

Lazard Global Real Estate Securities

US Real Estate Indicators Report

APR
2019

Real estate investment trusts (REITs) have had a banner first four months of the year, even though the sector returned -0.2% in April after investors moved to a more “risk on” focus. Notwithstanding April’s pause, REITs’ year-to-date returns of 16.9%, should be viewed as making up for lost ground. REITs’ performance had been challenged over the past few years due to higher interest rate concerns. Despite the handwringing over higher rates, it is really interesting that the outcome currently appears to be a non-event as the 10-year US Treasury hovers around 2.5% and REITs’ performance is almost in line with broader equities since the end of 2017. We believe that this scenario supports the idea that investors should consider a more probabilistic event outcome approach instead of a binary approach. In other words, while allocations to REITs (or even real assets) should ebb and flow, we believe the sector warrants some level of continual allocation. Based on the approximately \$23 billion in outflows from real estate funds in 2018 and effectively neutral flows so far in 2019, many investors have remained underweight the sector.

While public real estate valuations may not be screaming as “cheap” as they were last summer, valuations do not seem stretched. First, the tampered forward interest rate expectations due to a more dovish Federal Reserve is limiting downward pressure on real estate prices that would have existed with dramatically higher rates. Second, the continuing turbulent global macro environment continues to highlight REITs’ more predictable earnings and dividends given REITs’ higher exposure to domestically generated revenues than most all industry sectors. And arguably most importantly, real estate fundamentals remain quite solid, with a 40 basis point (bp) up tick in overall property-level net operating income (NOI) growth based on the first quarter earnings season.¹ As real estate growth closely tracks GDP growth with a slight lag (which is logical as real estate demand is so fundamentally tied to the economy), 2.4% estimated GDP growth in 2019 and even 1.8%–2.0% estimated GDP growth in 2020 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. Since 2010, US non-residential construction costs are up 39%,² which is 2.6 times the rate of inflation.

Looking more closely at trends from the first quarter reporting season, 81% of companies either met or beat consensus estimates with 91% of companies either maintaining or raising 2019 guidance.³ Of note, the positive results were across many of the real estate sectors including apartments, manufactured homes, industrial, storage, lodging, and even community retail. An important take away from the results should be the strength and growth potential of REIT dividends. In the first quarter, 35 REITs have already increased their dividends, the overall sector dividend payout ratio is close to record lows providing a cushion for the sustainability of dividends at current levels, and the sector’s current 4% dividend yield is projected to grow 4%–5% over the next two years. Metrics continue to be fairly attractive in a low rate and inflation environment.

Real Estate Indexes (SNL)

(%; cumulative)	1 Month	YTD	1 Year	3 Years	5 Years
US REIT Equity	-0.19	16.91	18.83	25.94	53.78
Global Real Estate	-1.06	12.55	4.46	27.03	39.84

Broad Market Indexes

(%; cumulative)	1 Month	YTD	1 Year	3 Years	5 Years
S&P 500	4.05	18.25	13.49	51.58	73.32
Russell 3000	3.99	18.60	12.68	51.06	70.00

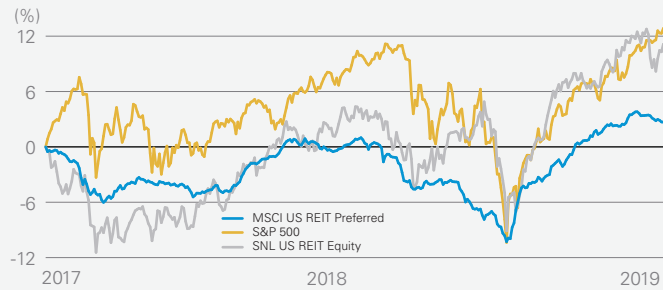
US REIT Property Focus Indexes (SNL)

(%; cumulative)	1 Month	YTD	1 Year	3 Years	5 Years
Diversified/Other	0.79	19.45	11.03	19.25	31.19
Health Care	-4.38	8.11	28.69	18.29	30.21
Hotel	2.07	18.14	3.07	34.24	24.49
Industrial	4.48	27.05	22.76	73.15	111.99
Multifamily	-0.12	15.99	25.23	33.61	82.08
Office	0.87	19.66	9.61	11.18	26.55
Retail Enclosed Mall	-5.19	4.29	6.28	-13.66	8.21
Retail Shopping Center	-1.18	17.07	16.36	-14.57	10.16
Self-Storage	1.25	11.14	14.77	10.16	68.90

As of 30 April 2019
Source: SNL Financial

Listed Real Estate Market Performance

Cumulative Returns (31 December 2017 to 30 April 2019)



As of 30 April 2019

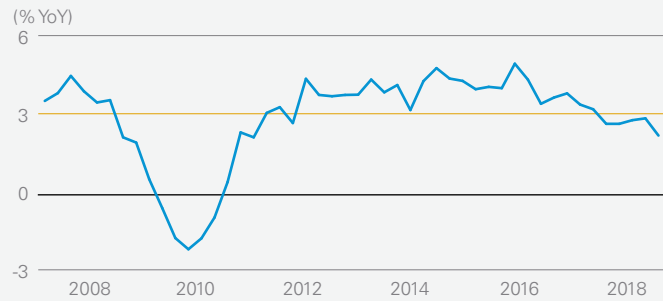
For illustrative purposes only. The performance quoted represents past performance. Past performance is not a reliable indicator of future results.

Source: Bloomberg

REITs returned -0.2% which lagged broader equity returns of approximately 4%. While REITs are up substantially year to date at 17%, due to a tough 2018, REITs have only returned 11% since the end of 2017. Of that return, approximately 50% was due to dividends. Hence, REIT prices are only up 5%–6%, which is quite reasonable given similar earnings growth. With the strong relative performance over the past few quarters, REITs are only lagging broader market returns by 1.9% since 2017.

Real Estate Fundamentals

Property Net Operating Income (NOI) Growth



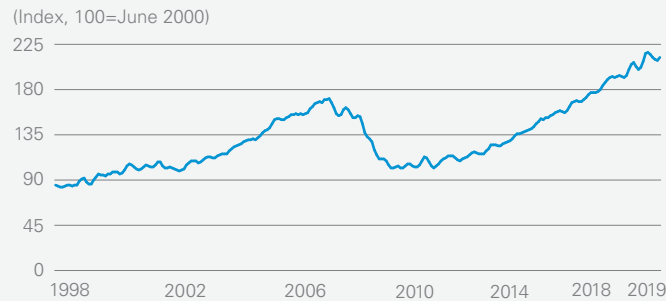
As of 30 April 2019

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 Q1 2016 to 2.1% in Q4 2018), though it continues to trend near inflation. With most of Q1 2019 earnings reported, it is likely same-store growth will hold steady in 2019 with most of the sectors moderate, but still positive growth. Some sectors, such as regional malls, have shown more resiliency than expected. 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 continuing.

Underlying Property Values

US Investment Grade Composite Index (Equal Weighted)



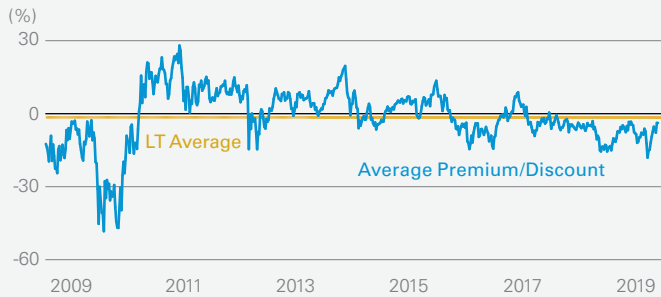
As of 30 April 2019

Source: Real Capital Analytics

US commercial real estate prices are up 3.2% over the last twelve months through March (as data lags by one month).⁴ This puts property pricing over 20% above prior peak levels and over 100% up since the recession lows of late 2009, though the rate of property price gains has slowed. Importantly, the price gains have been recorded across all core property sectors and are in contrast with market participants suggesting that REIT discount to NAV was foreshadowing weakness in property prices. Transaction sales volume also remained solid, up 4.6% 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)



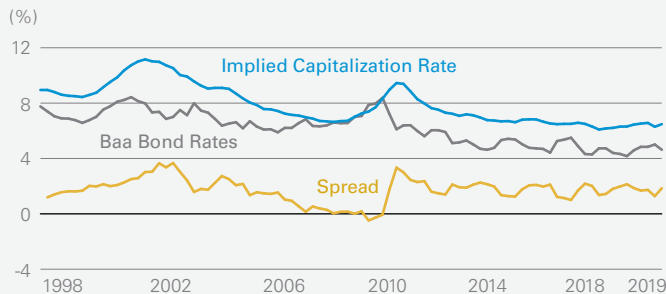
As of 30 April 2019

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 due to the strong price gains of the past few months, they are still trading at an approximate 6% discount to NAV. While narrowed, the current discount continues the sector's longest continual valuation below NAV since the financial crisis. Interestingly, the sustained discounted valuations have now brought the 10-year average down to a 2% discount as compared to the longer historical 2%–3% average premium. While private real estate prices may fall prospectively, the evidence from property sales⁵ 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



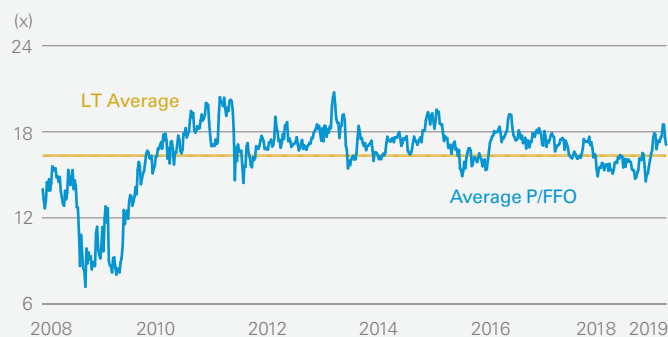
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Source: SNL Financial

Even though REIT prices have rebounded over the last two quarters, the subsequent drop in Baa bond rates has kept the spread between bond rates and REIT implied capitalization fairly level over the last year. At a current spread of approximately 185 bps, the REIT sector is trading right in line with the long-term 180 bps spread average. A reversal in the Fed's general dovish tone would certainly upend this generally benign environment, but for now suggests that relative value is likely fair, but still not "cheap" as a bond proxy.

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



As of 30 April 2019

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Source: SNL Financial

After the strong price performance over the last few months, current REIT P/FFO valuations of 17.1x are slightly above long-term averages of 16.3x P/FFO. With the first quarter 2019 earnings season almost complete, initial results can be viewed as decent for many of the sectors with affirmation of 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 Q1, but still 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' lower earnings volatility than other sectors.

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

Notes

- 1 Based on Evercore ISI "1Q 2019 Same Store NOI Report"
- 2 Source: Turner Construction Cost Index
- 3 Source: Bank of America Merrill Lynch. As of 3 May 2019.
- 4 CoStar's commercial real estate investment grade index
- 5 CoStar US Composite Index

Important Information

Published on 16 May 2019.

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