Lazard Global Real Estate Securities

US Real Estate Indicators Report

AUG
2019

So far, 2019 is shaping up to be an incredibly fascinating year, thanks to a turbulent mix of bull and bear arguments that have been made about equities in general, real estate writ large, and the overall health of the global economy. In an impressive demonstration of resiliency in the face of mounting challenges, equity markets have continued their upward trajectory, buoyed by increasingly dovish policy moves by central banks worldwide. In real estate, a combination of factors have created an environment conducive to strong performance. These factors include: above-inflation property cash flow growth; lower interest rates that have reduced leverage expenses; a continuation of capital flows seeking current income; and income streams that are generally more domestically focused and are therefore less susceptible to the immediate impact of heightened trade disputes. Against this backdrop, both US equities and real estate investment trusts (REITs) have had a banner year thus far, gaining 20.2% and 21.4%, respectively. Even with mounting concerns around a global economic slowdown, central bank dovish moves carried the markets higher in July. Specifically, the S&P 500 Index advanced 1.4% while REITs gained 1.5%.

With the price performance, public real estate valuations may not be as cheap as they were deemed last summer, but they should be viewed as quite reasonable on a number of measures, especially in contrast to alternative investment options and in light of the accommodative monetary policies adopted by the Federal Reserve (Fed), which should anchor the yields of long-term bonds lower. Broader equities may be seeing a deterioration in earnings growth, but the domestic focus of REIT earnings, combined with a decent relationship between demand and supply, is leading to stable earnings growth expectations. With most of the REIT market having reported second-quarter earnings, property-level income growth in 2019 has accelerated from 2.1% in the fourth quarter of 2018 to 3.5% in the second quarter of 2019.[1] Leveraging that to earnings, 80% of REITs either met or beat second-quarter earnings estimates, with 73% either raising or affirming 2019 earnings. This earnings stability makes fundamental sense. Because real estate growth usually closely tracks GDP growth with a slight lag (which is logical since real estate demand is so fundamentally tied to the economy), 2.4% 2019 estimated GDP growth—and even 1.8% 2020 estimated GDP growth—should continue to help propel property income growth for the foreseeable future. In addition, new supply deliveries look like they have peaked (or are about to) as development projects are getting harder to underwrite given ever-rising construction costs. According to the Turner Construction Cost Index, since 2010, US non-residential construction costs are up 39%, which is 2.6 times the rate of inflation.

Given that such a substantial component of REIT total returns are dividends, which may be taxed advantageously for tax-sensitive investors, there are important takeaways from the results. The strength and growth potential of dividends are key to the REIT investment thesis, in our view. Through the first seven months of the year, almost 70 REITs have already increased their dividends, while the overall sector dividend payout ratio is close to record lows, thereby providing a cushion for the sustainability of dividends at current levels. Moreover, the sector's current 3.8% dividend yield is projected to grow 4%–5% over the next two years, metrics that continue to be fairly attractive in a low-rate and low-inflation environment.

Real Estate Indexes (SNL)

(%; cumulative)	YTD	1 Month	1 Year	3 Years	5 Years
US REIT Equity	21.40	1.48	13.82	15.12	53.99
Global Real Estate	15.48	-0.54	6.99	21.51	34.73

Broad Market Indexes

(%; cumulative)	YTD	1 Month	1 Year	3 Years	5 Years
S&P 500	20.24	1.44	7.99	45.66	71.08
Russell 3000	20.48	1.49	7.05	44.70	68.19

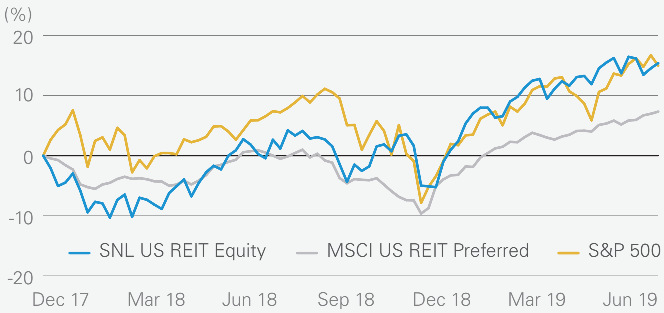
US REIT Property Focus Indexes (SNL)

(%; cumulative)	YTD	1 Month	1 Year	3 Years	5 Years
Diversified/Other	18.67	-0.77	4.03	4.19	27.45
Health Care	17.03	0.57	22.59	8.21	40.39
Hotel	7.95	-3.17	-14.28	8.44	9.43
Industrial	35.16	1.62	25.70	50.26	123.28
Multifamily	21.78	2.34	22.84	31.45	75.27
Office	18.36	3.12	2.58	-2.73	20.33
Retail Enclosed Mall	-2.90	1.21	-11.58	-29.82	-2.24
Retail Shopping Center	20.05	2.98	6.74	-23.74	9.32
Self-Storage	21.74	2.99	16.55	21.55	86.97

As of 31 July 2019
Source: SNL Financial

Listed Real Estate Market Performance

Cumulative Returns (31 December, 2017 to 31 July, 2019)



As of 31 July 2019

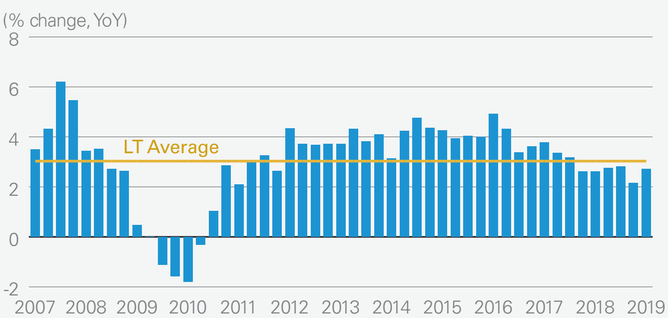
For illustrative purposes only. The performance quoted represents past performance. Past performance is not a reliable indicator of future results.

Source: Bloomberg

Even after a record-breaking performance in the first quarter, REITs, along with broader equities, have continued to grind higher as increasingly dovish Fed positioning superseded concerns about a global economic slowdown and rising trade and political tensions. As such, REITs were up 1.5% in July, which is essentially in line with broader equities. REITs are now up substantially year to date at 21%. However, due to a tough 2018, REITs have only advanced 15% over the last three years, compared to the 46% gain by the S&P 500. Of that return for REITs, almost all is due to dividends. Because of this, REIT prices are only up 2%, shedding light on why valuations on a number of perspectives seem reasonable.

Real Estate Fundamentals

Property Net Operating Income (NOI) Growth



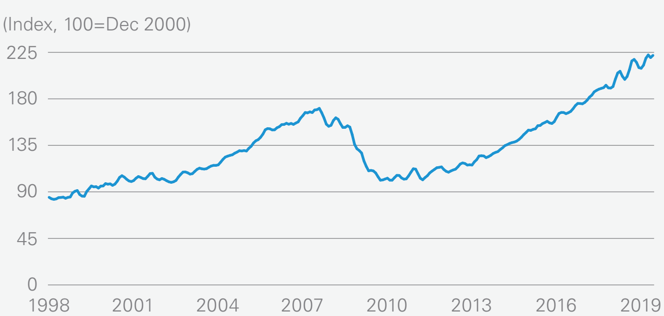
As of 31 July 2019

Source: S&P Global Market Intelligence, NAREIT T-Tracker®

Indicative of a sector multiple years into its cycle, property-level NOI growth has moderated from 4.9% in first quarter 2016 to 2.7% in first quarter 2019, though it continues to trend above inflation. With most of second-quarter earnings reported, it is likely same-store growth will hold steady in 2019, with most of the sectors showing moderate, but still positive, growth. Some sectors, such as regional malls, have shown more resiliency than expected. The combination of good GDP growth and generally moderate levels of new construction is constructive to future NOI growth continuing.

Underlying Property Values

US Investment Grade Composite Index (Equal Weighted)



As of 31 July 2019

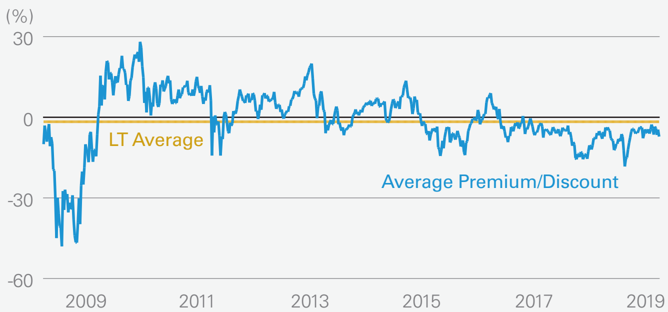
Source: Real Capital Analytics

According to CoStar's commercial real estate investment grade index, US commercial real estate prices are up 5.6% for the first six months of 2019 (through June as data lags by one month). This puts property pricing 30% above prior peak levels and up approximately 120% since the recession lows of late 2009. What has been interesting, but rational given the change in Fed tone, is that any concerns of a property price appreciation slowdown have been allayed. Importantly, the price gains have been recorded across all core property sectors and continue to contradict market participants who suggest that a REIT discount to net asset value (NAV) foreshadows weakness in property prices. Transaction sales volume also remained solid, up almost 5% for the investment grade segment.

Commercial real estate continues to benefit from increased allocations across most investor categories globally and this has translated into still significant amounts of "dry powder" for real estate investment.

Listed Real Estate Valuations

Premium/Discount to Underlying Net Asset Value (NAV)



As of 31 July 2019

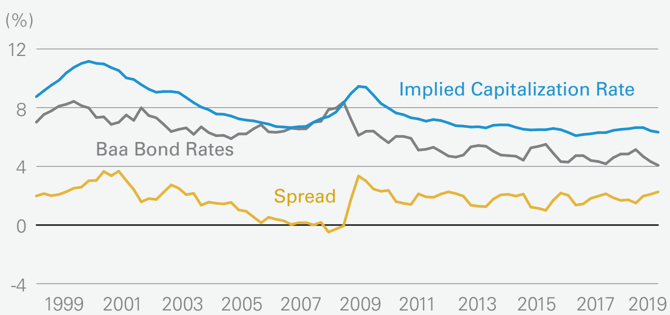
The REIT market as represented is a basket of 53 large and investable REITs across all sectors, as identified and selected by SNL Financial. The basket also includes companies that over time have gone private or merged in order to avoid survivor bias in the historical data.

Source: SNL Financial

While REITs have closed some of the valuation discount to underlying NAV that existed in 2018, they have been trading in a fairly narrow discount range to NAV over the past few months as any stock price gains have been met with increasing property prices. While the returns of 2019 would suggest heighted valuations, a closer look at REIT prices help elucidate how the valuations appear still reasonable. As mentioned above, REIT prices are barely up over the last three years even though property-level income has appreciated by over 10%. Interestingly, the sustained discounted valuations have now brought the 10-year average down to a 2% discount, compared to the longer historical 2%–3% average premium.

While private real estate prices may fall prospectively, the evidence from property sales (based on the CoStar US Composite Index) continues to suggest that prices remain strong across most sectors. The steadily growing economy, still-low levels of new construction, lower interest rates, and solid demand for US real estate are supporting pricing levels.

REIT-Implied Capitalization Rate Spread to Baa Bonds



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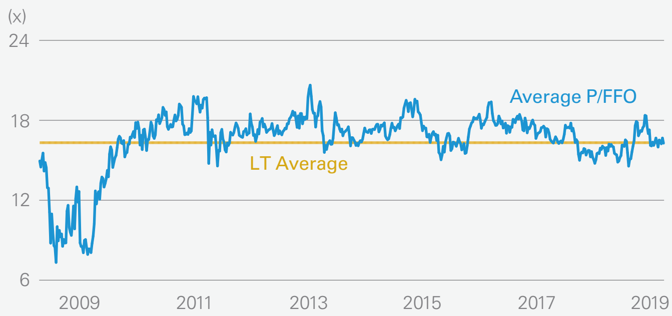
Source: SNL Financial

Even though REIT prices have rebounded in 2019, the steeper drop in Baa bond rates has caused the spread between bond rates and REIT-implied capitalization to widen. At a current spread of approximately 225 basis points (bps), the REIT sector is trading well above the long-term 180 bp spread average. In addition, the spread has widened by approximately 75 bps since the end of 2018. A reversal in the Fed's general dovish tone would certainly up end this generally benign environment, but for now, the data suggests that relative value of real estate has moved from "fair" to "looking cheaper."

Price-to-Funds from Operations (P/FFO)



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Source: SNL Financial

After the strong price performance over the last few months, current REIT P/FFO valuations of 16.3x are right in line with the long-term average of 16.3x P/FFO. The second-quarter 2019 earnings season is essentially complete and initial results can be viewed as decent for many of the sectors. Earnings growth expectations for 2019 have been affirmed, with some sectors reporting results slightly ahead of expectations. The outlier to this trend is the retail sector, whose results have been mixed and which continues to deal with the changing nature of the industry, tenant turnover, and the additional capital expenditures needed to reposition properties. Overall, the vast majority of REITs reporting to date have either met or beat analyst estimates for the second quarter, with 2019 guidance now being raised slightly. The results continue to demonstrate that REIT earnings are more "local economy dependent" than "global economy dependent" given REITs lower earnings volatility compared to other sectors.

Note: P/FFO is the standard REIT equivalent of the price-to-earnings (P/E) ratio.

Notes

1 Citigroup, REITcap, 5 August, 2019.

Important Information

Published on 19 August 2019.