REIT *VIEW* - DOMESTIC

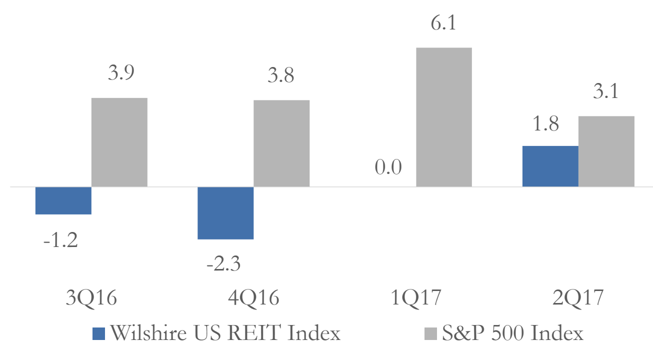
Second Quarter 2017

Panem et Circenses. Economic data released during the quarter was somewhat weak, headlined by an "advance" estimate for First Quarter 2017 GDP growth of just 0.7%, well below the consensus estimate of 1.0%. While projections have since been revised up to 1.4%, it is still below the average GDP growth of 1.9% and 1.6% in 2015 and 2016, respectively. The May nonfarm payroll number of 138,000 (compared to consensus estimates of 185,000) also proved disappointing during the quarter; again, that figure has since been revised up to 152,000 but it is still below the averages of 226,000 and 187,000 in 2015 and 2016, respectively. Based on the weak numbers, the yield on the 10-Year Treasury Note fell for the second straight quarter from 2.396% to 2.302%.

While politics may have provided plenty of entertainment during the quarter, its effect on the financial markets have been ephemeral at best. On the legislative front, nothing much has been accomplished (except perhaps the confirmation of Neil Gorsuch to the Supreme Court). President Trump firing FBI director Comey created a media firestorm and a sharp one-day drawdown in the equity markets but it may end up being a big fat "nothing burger." Ditto for "Trumpcare" and the President's one page tax plan.

The Wilshire US REIT Index ("Index") was up 1.8% in Second Quarter, underperforming both the S&P 500 and Russell 2000 Indices which advanced 3.1% and 2.5%, respectively. The majority of the constituents in the Index produced positive returns (66 out of the 118 constituents). The best performing REIT, Universal Health, was up 24.4% and the worst, DDR Corp., was down 26.1%.

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 2017 Performance

Sector	2Q17	Trailing 1-Year	Current Yield
Industrial	12.9%	21.9%	2.7%
Industrial Mixed	8.0	12.4	3.1
Mfd. Housing	7.5	13.6	2.2
Apartments	5.7	6.3	3.1
Health Care	5.4	3.6	4.9
Wilshire US REIT	**1.8**	**-1.7**	**3.7**
Office	0.4	6.4	2.9
Hotels	0.3	19.0	5.3
Diversified	-0.9	1.4	2.7
Storage	-2.6	-15.6	4.0
Retail-Regional	-4.6	-21.8	4.5
Retail-Local	-10.7	-27.5	4.8
Factory Outlets	-19.9	-32.8	5.3

Source: Wilshire Associates.

More of the Same. In terms of relative performance by sectors, Second Quarter 2017 looked very similar to the First; REIT investors continued to exhibit skepticism about the pace of economic expansion in the US and rewarded those property types that have tenancies benefitting from secular demand, primarily driven by technology, like Industrial (e-commerce) and Industrial-Mixed (data/cloud deployment). Interestingly, among the short-duration property types, REIT investors favored Manufactured Housing and Apartments over Hotels, despite well-documented concerns about the over-supply of multifamily in the high-end markets in gateway cities.

To a certain extent, Apartment REITs (as well as other "core" property types like Office) may just be benefitting from the flight of capital away from anything Retail. With the announcement of the acquisition of Whole Foods Market by Amazon for $13.7 billion during the quarter, the last bastion of safety in retail and retail real estate seems to have been swarmed by the e-commerce horde. To some, the transaction can be interpreted as a validation of well-located grocery anchored shopping centers as a viable venue for "last-mile" delivery, however, REIT investors chose to see the glass as being half empty and continued to sell all three Retail sectors.

A Busy Quarter for M&A. On April 24, RLJ Lodging Trust announced its acquisition of FelCor Lodging Trust in an all-stock transaction initially valued at $2.9 billion. FelCor had recently been targeted by activist investors and had been pursuing strategic alternatives for a while; however, the combination of RLJ (high-quality limited service) with FelCor (low-quality full service) seems to offer little besides the $22 million in G&A savings and, as a result, RLJ shares declined 6.3% on the day that the deal was announced.

On May 7, Sabra Health Care REIT announced its acquisition of Care Capital Properties, Inc. in an all-stock transaction. While Care Capital shareholders are expected to own 59% of the combined entity, the company will be led by the Sabra management team and board. Benefits to Sabra shareholders include diversification of tenancy, earnings accretion and $20 million in cost savings; negatives include a reduction in overall EBITDAR coverage in the combined Skilled Nursing portfolio as well as an overall decline in portfolio quality. For better or for worse, the deal can best be characterized as two drunken sailors leaning on each other for support, i.e. two mid-sized operators combining to drive down their cost of capital in a challenging Skilled Nursing sector buffeted by regulatory and reimbursement headwinds.

On June 9, Digital Realty announced its acquisition of DuPont Fabros in an all-stock transaction initially valued at $7.6 billion. M&A has been steady in the data center space as companies use their cost of capital advantage to create broadly diversified companies capable of serving an array of customer needs ranging from "hyperscale" to retail. DuPont Fabros was the only pure play wholesale data center company extant and it was only logical that it get absorbed into a more diversified platform with all its promise, real or not, of cross-selling and pricing power.

Two smaller M&A transactions were announced during the quarter. On June 28, Government Properties Income Trust announced its acquisition of First Potomac Realty Trust in an all-stock transaction initially valued at $1.4 billion and on June 30, Parkway Inc. announced that it will be acquired by the Canada Pension Plan Investment Board for $1.2 billion. In the REIT space, there have always been willing buyers but not always willing sellers. With the exception of DuPont Fabros, the selling companies have either underperformed and/or are facing challenging fundamentals or irrelevance. Kudos to the boards and management teams of FelCor, Care Capital, DuPont Fabros, First Potomac, and Parkway for pursuing a favorable outcome for their shareholders, ignoring the siren song of job security.

Observations from the Field – Michael Torres

In May, the Urban Land Institute's Spring Meeting descended on Seattle, WA to network and bear witness to large scale urban development underway to a burgeoning technology eco-system. In fact, a new acronym is being thrown around town, "GAFA," referring to Google, Amazon, Facebook, and Apple, all of whom have been expanding very quickly in Seattle despite Microsoft's presence.

Amazon is the key driver of this office development cycle as it expands from South Lake Union into the Denny Triangle neighborhood, an easy walk away. The result of the development efforts of three generations of the Clise family, the Denny Triangle has become one of the most unique urban sites in America. This low-rise area will now accommodate 4 million square feet of new office space, anchored by Amazon. According to GeekWire, Amazon is projected to occupy about 12 million square feet across 40 buildings in Seattle by 2022, up from 8.5 million square feet at year end 2016; their requirements now stand at more than 20% of the current office inventory for the MSA! One of the unique features of Seattle's development boom will be the Biospheres - three giant, greenery-filled domes. This will surely become a local attraction, serving to remind Amazon employees of the eponymous rainforest.

Not surprisingly, investors (a.k.a. capital) have also been attracted to Seattle. In January, New York-based TriStar Capital and RFR Holding bought the newly constructed 290,647 square foot Urban Union office building in South Lake Union for $268.9 million, setting a record high price of $925 per square foot. Kilroy Realty Corp, an office REIT, has begun its 333 Dexter development, a 630,000 square foot office building in South Lake Union, on a speculative basis. Rainer Square Tower, an impressive mixed use tower, will begin construction in Seattle's CBD core later this year.

Of course, there are consequences to this Gold Rush: traffic, soaring construction costs, declining affordability and now proposals for taxes targeting the wealthy. With only 70,000 residents in the downtown core, Seattle drivers spent an average of 55 hours stuck in traffic last year, making it one of the top 10 worst cities in the US for congestion. Construction labor costs in Seattle are now the third highest in the world behind only Zurich and New York. Average apartment rents exceed $2,100 per month and home prices are up 12% year-over-year with the median home price exceeding $630,000. Paradoxically, U.S. News and World Reports ranked Seattle as the sixth best city to live in the country. This social laboratory will be one to monitor and visit for years to come.

Capital issuance is down slightly. According to NAREIT, $21.1 billion in capital was raised in Second Quarter 2017, slightly less than both the $23.1 billion raised in the prior quarter and the $22.7 billion raised a year ago in Second Quarter 2016.

The capital activity took place primarily in the issuance of unsecured bonds (there were 29 offerings totaling $10.2 billion during the quarter, slightly less than both the $11.4 billion issued in the prior quarter and the $12.3 billion issued a year ago) and secondary issuance of equity (there were 29 offerings totaling $8.8 billion during the quarter, slightly less than the $8.9 billion issued in the prior quarter and more than the $7.6 billion issued a year ago). Additional issuances include four small IPOs totaling $0.8 billion and six offerings of preferred equity totaling $1.3 billion.

Funds flow out. According to AMG Data Services, net flows out of dedicated real estate funds, excluding ETFs, totaled $2.0 billion in Second Quarter 2017 compared to outflows of $0.9 billion in Second 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 as well as greater regulatory scrutiny over mutual funds that over distribute their dividends have stemmed the tide from Japan.

Flows out of US and global mutual funds registered in Japan are estimated to be $1.1 billion in Second Quarter 2017 compared to inflows of $6.0 billion in Second Quarter 2016.

Transactions are down. According to Real Capital Analytics ("RCA"), sale of commercial properties in Second Quarter totaled $109.2 billion, down 5% year-over-year. Per RCA, "Volume peaked in this cycle six quarters ago in Q4'15. Looking at volume on a 4-quarter trailing basis to control for seasonal variations, volume is now 13% lower than that peak. Six quarters after the peak in Q4'07, deal volume had already fallen 83%. So the current deal slowdown is nothing like the previous cycle and one should not fret that prices will follow the same path." The property type experiencing the most headwinds is, not surprisingly, retail.

In terms of markets, capital is moving away from the priciest MSAs. Cities like Dallas and Charlotte experienced record transactional volumes in the first half of 2017, up 21% and 44%, respectively, while gateway cities like Manhattan, Seattle and San Francisco all explained declines.

Premium/Discount to Net Asset Value

REIT Universe

June 30, 2007 to June 30, 2017

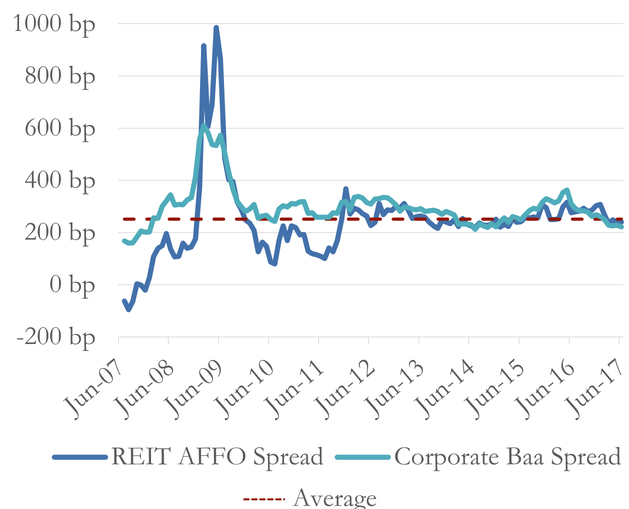
Source: Adelante Capital Management and Green Street Advisors.

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 251 bps. The cash flow yield for REITs was relatively unchanged at 4.76% as was the yield on the 10-Year Treasury Note and, as a consequence, the spread between REIT cash flow yields and the 10-Year Treasury Note yield only increased slightly from 240 bps to 246 bps. As of June 30, there was still a healthy yield premium for taking the risk of owning commercial real estate via REITs. In Second Quarter, the Corporate Baa spread ticked down to 212 bps.

Spread Comparison

REIT Cash Flow and Corporate Baa Yields vs.
10-Year Treasury Note Yield

June 30, 2007 to June 30, 2017



Source: Adelante Capital Management and Green Street Advisors.

OUTLOOK

> Recent readings on headline and core PCE price inflation had come in lower than participants had expected. On a 12-month basis, headline PCE price inflation was running somewhat below the Committee's 2 percent objective in April, partly because of factors that appeared to be transitory. Core PCE price inflation—which historically has been a more useful predictor of future inflation, although it, too, can be affected by transitory factors—moved down from 1.8 percent in March to 1.5 percent in April. In addition, CPI inflation in May came in lower than expected. Most participants viewed the recent softness in these price data as largely reflecting idiosyncratic factors, including sharp declines in prices of wireless telephone services and prescription drugs, and expected these developments to have little bearing on inflation over the medium run…
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> In their discussion of monetary policy, participants generally saw the outlook for economic activity and the medium-term outlook for inflation as little changed and viewed a continued gradual removal of monetary policy accommodation as being appropriate. Based on this assessment, almost all participants expressed the view that it would be appropriate for the Committee to raise the target range for the federal funds rate 25 basis points at this meeting. These participants agreed that, even after an increase in the target range for the federal funds rate at this meeting, the stance of monetary policy would remain accommodative, supporting additional strengthening in labor market conditions and a sustained return to 2 percent inflation.
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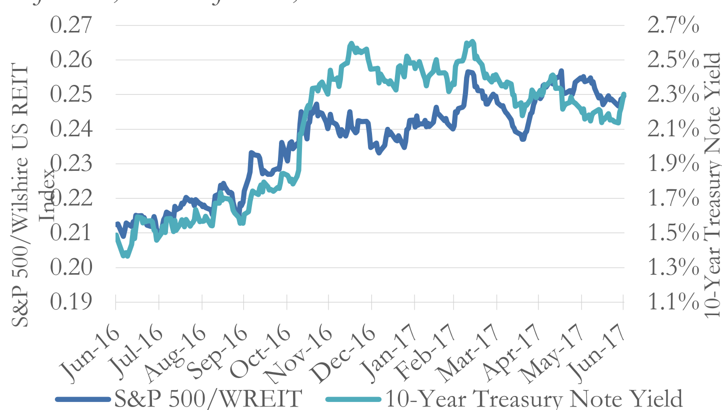
> *Minutes of the Federal Open Market Committee ("FOMC"), June 13-14, 2017*

If the dual mandate of the FOMC is full employment and stable prices (i.e. fighting inflation) and the Committee's preferred measure of inflation, the core personal consumption expenditures price index ("PCE"), is, by their own admission, tipping downward, why is the FOMC continuing on their tightening path? Well, the Committee's Philips Curve models say so. Named after a British economist named A.W. Philips, the Philips Curve suggests that there is an inverse relationship between unemployment and inflation. As we approach what the FOMC considers full employment, the Committee expects that inflation will start to pick up. In anticipation, the FOMC has embarked on a path of reducing monetary accommodation. The Committee has raised the target range for the federal funds rate by 25 bps twice already in 2017 with the expectation of one more 25 bps increase before year-end. In the past two meetings of the FOMC, there have also been detailed discussions about the timing and pace of a balance sheet normalization program to begin in 2017; in a recent appearance on CNBC, former Committee Chairman Ben Bernanke suggested a balance sheet target of $2.5 trillion from current levels of $4.5 trillion.

In the June 17th *Barron's*, there was an article entitled "Is the Federal Reserve Living in the Real World?" suggesting that the FOMC may be underestimating the deflationary forces stemming from technological disruption that are driving prices and wages down. Take, for example, the $13.7 billion acquisition of Whole Foods by Amazon which was announced a few days after the FOMC meeting wherein the Committee members were deliberating over inflation readings that were stubbornly lower than their expectations. Well, Amazon's merchandise margins (excluding AWS, their cloud business) are about one-third of the typical retailers' gross margins; will prices at Whole Foods go up or down subsequent to its acquisition by Amazon? Revenue per employee at Amazon is approximately 10 times the revenue per employee at Whole Foods. Will Whole Foods operate with more or less people at its stores subsequent to its acquisition by Amazon? While globalization may still be the deflationary boogeyman in many parts of the US, the effects of technology will most likely prove more pernicious on wages and prices going forward. It should not be at all surprising that whispers of "universal income" are emanating from Silicon Valley.

So what does this mean for commercial real estate? Well, good news for the denominator; cap rates should stay low, supporting asset prices. It may be a more nuanced story for the numerator. Oversupply should be avoided at all costs as demand (most likely correlated to GDP growth) will not be particularly robust. In the same vein, landlords benefitting from secular demand drivers should outperform those looking for a cyclical uplift. Finally, quality of location is paramount; even in a property type like retail. It is noteworthy that Amazon chose to take on the real estate liabilities of Whole Foods rather than those of Kroger or Safeway.

Relative Performance (REITs vs S&P 500) vs. 10-Year Treasury Note Yield
June 30, 2016 to June 30, 2017



Source: Bloomberg and Wilshire Associates.