REIT *View* - Domestic

Second Quarter 2018

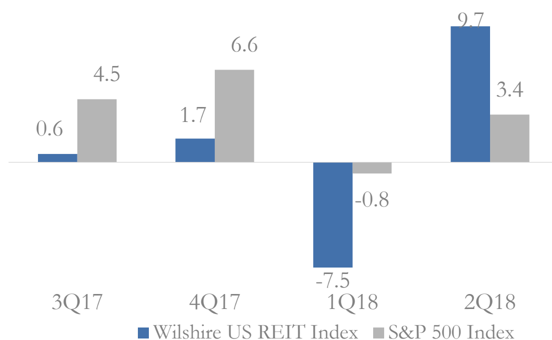
Risk assets in recovery. US equity investors spent most of Second Quarter wondering if the various indices would revisit the lows made in February. From a top down perspective, they had plenty of reasons to worry: (i) an activist FOMC, (ii) trade wars all around and (iii) mega-cap tech companies under regulatory threat; however, the balance or risk did seem more favorable within the US than without (political risk in Italy/EU, FX problems/bear markets for a number high profile emerging markets, etc.) and, buoyed by a strong earnings season (and subsequent share buybacks), risk assets saw a rebound in the US with domestically focused stocks (Russell 2000) outperforming companies which derive their revenues from overseas (S&P 500).

The third estimate of First Quarter GDP growth came in at 2.0% compared to 1.2% for First Quarter 2017; the latest estimate for Second Quarter GDP growth from the Federal Reserve Bank of Atlanta is 4.5% so 2018 is shaping up to be a banner year for economic growth in the US. According to the Bureau of Labor Statistics, changes in total nonfarm payroll in the past three months were 213,000, 244,000 and 159,000, respectively, an average of 205,333 compared to an average of 193,000 for the 12 months prior. The yield on the 10-Year Treasury Note peaked at 3.115% on May 17 and ended the quarter at 2.849%.

The Wilshire US REIT Index ("Index") was up 9.7% in Second Quarter, besting both the S&P 500 and Russell 2000 Indices which advanced 3.4% and 7.8%, respectively; this is the first quarter of REIT outperformance in eight, a clear reversion to the mean for the group; every constituent in the Index except one produced positive returns.

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 2018 Performance

Sector	2Q18	Trailing 1-Year	Current Yield
Storage	15.1%	21.3%	3.6%
Health Care	14.9	-9.7	5.9
Hotels	13.2	16.3	4.7
Retail-Local	12.3	3.5	4.9
Diversified	11.1	0.9	3.8
Industrial Mixed	10.6	3.9	3.1
Wilshire US REIT	**9.7**	**3.9**	**3.9**
Retail-Regional	9.4	5.3	4.8
Factory Outlets	8.5	-4.3	6.0
Office	7.5	1.7	3.1
Industrial	7.2	16.4	2.9
Mfd. Housing	6.5	11.9	2.1
Apartments	6.2	-1.3	3.5

Source: Wilshire Associates.

A "junk rally" in REITs. Interestingly, the Second Quarter charge by the group was led by the previous laggards in the Index; Health Care, Diversified and Retail-Local all rebounded strongly from negative double digit returns for the year prior while Industrial and Manufactured Housing (which delivered 21.6% and 16.9%, respectively, for the year prior) both underperformed. Given the continued outflows from REIT funds in the US and in Japan, short covering by hedge funds and bottom fishing by generalists probably provided the spark for the Second Quarter rally (sectors favored by dedicated REIT investors, as surveyed in Citi's 23rd Annual Global Property CEO Conference in March, all underperformed and vice versa).

Even within the sectors themselves, it was a rally led by the under-owned and the under-appreciated. Segregating the Index into quartiles, it was the stocks with the highest dividend and cash flow yields (B/C quality assets, secondary and tertiary markets, bad balance sheets, etc.) that handedly outperformed in Second Quarter, delivering 16.9% and 16.8%, respectively. Unfortunately, constituents in those quartiles comprised only 17.2% and 10.1% of the Index so institutional shareholders were probably under-represented and did not derive full benefit from the "junk rally" in REITs.

No shortage of interest in REIT assets. After weeks of speculation and news coverage, EDR, the second largest student housing REIT, announced on June 25 that it will be acquired by a partnership between Greystar and Blackstone REIT (BREIT) for $41.50/share in cash, a 13.6% premium to the closing price on May 31, prior to news reports about a pending acquisition surfacing. According to the press release, Greystar is the largest operator of apartments in the US and BREIT is the non-traded REIT vehicle of the Blackstone, a $15 billion expression of the almost limitless fund-raising prowess of the private equity firm. Kudos to EDR's Board of Directors and management for getting out of the way and closing the discount to NAV. The journey is just beginning for Greystar and BREIT (Greystar started investing in student housing in 2016); while there has been supply introduced in a number of markets resulting in development snafus, student housing does fill a need for the income oriented clients of both partners - all in all, probably a win-win.

On May 21, LaSalle Hotel Properties announced that it has reached an agreement with Blackstone Real Estate Partners VIII to be acquired for $33.50/share in cash, a 34.9% premium to the closing price on March 27, prior to the share-for-share merger proposal by rival hotel REIT, Pebblebrook Hotel Trust. According to the press release, "After careful consideration of multiple proposals, received, the Board determined that this transaction represents the most compelling opportunity for LaSalle's shareholders, delivering a significant premium with immediate and certain cash value." Given the fact that the shares of LsSalle continue to trade at premiums to Blackstone's bid, public market participants are probably betting that either (i) the LaSalle shareholders will reject Blackstone's embrace or (ii) Blackstone will have to sweeten the pot to close the gap between the value of their offer and Pebblebrook's (80% shares/20% cash).

According to *Real Estate Alert,* Host Hotels & Resorts is marketing twelve hotels through Eastdil Secured with proceeds estimated to be $1.2 billion. The disposition is part of Host's recent capital recycling program aimed at improving its portfolio quality. Finally, reading through the DCT/Prologis merger proxy, apparently there was a private equity bid for the company of approximately $61.50/share. The common thread in all these articles and press releases is the abundance of capital (mostly private) for commercial real estate; the flow of capital not only demonstrates the cost of capital advantage for private investors but also the value of the underlying portfolios of the public companies.

Observations from the Field – Ben Yang

Our attendance at the International Council of Shopping Centers (ICSC) "RECon" convention in May was timely as 2017 was a historic year for retailer bankruptcies and store closures. Although attendance had been a respectable retail real estate barometer in past years, the read through going forward will likely be shakier as more companies (including a majority of the mall REITs) continue to set up meetings outside the convention halls. The 10% decline in attendees this year to roughly 33,000 was also attributable to poor timing as the convention fell on a Jewish holiday.

The overall mood amongst the noticeably fewer attendees was brighter than just a year ago when it seemed the prophecy regarding the "retail apocalypse" had finally come to fruition - that bricks-and-mortar was succumbing to the relentless surge of e-commerce and Amazon at an accelerating pace. The ongoing success of omni-channel retailing has been a positive development with its "halo effect" now widely accepted - internet sales rise/fall with store openings/closings. Prominent e-tailers continue to open stores while legacy retailers are becoming more selective in their real estate strategies, investing in their existing fleets to support their on-line growth. Additionally, Amazon's $13.7 billion acquisition of Whole Foods Market (and its leasehold interests across 460+ storefronts) has yet to disrupt the grocery industry, allaying initial fears.

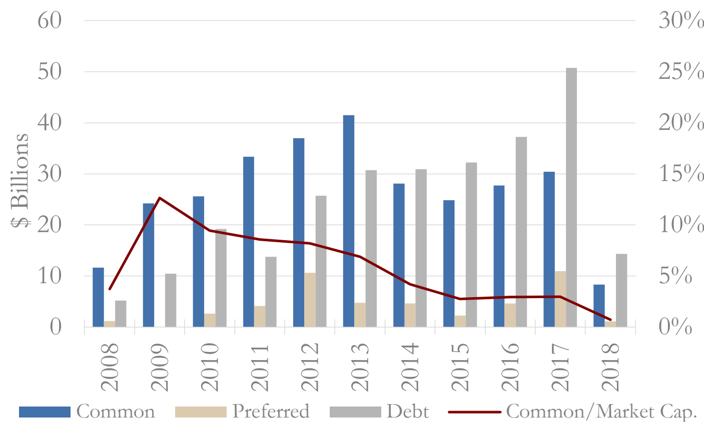
Despite this brightening mood, bricks and mortar retailers are not out of the woods yet. Year-to-date major US store closures top 4,100, tracking below the record 7,000 last year but still well above the roughly 2,000 openings. Physical retail is poised to shrink further as the US is over-retailed with gratuitously more retail space compared to other developed countries - roughly 24 retail square feet per capita compared to Canada and Australia at 16 and 11, respectively, and Europe at less than 5. The continued irrelevance of department stores will accelerate this retail shrinkage, most notably when Sears Holdings and its roughly 900 remaining stores (from nearly 2,400 just four years ago) finally collapse into bankruptcy.

While many retail REITs do not provide disposition guidance, the brokers we met with at RECon confirmed that most continue to divest the bottom tier of their portfolios, which should prove prescient as store openings/closings seem to be concentrated at the highest/lowest quality locations. High-quality retail centers have proven more able to replace laggards (often at higher rents) and attract desired tenants, recently "experiential (dining, fitness, entertainment)," that is less susceptible to the threat of Amazon-induced extinction.

Capital issuance is down slightly. According to NAREIT, only $7.9 billion in capital was raised in Second Quarter 2018, significantly less than the $15.9 billion raised in the prior quarter and the $21.1 billion raised a year ago in Second Quarter 2017. Almost all the capital activity took place in the issuance of unsecured bonds (there were 14 offerings totaling $5.6 billion during the quarter, less than the $8.8 billion issued in the prior quarter and the $10.2 billion issued a year ago).

There were only 7 secondary equity offerings totaling $1.5 billion during the quarter, less than the $3.5 billion issued in the prior quarter and significantly less than the $8.8 billion issued a year ago; there was only one offering of preferred equity totaling $0.3 billion and one small IPO worth $0.5 billion. As REITs continue to trade below NAV and interest rates rise, expect little activity from both equity and debt capital markets for REITs unless the uses of proceeds prove accretive to the discounted cost of capital.

Historical Offering of Securities
2008 – 2018 YTD



Source: NAREIT.

Funds flow out. According to AMG Data Services, net flows out of dedicated real estate funds, excluding ETFs, totaled $3.3 billion in Second Quarter 2018 greater than outflows of $2.0 billion in Second Quarter 2017. However, REIT ETFs saw a significant slowing of outflows, only $0.9 billion in Second Quarter 2018 compared to $2.7 billion in the prior quarter. According to Bloomberg, almost a quarter of all REITs are owned passively; perhaps flows into REIT ETFs helped stem the tide in performance for the asset class.

Flows out of US and Global mutual funds registered in Japan totaled $2.2 billion in Second Quarter 2018 compared to outflows of $1.1 billion in Second Quarter 2017.

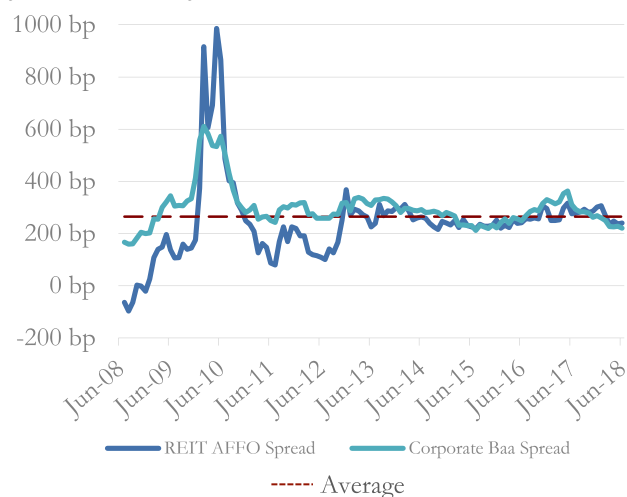
Premium/Discount to Net Asset Value
REIT Universe
June 30, 2008 to June 30, 2018

Source: Adelante Capital Management and Green Street Advisors.

Risk premium below 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, trades below the 10-year average of 265 bps. With the sharp rebound in REIT share prices, the cash flow yield for REITs decreased 29 bps to 4.76% and the yield on the 10-Year Treasury Note increased 11 bps and, as a consequence, the spread between REIT cash flow yields and the 10-Year Treasury Note yield fell 40 bps to 191 bps.

In Second Quarter, the Corporate Baa spread increased to 199 bps, well below the 10-year average of 290 bps.

Spread Comparison
REIT Cash Flow and Corporate Baa Yields vs.
10-Year Treasury Note Yield
June 30, 2008 to June 30, 2018



Source: Adelante Capital Management and Green Street Advisors.

OUTLOOK

Even though longer-term Treasury yields have moved up, on net, since the beginning of the year, there has been growing attention of late to the possibility of an inversion of the yield curve--that is, circumstances in which short-term interest rates exceed long-term interest rates on Treasury securities. Historically, yield curve inversions have had a reliable track record of predicting recessions in the United States. Since 1960, there has only been one case where the 3-month Treasury yield has moved above the 10-year Treasury yield and a recession has not followed--in 1966…

As we try to assess the implications of this flattening of the yield curve, it is important to take into account the very low level of the current 10-year yield by historical standards. For the 20 years before the crisis, the 10-year Treasury yield averaged about 6-1/4 percent, compared with recent readings around 3 percent. One reason the 10-year Treasury yield may be unusually low is that market expectations of interest rates in the longer run may be unusually low. A second reason may be that the term premium--the extra compensation an investor would demand for investing in a 10-year bond rather than rolling over a shorter-dated instrument repeatedly over a 10-year period--has fallen to levels that are very low by historical standards. According to one estimate from Federal Reserve Board staff, the term premium has tended to be slightly negative in recent years. By contrast, when the spread between the 10-year and 3-month Treasury yields was at its peak in early 2010, this measure of the term premium was close to 100 bps.

Other things being equal, a smaller term premium will make the yield curve flatter by lowering the long end of the curve. With the term premium today very low by historical standards, this may temper somewhat the conclusions that we can draw from a pattern that we have seen historically in periods with a higher term premium. With a very low term premium, any given amount of monetary policy tightening will lead to an inversion sooner so that even a modest tightening that might not have led to an inversion in the past could do so today…

In the median outlook in the FOMC's Summary of Economic Projections (SEP), the federal funds rate is projected to reach its longer-run value by 2019 and exceed it in 2020. If the 10-year term premium were to stay very low, that path would likely imply a yield curve inversion. But for the reasons I just noted, if the term premium remains low by historical standards, there would probably be less adverse signal from any given yield curve spread.

It is important to emphasize that the flattening yield curve suggested by the SEP median is associated with a policy path calibrated to sustain full employment and inflation around target. So while I will keep a close watch on the yield curve as an important signal on how tight financial conditions are becoming, I consider it as just one among several important indicators. Yield curve movements will need to be interpreted within the broader context of financial conditions and the outlook and will be one of many considerations informing my assessment of appropriate policy.

Governor Lael Brainard, Forecaster's Club of NY, May 31, 2018

To a certain extent, headwinds confronting the asset class are still gusting against the bow of USS REITs but perhaps the 13% decline to start the new year was overdone. Retail REITs still comprise 18% of the Index but sentiment has certainly shifted in favor of the tenants and, by extension, the landlords. The message coming out of RECon, ICSC's (International Council of Shopping Centers) annual convention, was one of optimism – attendance was lower but mood and deal making was better than in 2017. On June 3, Evercore ISI, a prominent sell-side firm, came out with a research piece titled *The "Retailpocalypse" is Over* suggesting that retailers are learning to adapt in the digital era, something not priced into their very reasonable valuations. On June 21, the Supreme Court ruled in *South Dakota vs. Wayfair, Inc.* that states have the authority to make internet retailers collect state taxes, leveling somewhat the playing field between e-commerce and bricks and mortar. All in all, Second Quarter was a good one for retailers and their landlords; while America is still over-retailed, perhaps not every shop is going to go out of business.

As for interest rate sensitivity, since the sharp spike at the beginning of the year, the yield on the 10-Year Treasury Note has been on a steady decline. With the FOMC on a steady course to raise the federal funds rate three if not four times this year, the yield curve has flattened noticeably; the spread between the yields on the 2-Year and 10-Year Treasury Notes has gone from a high of 78 bps in First Quarter to end the Second at 33 bps. While Fed Governor Brainard points out that in the current environment of historically low term premium (defined in a recent Bloomberg article as "the difference between what you get for locking up your money for an extended period and what you would get if you simply kept rolling over short-term instruments for the same amount of time"), even a modest tightening of monetary policy will lead to a flattening (and even inverted) yield curve, her suggestions are more descriptive than explicative. Why is the term premium heading lower despite the unwinding of the Fed's balance sheet and prospects for a ballooning fiscal deficit? Whatever the reason, the fact that regulators can take comfort in the one time (out of seven) since 1960 that an inverted yield curve did not lead to a recession smacks of "this time is different" and certainly heightens the risk of policy error. As mentioned in last quarter's *REITView*, the stubbornly low yield on the 10-Year Treasury Note does suggest some value for REITs; however, given the continued outflows from dedicated REIT funds, it may be the generalist investors and private equity (think Blackstone/LaSalle Hotel Properties, Greystar/EDR) who have first mover status in taking advantage.