Lazard Global Real Estate Securities

US Real Estate Indicators Report

JAN
2019

Real estate investment trusts (REITs) had a record January, extending their recent relative outperformance over US equities. With returns of 11.6%, REITs outperformed the S&P 500 Index by approximately 260 basis points (bps) in January and by more than 1,100 bps since September 2018. January's outperformance is intriguing since REITs generally lag when there are sharp upward moves in equities, especially when the gains are very broad based as all 11 GICS sectors recorded positive returns. We traced the deviation from norm to some broad trends that should continue to serve the REIT sector well. First, a more dovish Federal Reserve tone has tampered forward interest rate expectations, which limits potential downward pressure on real estate prices due to higher rates. Second, a more turbulent global macro environment, whether the lower IMF global growth forecasts or the lingering impacts from the longest-ever government shutdown, highlights the benefits of REITs' more predictable earnings and dividends. Lastly, as investors shift focus to 2019/2020 expectations, REIT earnings growth could exceed that of the S&P 500 in 2019. Currently, consensus estimates put 2019 REIT growth at 4%–5% as compared to 5% for the S&P 500. When combined with a current dividend yield approximately 200 bps better than the S&P 500 (4.1% vs. 1.9%), REIT baseline total return expectations (growth + income) shift ahead of the S&P 500. Since 1997, 52% of the 10.6% per annum REIT return has come from the reinvestment of dividends. Not only are REITs currently yielding 4.1% on average, but after averaging 8% compounded annual growth over the past five years, dividend growth is still estimated at 5% in 2019 and 4% in 2020.[1] Certainly, these are fairly attractive metrics in a low-rate and inflationary environment.

REITs' ability to deliver consistent and growing income was driven home during recent earnings calls by two REITs that will celebrate 25 years of being public in 2019. Simon Property Group commented that with its upcoming second quarter dividend it will have paid over $100 per share in dividends over its history. Not bad for a stock that went public at $20 per share and is currently trading above $175 per share. Essex Property Trust mentioned that it has grown its funds from operations per share at an 8.5% compounded annual rate since its IPO, and this growth has allowed it to increase its dividend for 24 consecutive years. Assuming its board of directors vote to increase the dividend later this quarter, it would put Essex in a rare group of companies that have increased dividends for 25 consecutive years. In turbulent times, this type of consistency is worthwhile to highlight. As we have referenced before, "real estate cannot be lost or stolen, nor can it be carried away."[2] In other words, real estate has a durability and a link to local economics (and a contractual aspect to its cash flows or leases) which may insulate it from shorter-term swings and thereby makes real estate cash flows less exposed to the global environment. Lastly, due to the nature of REIT dividends and the 2018 tax code changes, REIT dividends are also "tax advantaged." As a rule of thumb, REIT dividend composition is 70% ordinary income and 30% capital gains or return of capital, which is certainly better than having 100% of a dividend qualifying as ordinary income. Further, the 2018 tax changes view REITs as pass-through entities which allows investors to use the 20% pass-through dividend deduction on the ordinary income portion of the REIT dividend. This effectively lowers the effective tax rate from 37% to approximately 30% at the highest tax bracket. In December 2018 the IRS clarified that this favorable tax treatment extends to all REIT investors, including when REITs are owned through mutual funds. As they say, the devil is in the details, but when it comes to REITs it's worth getting into the details around the power of its dividend streams to generate favorable after-tax returns.

Real Estate Indexes (SNL)

(%; cumulative)	1 Month	1 Year	3 Years	5 Years
US REIT Equity	11.56	9.43	29.50	58.72
Global Real Estate	8.21	-3.35	37.73	43.94

Broad Market Indexes

(%; cumulative)	1 Month	1 Year	3 Years	5 Years
S&P 500	8.01	-2.31	48.23	68.19
Russell 3000	8.58	-2.26	48.91	64.09

US REIT Property Focus Indexes (SNL)

(%; cumulative)	1 Month	1 Year	3 Years	5 Years
Diversified/Other	14.99	3.30	32.64	31.89
Health Care	13.07	27.86	34.77	47.23
Hotel	12.62	-5.46	42.14	34.47
Industrial	15.56	14.33	83.32	105.29
Multifamily	10.37	18.48	30.25	90.32
Office	14.19	-1.51	18.04	31.43
Retail Enclosed Mall	8.79	3.52	-4.84	27.46
Retail Shopping Center	14.77	7.15	-14.02	16.71
Self-Storage	6.31	15.86	1.69	82.39

As of 31 January 2019
Source: SNL

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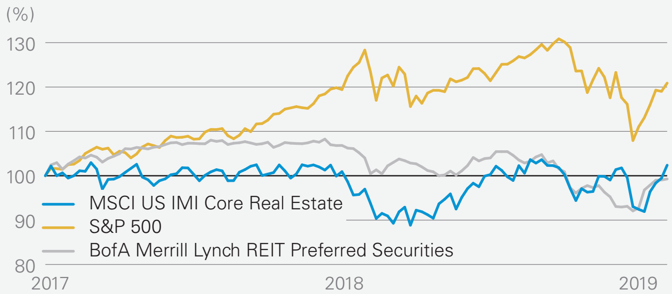
Listed Real Estate Market Performance

Cumulative Returns (Indexed to 100)



As of 31 January 2019

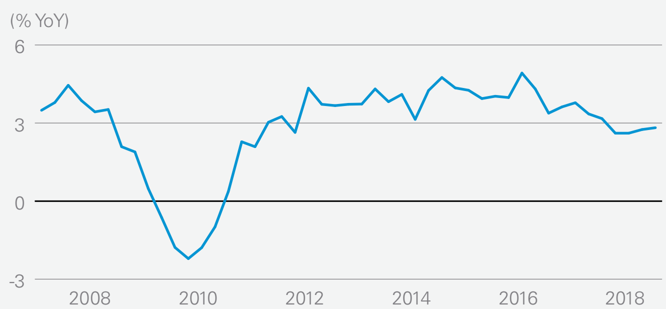
For illustrative purposes only. The performance quoted represents past performance. Past performance is not a reliable indicator of future results.

Source: Bloomberg

After a December in which REITs were down, but saw good relative performance to broader equities, the start to 2019 was very strong in both absolute and relative terms with REITs up 11.6% compared to broader equities' 8.0% return. REITs have outperformed the S&P 500 by approximately 1,100 bps since September 2018. While the late 2018 performance was primarily due to a decidedly "risk-off" perspective, the January outperformance is more due to the more benign interest rate outlook and potentially better 2019 earnings growth than the S&P 500. However, until very recently, the market seemed to be discounting REIT growth as investors contemplate an end of a decade-long real estate "up cycle" and as such, fund flows into the sector have been anemic.

Real Estate Fundamentals

Property Net Operating Income (NOI) Growth



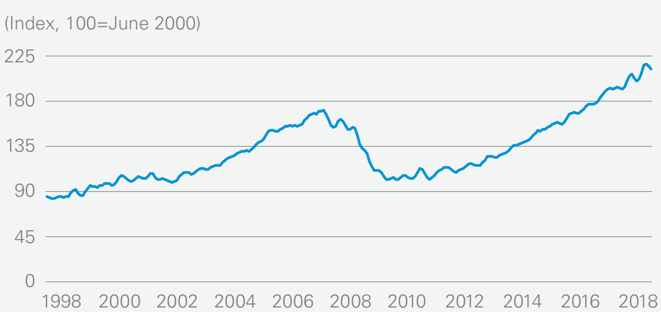
As of 31 December 2018

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 Q1 2016 to 2.8% in Q3 2018), though it continues to trend above inflation and has actually increased over Q1/Q2 2018. With real estate geared to general economic health, the combination of good GDP growth and generally moderate levels of new construction are constructive to future NOI growth, and if the improvement in growth from Q1 to Q3 is any indication, the sector has hit an NOI growth base in the mid-to-high 2% range as the residential sector in particular is likely witnessing a mild acceleration in growth rates.

Underlying Property Values

US Investment Grade Composite Index (Equal Weighted)



As of 31 January 2019

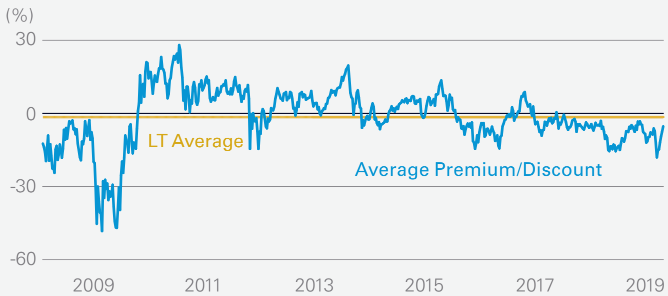
Source: Real Capital Analytics

According to CoStar's commercial real estate investment grade index, US commercial real estate prices ended 2018 up 10.4%, after having been generally flat for the second half of 2017 (data lags by one month). This puts property pricing over 20% above prior peak levels and 100% up since the recession lows of late 2009. Importantly, the price gains have been recorded across all core property sectors with transaction volume increasing as well. Transaction sales volume was also strong in 2018, up 9.7% 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 with institutions increasing target allocation to real estate by 30 bps to 10.4% in 2018. Based on current valuations, 60% of institutions are underinvested to their targets by an average of 200 bps.[3]

Listed Real Estate Valuations

Premium/Discount to Underlying Net Asset Value (NAV)



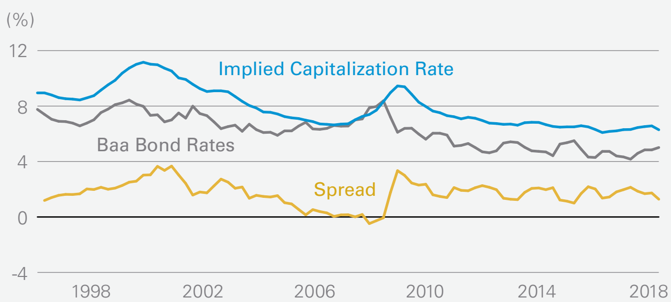
As of 31 January 2019

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

With the strong price gains in January, REITs have closed the valuation discount to underlying NAV and are now trading at an approximate 5% discount to NAV. While narrowed, the current discount continues the sector's longest continual valuation below NAV since the financial crisis. The discount is also below the sector's long-term historical 2%–3% long-term average premium. However, with the discounts to NAV since October 2016, the sector's shorter-term average since 2007 has now been pulled down to a slight discount to NAV. While private real estate prices may fall prospectively, the evidence from property sales (based on the CoStar US Composite Index) suggests that prices remain strong across most sectors. The steadily growing economy, still lower level of new construction, and solid demand for US real estate should support asset prices even if rates rise modestly.

REIT-Implied Capitalization Rate Spread to Baa Bonds



As of 31 December 2018

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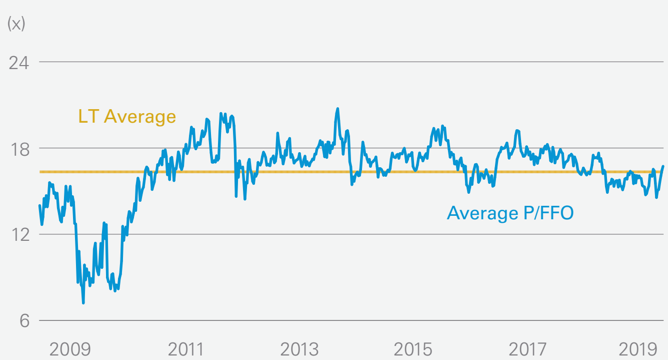
Source: SNL Financial

The combination of higher Baa bond rates and a rebound in REIT pricing has narrowed the spread between bond rates and REIT implied cap rates to the lowest levels since Q4 2015. In addition, at a current spread of approximately 130 bps, the REIT sector is trading at approximately 50 bps below the long-term 180 bps spread average. A reversal in the Fed's general "wait and see" approach would likely further jeopardize this cushion, but for now suggests that *relative* value is likely fair, but certainly not "cheap" as a bond proxy.

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



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Source: SNL Financial

After the strong price performance over the last few months, REIT P/FFO valuations are now back up to long-term averages of 16.5x P/FFO. With the fourth quarter 2018 earnings season in full swing, initial results can be viewed as decent for many of the sectors with 4%–5% earnings growth expectations for 2019. The main outlier to this trend is the retail sector which continues to deal with the changing nature of retail, tenant churn, and the additional needed capital expenditures in order to reposition properties. Overall, the vast majority of REITs reporting to date have either met or beat analyst estimates for Q4, but seem to be conservative on 2019 guidance. The results continue to demonstrate that REIT earnings are more "local economy dependent" rather than "global economy dependent" given REITs' earnings volatility are lower than other sectors'.

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

Notes

1 Source: Citi Research, As of 8 February 2019

2 Source: Franklin D. Roosevelt

3 Source: Institutional Real Estate Allocations Model

Important Information

Published on 19 February 2019.

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Equity securities will fluctuate in price; the value of your investment will thus fluctuate, and this may result in a loss. Securities in certain non-domestic countries may be less liquid, more volatile, and less subject to governmental supervision than in one's home market. The values of these securities may be affected by changes in currency rates, application of a country's specific tax laws, changes in government administration, and economic and monetary policy. Small- and mid-capitalization stocks may be subject to higher degrees of risk, their earnings may be less predictable, their prices more volatile, and their liquidity less than that of large-capitalization or more established companies' securities. Emerging markets securities carry special risks, such as less developed or less efficient trading markets, a lack of company information, and differing auditing and legal standards. The securities markets of emerging markets countries can be extremely volatile; performance can also be influenced by political, social, and economic factors affecting companies in emerging markets countries.

Fixed income and preferred securities are subject to credit risk, interest rate risk, and call and reinvestment risk. The strategy's investments in lower-rated, higher-yielding securities are subject to greater credit risk than its higher-rated investments. Junk bonds tend to be more volatile, less liquid, and are considered speculative, and a strategy may not be able to sell certain securities at the time and price it would like.

Non-domestic securities carry special risks, such as exposure to currency fluctuations, less developed or less efficient trading markets, political instability, a lack of company information, differing auditing and legal standards, and, potentially, less liquidity. The strategy may invest in a smaller number of issuers than other, more diversified, investment portfolios, and therefore the strategy's net asset value may be more vulnerable to changes in the market value of a single issuer or group of issuers and may be relatively more susceptible to adverse effects from any single corporate, industry, economic, market, political, or regulatory occurrence.

Derivatives transactions may cause a strategy to experience losses greater than if the strategy had not engaged in such transactions. Investments in derivatives are subject to many of the risks of, and can be highly sensitive to changes in the value of, the related security or index. As such, a small commitment to derivatives could potentially have a relatively large impact on a strategy's performance.