield
Mfd. Housing	8.1%	11.8%	2.3%
Health Care	6.6	10.8	5.1
Industrial	3.8	22.5	3.4
Office	1.9	14.9	2.8
Apartments	0.3	-0.3	3.3
Wilshire US REIT	0.0	2.0	3.8
Industrial Mixed	-0.4	22.1	3.3
Storage	-1.4	-18.4	3.9
Hotels	-1.5	14.6	5.2
Diversified	-2.2	7.7	2.7
Regional-Retail	-4.6	-14.3	4.2
Factory Outlets	-7.5	-6.6	4.0
Retail-Local	-8.0	-12.1	4.2

Source: Wilshire Associates.

A Reversal of Fortunes. In terms of relative performance by sectors, First Quarter saw a reversal of the reflation trade as REIT investors, at least, had some misgivings about Trumpflation. Short duration property types gave back some of their Fourth Quarter 2016 gains while interest rate sensitive sectors like Health Care and Manufactured Housing bounced back in performance.

The one constant in relative performance by property type, recently, has been the woes of retail REITs; while the calendar may have turned, investor sentiment on malls and shopping centers has not. Holiday sales were anemic; J.C. Penney said that it would close 140 stores and Sears frightened shareholders with “going concern” language. It has gotten so bad that hedge funds are starting to buy credit default swaps on commercial mortgage backed securities secured, at least in part, by malls and shopping centers, a strategy reminiscent of bets against subprime mortgages during the financial crisis. Clearly e-commerce is a global threat; however, unlike the rest of the world, America is extremely over-retailed and anchor tenants in the US are having an existential crisis. Until the rationalization runs its course, the baby (internet resistant formats like grocery anchored neighborhood centers and A malls in top-flight locations) will continue to get thrown out with the bath water.

An Inflection Point for Single Family Rentals? First Quarter was very important for the burgeoning property sector of single family rental homes as REIT investors saw the high-profile IPO of Invitation Homes, Inc. (“INVH”) as well as a large M&A transaction between Silver Bay Realty Trust (“SBY”) and acquiring Canadian company, Tricon Capital Group (trades on TSX under “TCN”). Both the IPO and merger highlighted the importance of scale as a driver of future efficiency/margin expansion; four years after its debut, the sector is starting to prove itself and garner institutional investors as operations have become streamlined with the help of sophisticated technology systems to facilitate leasing and maintenance.

On January 31st, Blackstone successfully listed its single family rental platform, Invitation Homes, with gross assets of ~\$13 billion/~50,000 homes in a \$1.8 billion IPO; the IPO priced at \$20/share, the high end of the range, and the company used the proceeds to pay down debt. The INVH portfolio is high quality (average rental rate of ~\$1,625/month and occupancy of 96%), concentrated in major markets like Atlanta, Phoenix, Tampa, Los Angeles, Seattle and Orlando. INVH has achieved significant scale in most of its markets with an average of ~2,000 homes/market and prides itself on its strong operational prowess/potential for industry leading same-store NOI growth. Prior to its IPO, INVH made a significant announcement that it had secured a \$1 billion commitment from Fannie Mae (with Wells Fargo) for a 10-year, fixed rate securitization financing. While the GSEs have been long-time lenders to multifamily (Fannie Mae and Freddie Mac represent ~40% of the multifamily mortgage market), the INVH securitization represents the first time the GSEs have provided financing to the single family rental market.

On February 27th, Silver Bay announced an agreement to be acquired by Tricon Capital Group for \$21.50/share or \$1.4 billion, including the assumption of debt. While the deal price was slightly below SBY’s own published NAV estimate, it did represent an 18% premium to the previous close. SBY had been handicapped by size/cost of capital disadvantage; conversely the buyer was motivated by a desire to gain critical mass. Tricon was able to double its portfolio, making it the fourth largest public company in the nascent sector. From a portfolio quality perspective, TCN and SBY are a good match (average rental rates of ~\$1,200/month) with significant geographic overlap (top six MSAs now average more than 1,000 homes/market). Going forward, it remains to be seen whether Tricon will be the consolidator of lower quality single family rentals currently being eschewed by the likes of Invitation Homes and the other large US REITs, American Homes 4 Rent and Colony Starwood.

Observations from the Field – Jeung Hyun

In March, we attended Citi’s 22nd Annual Global Property CEO Conference in Florida. There were over 1,100 registered attendee from around the globe, investors (from 200 investment firms) and company representatives (from 150 companies); this year, there was an increase in attendance by generalist investors. Citi is always the first industry-wide conference for the year, a good venue to gauge investor and company sentiment following fourth quarter earnings.

Michael Bilerman, head of Citi’s REIT research conducts three surveys during the Conference, one targeted to CEOs and two to the broad audience (during lunches). This year, CEOs expected same-store NOI to be up 3.1% in 2018, down 70 bps from the same survey taken last year; CEOs are also anticipating a slight increase in private market cap rates to accompany hikes by the FOMC. The attendees were equally divided between expectations for positive and negative total returns for REITs in 2017, concerned mostly with the path for interest rates; they believed that the best performing sectors will be data centers, industrial and “other residential” while the worst performing sectors will be net lease and health care, not surprising given the source of their concerns. The vast majority of the attendees thought that we were in the latter innings of the real estate cycle, both public and private; consistent with that view, about half of the attendees thought that the US would enter a recession in either 2018 or 2019.

Coming so soon after Fourth Quarter 2016 earnings and 2017 guidance, there was not much said at the conference that surprised investors. Protestations from retail landlords that they were not going to be put out of business by Amazon fell on deaf ears as retail REITs were the worst performing stocks in the Index during the week of the conference; conversely, CEOs on the right side of the technology divide (data centers and industrial) had an easier time at the conference with tailwinds behind their operating fundamentals. The biggest question for apartment and self-storage CEOs pertained to supply in 2017 and beyond; in reality, the CEOs did not come to Florida with crystal balls in their luggage and investors probably left the conference with their biases intact. Hotel and office CEOs were asked about the effect of “animal spirits” on demand for room nights and office space; not surprisingly, “too early to tell” was the most popular answer. Finally, health care and triple-net investors were grilled about corporate strategy in the face of rising cost of capital; unfortunately, CEOs are not compensated to shrink their companies so they will most likely continue to pursue external growth opportunities despite diminishing accretion and/or rising risk.

Capital issuance is up slightly. According to NAREIT, \$23.1 billion in capital was raised in First Quarter 2017, significantly more than both the \$10.5 billion raised in the prior quarter and the \$15.1 billion raised a year ago in First Quarter 2016.

The capital activity took place primarily in the issuance of unsecured bonds (there were 32 offerings totaling \$11.4 billion during the quarter, significantly more than both the \$6.1 billion issued in the prior quarter and the \$8.0 billion issued a year ago) and secondary issuance of equity (there were 23 offerings totaling \$8.9 billion during the quarter, significantly more than both the \$2.9 billion issued in the prior quarter and the \$6.6 billion issued a year ago). Additional issuances include three IPOs totaling \$1.9 billion and six offerings of preferred equity totaling \$0.9 billion.

Fund flows are mixed. According to AMG Data Services, net flows out of dedicated real estate funds, excluding ETFs, totaled \$2.3 billion YTD in 2017 compared to outflows of \$2.1 billion in First Quarter 2016. Dedicated real estate funds have been seeing outflows for a while, \$5.5 billion and \$6.1 billion in 2016 and 2015, respectively, but, flows from US and Global mutual funds registered in Japan had more than compensated in the past; however, highly publicized reductions in distributions have stemmed the tide from Japan in the past two quarters.

Flows out of US and Global mutual funds registered in Japan are estimated to be \$1.8 billion YTD in 2017 compared to inflows of \$8.3 billion in First Quarter 2016. According to Citi, “The \$1.8 billion of outflows from Japan is before the funds’ over distribution of their dividends, and we estimate outflows from Japan are actually closer to ~\$4.0 billion YTD when accounting for the over-distribution of dividends paid... Recent reductions (in dividends) have meaningfully lowered the amount of stock that would need to be sold to meet the difference between the Japanese REIT funds’ now reduced dividend yield of ~19% (and the actual dividend yield on the underlying REIT securities).”

Transactions are down. According to Real Capital Analytics (“RCA”), total sales of commercial properties were down 23% year-over-year (on a preliminary basis) for First Quarter, the second straight quarter of double digit declines. Per RCA, “Investment sales activity fell in 2016 due mostly to the pullback of the portfolio and entity-levels which had fueled the sharp pace of deal growth in 2015. For 2016 as a whole, single asset sales still posted positive gains in volume. Into Q1 ’17, however, single asset sales have now fallen at double-digit rates as well.” The property type experiencing the greatest decline in transaction volume was apartments.

Premium/Discount to Net Asset Value

REIT Universe

March 31, 2007 to March 31, 2017



Source: Adelante Capital Management and Green Street Advisors.

Risk premium is in-line with the ten-year average.

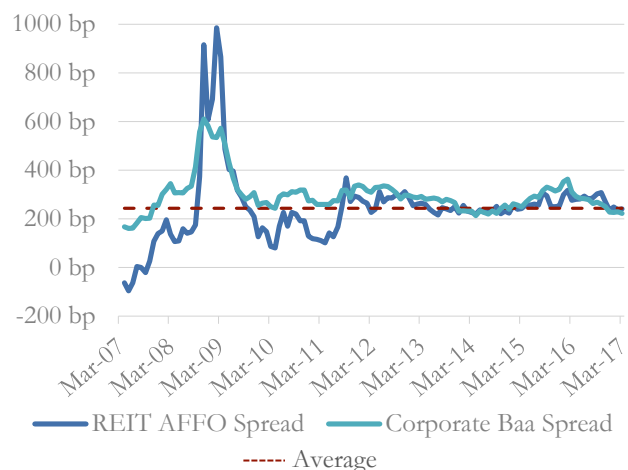
The risk premium for owning commercial real estate, as represented by the spread between REIT cash flow yields and the riskless rate of return, now trades on par with the 10-year average of 243 bps. The cash flow yield for REITs was unchanged at 4.80% while the yield on the 10-Year Treasury Note declined from 2.45% to 2.40% and, as a consequence, the spread between REIT cash flow yields and the 10-Year Treasury Note yield increased slightly from 235 bps to 240 bps. As of December 31, there was still a healthy yield premium for taking the risk of owning commercial real estate via REITs. The Corporate Baa spread was also relatively unchanged at 221 bps.

Spread Comparison

REIT Cash Flow and Corporate Baa Yields vs.

10-Year Treasury Note Yield

March 31, 2007 to March 31, 2017



Source: Adelante Capital Management and Green Street Advisors.

OUTLOOK

Consistent with the Policy Normalization Principles and Plans, nearly all participants preferred that the timing of a change in reinvestment policy depend on an assessment of economic and financial conditions. Several participants indicated that the timing should be based on a quantitative threshold or trigger tied to the target range for the federal funds rate. Some other participants expressed the view that the timing should depend on a qualitative judgment about economic and financial conditions. Such a judgment would importantly encompass an assessment by the Committee of the risks to the outlook, including the degree of confidence that evolving circumstances would not soon require a reversal in the direction of policy. Taking these considerations into account, policymakers discussed the likely level of the federal funds rate when a change in the Committee’s reinvestment policy would be appropriate. Provided that the economy continued to perform about as expected, most participants anticipated that gradual increases in the federal funds rate would continue and judged that a change to the Committee’s reinvestment policy would likely be appropriate later this year...

Minutes of the Federal Open Market Committee, March 14-15, 2017

In the previous *REITView*, some mitigating factors capping the 10-Year Treasury Note yield were noted: “monetary offset,” global yield differentials and the possibility that the Trump administration may disappoint in actuality.

Thus far, the legislative accomplishments of President Trump and a unified Congress have been underwhelming. After demonizing Obamacare for the past seven years, Speaker Ryan and the Republican House of Representatives couldn’t even muster enough partisan votes to bring the hastily prepared American Health Care Act up for vote, blocked by hard-core conservatives on their own side of the aisle. Aside from ideology, there was apparently a procedural rationale for trying to enact AHCA before taking on tax reform. AHCA would have reduced the deficit for the current fiscal year allowing for easier targets for the next fiscal year (and bigger tax cuts). The failure to pass AHCA has certainly put a ding on that supply-side dream as was acknowledged by House Speaker Ryan on March 24th when he said, “Yes, this does make tax reform more difficult. But it does not, in any way, make it impossible.”

In the most recent *Minutes of the Federal Open Market Committee* there was a section titled “System Open Market Account Reinvestment Policy,” where the staff briefed the Committee on what to do with its \$4.5 trillion balance sheet and the participants deliberated on details. The participants on the Committee generally seemed sanguine about the economy going forward and they anticipated both continued increases in the federal funds rate and the potential start of balance sheet reduction by

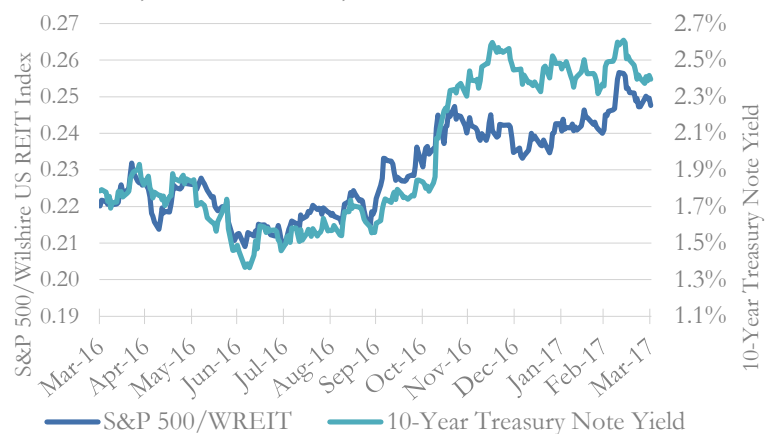
the end of 2017 (a ~five year process assuming a target of ~\$2.0 trillion, according to John Williams, president of the San Francisco Federal Reserve Bank). Never mind that the Committee has been overly optimistic, intentionally or unintentionally, about both the improvement in the US economy and the pace of rate hikes; if they embark on reducing the balance sheet, a large buyer of long-duration Treasuries and agency MBS would be out of the market place auguring declining prices and higher yields (and a steepening yield curve if reducing the balance sheet replaces raising the federal funds rate). Or would it?

According to Michael Darda, Chief Economist at MKM Partners, “The consensus view remains that any prospective balance sheet shrinkage will send long rates higher, perhaps appreciably. But this may turn out to be wrong. Yes, there would be a short term ‘liquidity effect’ from asset sales/the cessation of reinvesting interest and maturing securities. But the long term ‘income and inflation effects’ tend to dominate the liquidity effects, meaning a tighter monetary policy (relative to a looser one) will tend to be associated with 1) slower NGDP growth than would otherwise be the case; 2) lower inflation than would otherwise be the case, and 3) lower nominal bond yields than would otherwise be the case.”

Propelled by prospects for Trumpflation, the S&P 500 Index advanced 6.1% during the quarter; however, the bond markets tell a different, less upbeat, story as the yield on the 10-Year Treasury Note actually fell 5 bps. While REITs finished flat for the quarter, given (i) a reasonable cash flow yield above the riskless rate of return, (ii) share prices below break-up values and (iii) supply held in check in most markets, prospects for REITs for the rest of 2017 do not seem all that dire.

Relative Performance (REITs vs S&P 500) vs. 10-Year Treasury Note Yield

March 31, 2016 to March 31, 2017



Source: Bloomberg and Wilshire Associates.