REIT *VIEW* - DOMESTIC

Third Quarter 2018

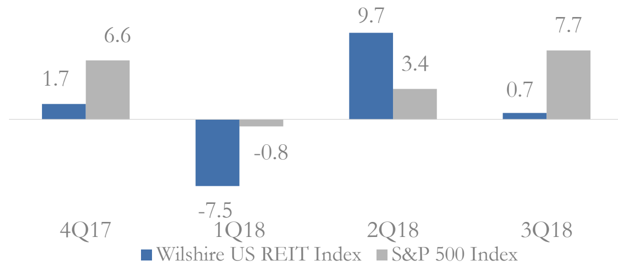
Party on Wayne! Party on Garth! Make no mistake; the US economy is doing well. The third estimate of Second Quarter GDP growth came in at 4.2%, compared to 3.0% for Second Quarter 2017, and the latest estimate for Third Quarter GDP growth from the Federal Reserve Bank of Atlanta is 4.0%. According to the Bureau of Labor Statistics, changes in total nonfarm payroll in the past three months were 134,000, 270,000 and 165,000, respectively, an average of 189,667, in-line with the average of 199,417 for the 12 months prior**.** With the Index of Small Business Optimism from the National Federation of Independent Business hitting an all-time high of 108.8 in August, is it any wonder that risk assets, at least in the US, are setting records?

Coming off the best quarter for the S&P 500 Index since 2013, it's hard to pinpoint storm clouds in the horizon. The third hike in the federal funds rate by the FOMC did very little to deter risk appetite. Ditto for prospects for a trade war. Funny enough, all that the rate hike (with the concomitant rise in the Dollar Index) and the President's America First policy did was to create a moat around US risk assets at the expense of emerging markets and China. The long end of the yield curve did increase a bit as the yield on the 10-Year Treasury Note rose from 2.849% on June 30 to 3.056% on September 30 but the yield curve flattened with the spread between the yields on the 2-Year and 10-Year Treasury Notes going from 33 bps on June 30 to 24 bps on September 30.

The Wilshire US REIT Index ("Index") was up 0.7% in Third Quarter, trailing both the S&P 500 and Russell 2000 Indices which advanced 7.7% and 3.6%, respectively. Approximately half of the constituents of the Index produced positive returns; NexPoint Residential Trust, Inc. was the best performing name, advancing 17.6%, compared to the worst, Government Properties Income Trust, which fell 26.7%.

REITs vs. S&P 500 Index (%)

Total Return



Source: Bloomberg and Wilshire Associates.

Sector Performance of the Wilshire US REIT Index

Ranked by Third Quarter 2018 Performance

Sector	3Q18	Trailing 1-Year	Current Yield
Apartments	4.4%	3.8%	3.3%
Retail-Regional	3.6	11.6	4.9
Mfd. Housing	2.5	18.9	2.1
Industrial	2.5	10.8	2.9
Health Care	2.2	-2.2	5.9
Diversified	1.2	-0.5	3.2
Retail-Local	0.8	0.5	4.7
Wilshire US REIT	**0.7**	**4.0**	**3.9**
Hotels	0.3	14.0	4.8
Factory Outlets	-1.2	-0.6	6.1
Office	-1.9	0.5	3.3
Industrial Mixed	-4.4	0.5	3.6
Storage	-10.2	4.1	4.0

Source: Wilshire Associates.

Back to normal. With the 21 bps increase on the long end of the curve, it is not surprising that property types with short lease durations like Manufactured Housing and Apartments outperformed during the quarter and, for the most part, retail landlords continue to bask in the afterglow of a positive annual convention of the International Council of Shopping Centers which took place in May. Secular growth stories like Industrial and Data Centers (particularly those catering to hyper-scale demand from cloud providers) clambered back on the leaderboard after reporting solid Second Quarter earnings. The only real outlier in performance was Storage to the downside but that was more the case of reversion to the mean (under the guise of renewed concern about supply) after a particularly strong bout of outperformance in the first half of year.

Looking at the trailing 1-Year performance by property type, short duration property types like Hotels and Manufactured Housing have performed well and Apartments and Storage REITs have delivered in-line performance despite heightened supply. In contrast, property types with longer duration leases like Health Care and Office have underperformed. Taking a step away from short-term relative performance, the trailing 1-Year performance by sectors make a whole lot of sense in a period where there has been a steady upward bias to interest rates (2.326% to 3.056%, year over year).

RIP, Three More Constituents; Fourth on Life Support. On September 20, EDR, the second largest student housing REIT, stopped trading on the NYSE as its acquisition by Greystar and Blackstone REIT was completed. On August 22, DCT Industrial Trust, Inc., the fourth largest industrial REIT, stopped trading on the NYSE as its acquisition by Prologis, Inc. was completed. On August 28, GGP, Inc., the second largest regional mall REIT, stopped trading on the NYSE as its acquisition by Brookfield Property was completed.

On September 5, the Board of Trustees of LaSalle Hotel Properties announced that it had unanimously determined that the proposal received from its competitor, Pebblebrook Hotel Trust, was superior to its merger agreement with Blackstone Real Estate Partners VIII; although Blackstone did have four business days to sweeten its offer, it promptly took its $112 million termination fee and left the sandbox. In a presentation released on September 13, Pebblebrook detailed a number of positives from the merger/acquisition. Aside from the $18-20 million in G&A savings, Pebblebrook believes that there will be synergies derived from (i) having critical mass in a number of key gateway markets, (ii) greater leverage over brands, operators and online travel agencies, and (iii) lowered cost of capital (both debt and equity). The combined portfolio will certainly derive immediate benefit from (i) having an 18% concentration in San Francisco where operational fundamentals will be strong for 2019 and beyond, and (ii) recently completed or soon to be completed renovations and redevelopments.

Pebblebrook did announce that it will take advantage of a robust private market for commercial real estate by selling three LaSalle assets at closing for $715 million: Park Central and WestHouse in New York and Park Central in San Francisco, with additional asset sales up to $1 billion possible. On its DCT merger call, Eugene F. Reilly, Prologis' CEO of the Americas outlined that they will dispose the bottom 7% of the acquired portfolio at proceeds of approximately $550 million. Finally, Brookfield announced that it sold ownership interest in three of the GGP assets to TH Real Estate, an affiliate of Nuveen, subsequent to the close of the deal, part of $4 billion slated for joint ventures. These moves to take advantage of the public market discount, deleverage transactions, and prune acquired portfolios is becoming part of the playbook for public companies fortunate enough to have a cost of capital advantage for M&A. Interestingly, there was no comparable announcement from Greystar and Blackstone REIT but then, asset accumulators aren't incentivized to trim their portfolios; besides, to whom would they sell?

Observations from the Field – Elvis Rodriguez

Los Angeles has become another center of innovation on the West Coast for tech and media companies. Competing for talent is paramount and companies are using real estate as one of the primary tools to recruit and retain human capital. As the second largest Metropolitan Statistical Area in the United States, Los Angeles has only seen increasing traffic problems, lacking an adequate, reliable public transportation system. As a result, companies have made critical decisions to concentrate their real estate holding in the various submarkets: Google/Facebook in Playa Vista, Amazon/Apple in Culver City, Hulu/Snap in Santa Monica, and Nielsen/Netflix in West Hollywood.

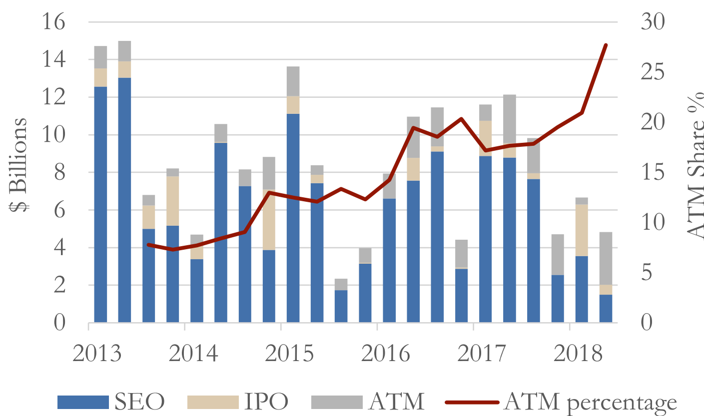
To better understand these dynamics and why companies are establishing a presence in Los Angeles, we recently toured real estate assets owned by Boston Property Group (BXP), Douglas Emmett (DEI) and Rexford Industrial (REXR). BXP recently established its West LA presence in Santa Monica with their acquisitions of Colorado Center and the Santa Monica Business Park. DEI owns office and multifamily properties along the Wilshire Corridor and in the San Fernando Valley. Rexford Industrial has an irreplaceable footprint of smaller, infill distribution warehouses throughout LA and Orange counties which are benefitting from the growth of e-commerce sales and faster delivery times (distribution companies are lowering transportation and delivery costs by moving closer to their customers). The real estate these landlords own are in submarkets with little risk of new supply and where buildings are constantly reevaluated for conversion into higher and better uses, both fantastic drivers for growth in rents and asset values going forward.

The tenant demand and job/population growth over time has driven LA to be a magnet for institutional real estate investors, including foreign sovereign buyers. Although many believe we are in the later innings of this real estate recovery and that rising rates will eventually increase cap rates, the growth in LA rents are outpacing inflation and the lack of new supply has elevated rents for quality, well located, real estate. Lack of investment opportunities and higher rents in markets like Santa Monica have created investor and tenant demand for other submarkets like El Segundo, which has won over institutional investors' appetite for higher yields through redevelopment opportunities of multifamily and creative office spaces, the latter beloved by tech and media tenants. Since LA has lagged San Francisco and Seattle in real estate recovery subsequent to the last recession, there is a real possibility that there are extra innings left for this market for both landlords and investors.

Capital issuance is down slightly. According to NAREIT, $14.6 billion in capital was raised in Third Quarter 2018, significantly more than the $7.9 billion raised in the prior quarter but significantly less than the $29.8 billion raised a year ago in Third Quarter 2017. Approximately half the capital activity took place in the issuance of unsecured bonds (there were 17 offerings totaling $6.3 billion during the quarter, more than the $5.6 billion issued in the prior quarter but much less than $15.6 billion issued a year ago).

Accounting for the remainder of the capital activity were 21 secondary equity offerings totaling $7.9 billion during the quarter, more than the $1.5 billion issued in the prior quarter and the $7.7 billion issued a year ago, and two offerings of preferred equity totaling $0.4 billion. Interestingly, the NAREIT data does not take into account equity issuance by at-the-market ("ATM") programs, a low cost alternative that REITs are increasingly tapping; in Second Quarter of this year, ATM issuance by REITs reached a total of $2.8 billion, an all-time record, and 28% of all equity raised.

Equity Issuance by REITs
2013 – 2Q 2018

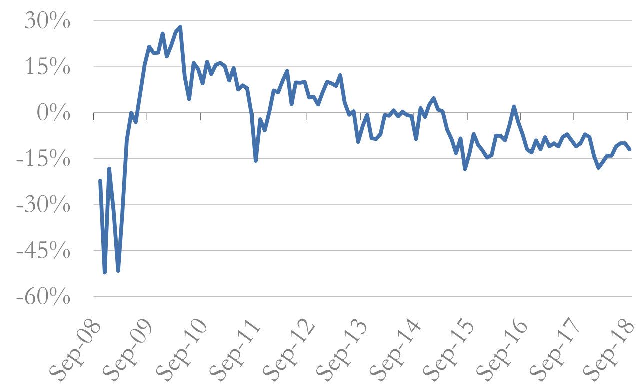


Source: S&P Global Market Intelligence, NAREIT 2018.

Funds flow out. According to AMG Data Services, net flows out of dedicated real estate funds, excluding ETFs, totaled $2.0 billion in Third Quarter 2018. However, REIT ETFs continued the positive trend from the prior quarter, actually matching the outflows from dedicated funds with inflows of $2.0 billion in Third Quarter 2018. According to Bloomberg, almost a quarter of all REITs are owned passively so flows into REIT ETFs certainly helped keep the returns of the Index positive.

Flows out of US and Global mutual funds registered in Japan totaled $1.7 billion in Third Quarter 2018 compared to outflows of $2.1 billion in Second Quarter 2017.

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

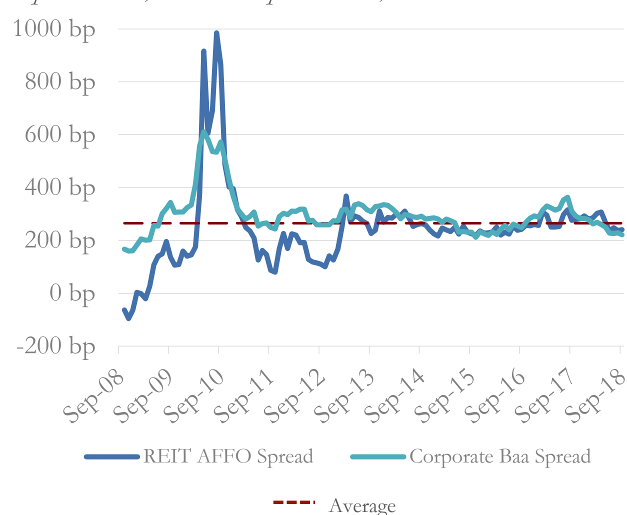


Source: Adelante Capital Management and Green Street Advisors.

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. While the cash flow yield for REITs increased modestly to 4.8%, the yield on the 10-Year Treasury Note increased 21 bps and, as a consequence, the spread between REIT cash flow yields and the 10-Year Treasury Note yield fell 17 bps to 174 bps.

In Second Quarter, the Corporate Baa spread decreased to 186 bps, also well below the 10-year average of 286 bps.

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



Source: Adelante Capital Management and Green Street Advisors.

Outlook

The recent spike in Treasury yields has come primarily from real yield's climb. We view higher real yields as the market expecting strong growth and/or additional market volatility, though not necessarily inflation. Expectations for inflation have stayed well contained. Ten-year TIPS inflation breakevens remain in the 2.08-2.21% range traded most of the year, while 10-TIPS (real) yields have broken out to higher levels last seen in 2011. There have been many theories about why the spike occurred. These include higher short-term foreign-currency hedging costs, fears about higher deficits eroding US credit quality, and aggregate fixed-income supply thanks to heavy deal-related corporate issuance.

Ira F. Jersey and Angelo Manaolatos, Bloomberg Intelligence, October 8, 2018

As long-time traders know, it's hard to have a lasting bear market in bonds without a big acceleration in both realized inflation and inflation expectations. Regarding the former, the three-month annualized rate for the core personal consumption expenditure index, which excludes food and energy, dropped from a recent peak of 2.2 percent to 1.8 percent in August. That's important because the Federal Reserve targets a 2 percent inflation rate, and if the core PCE rate falls further below 2 percent it may eliminate a big reason policy makers have to keep raising interest rates.

Of course, markets never go up or down in a straight line and the rise in bond yields could resume, especially if traders become more concerned about all the supply of debt that the U.S. government is dumping on them to finance a soon-to-be $1 trillion budget deficit. But there are a couple of metrics suggesting that perhaps bonds are a relative bargain. First, 10-year notes yield about 1 percent after inflation, which is toward the high end of the range since 2011. Second, more than 50 economists and strategist surveyed last month by Bloomberg didn't expect yields to get this high until mid-2019, indicating that the rise went too far, too fast.

Robert Burgess, Bloomberg Opinion, October 9, 2018

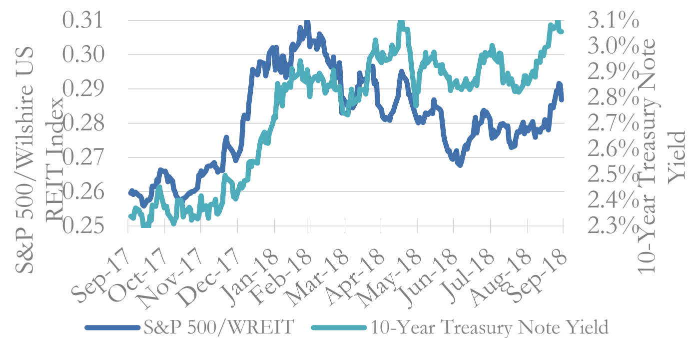
In an era of rising rates, proponents of sectors like Utilities and REITs which are perceived to be interest rate sensitive can only offer two arguments in their defense: (i) interest rates (on the long end) aren't going to go up much further or (ii) the afore-mentioned sectors aren't really negatively impacted by rising rates. On September 25 last year, the Federal Reserve Bank of San Francisco published a paper titled *Demographic Transition and Low US Interest Rates* by Carlos Carvalho, Andrea Ferrero and Fernanda Nechio which proposes that a change in life expectancy higher is leading to a greater propensity to save rather than spend, putting a downward pressure on the natural rate of interest. Of course, there is no unanimity of opinions on what r-star is. In a Q&A session with Judy Woodruff of PBS on October 3, FOMC Chairman, Jerome Powell, stated, "Interest rates are still accommodative, but we're gradually moving to a place where they will be neutral. We may go past neutral, but we're a long way from neutral at this point, probably." Keep in mind that policy error by the Chairman could lead to an overly restrictive monetary policy, leading to below potential GDP growth (and lower interest rates on the long end anyway).

In the June issue of Green Street Advisors' monthly missive, *Heard on the Beach* (do people really talk about REITs on the beach?), Mike Kirby and Peter Rothemund suggest that REITs have become materially more prone to interest rate sensitivity since 2012. They write, "The sea change has been remarkable from a statistical perspective, as a previously non-existent relationship (from '98 – '11) between changes in Treasury rates and relative performance has morphed into one that is now very strong. Since '12, a 100 bps upward move in rates has corresponded with a 1400 bps underperformance by REITs (vs. S&P 500), and vice versa."

The most logical explanation for the shift in relative performance is a change in ownership composition; as more and more REIT shares fall into the hands of generalists and passive funds, prices have become untethered from underlying real estate values. Without effective intermediation by dedicated REIT funds, the narrative of interest rate sensitivity has ruled the roost, interrupted sporadically by buying interest from private equity. Never mind that cash flows and dividends for REITs are growing alongside the rest of the economy and that inflation leads to higher construction costs and lower supply. Unless the makeup of the shareholders changes in the near future, expect discounts to NAV to persist longer than in the past and dedicated funds and their clients will actually have to hold true to their stated investment horizons (hopefully longer than one quarter) in order to achieve a favorable outcome from both an absolute and relative perspective.

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

September 30, 2017 to September 30, 2018



Source: Bloomberg and Wilshire Associates.