Lazard Global Real Estate Securities

US Real Estate Indicators Report

APR
2018

Since the initial price weakness in January and February that started the year, real estate investment trusts (REITs) have been oscillating within a small range over the preceding two months as investors have been struggling to assess the next shifts in the current goldilocks economic environment. As that has been unfolding, domestic real estate fundamentals remain sound. Some sectors where expectations were low (retail and health care) performed better than expected during the latest earnings season, real estate pricing has remained firm, and the REIT merger and acquisition (M&A)/deal environment is heating up. It's a generally positive foundation for property stocks, but since the industry has experienced an excess of $10 billion in fund outflows year to date (this is on top of the approximate $16 billion in outflows in 2017), sentiment has soured for listed real estate.[1]

As a result, four months into 2018, US REITs have lagged the S&P 500 Index by six percentage points, with REITs down 6.5% and the S&P 500 down 0.4%. Extending the time period over the last five years (essentially since then-Federal Reserve Chair Ben Bernanke started to talk about higher interest rates), REITs have underperformed the S&P 500 Index by approximately 50 percentage points when including the impact of dividends. Excluding dividends, the gap increases to 56 percentage points, with the S&P 500 Index gaining 64%, while REIT prices are up only 8% over that same period. In comparison, REIT same-store property net operating income has risen more than 20% over the last five years.

The just completed first quarter earnings season seems to confirm the general stability of US real estate across sectors, which, we believe, should continue. Certainly, there are always some areas of concern (such as self storage or New York City office new supply), and it is likely we are in a mature phase of the cycle (and likely in the later stages of that phase), but the breadth of stability and stronger-than-expected first quarter results are encouraging. According to Bank of America Merrill Lynch, 86% of companies met or beat estimates while 97% either raised or maintained 2018 guidance. Of note, there was good leasing activity in data centers, industrials, select office, life sciences, and self-storage. This activity is driven by increased demand for space as high levels of business and consumer confidence, and good job growth are pushing that real estate demand. In addition, the notion that net asset valuations are an important valuation metric for REITs is being proven through growing M&A activity. This should help to support a valuation "floor" for many companies. Importantly, this activity is occurring in many sectors (i.e., regional malls, industrials, hotel, health care) which highlights the extent of the theoretical valuation disconnect across the real estate space.

The macro sentiment environment may still be tilted negatively toward REITs for some time as REITs are generally not considered growth or momentum investments and the bond proxy play is less attractive, in our view. However, from a historical context, today's environment still strikes a similar tone to that of the late 1990s. By the end of 2000, REITs had underperformed equities by 40 percentage points over a three-year period and were trading at steep discounts to net asset value. Yet, real estate markets were posting good results, overbuilding was minimal, and institutional quality real estate still posted 25 more consecutive quarters of positive returns from that point forward (i.e., the cycle still had room to run). The end of 2000 through 2006 was among the best relative and absolute performance periods for REITs. During this time, REITs returned 200 percentage points more than the S&P 500 Index.

US Real Estate Market Returns

(%; cumulative)	YTD	1 Month	3 Months	1 Year	3 Years	5 Years
SNL US REIT Equity	-6.5	0.6	-2.4	-1.5	14.6	30.2
MSCI US REIT (RMS)	-6.8	1.4	-1.7	-3.2	10.7	26.4
S&P 500	-0.4	0.4	-6.8	13.3	35.2	83.9
Russell 3000	-0.3	0.4	-6.3	13.1	33.8	82.2

US Real Estate Market Returns by Property Type

(%; cumulative)	YTD	1 Month	3 Months	1 Year	3 Years	5 Years
Diversified/Other	-6.0	3.5	-2.1	-5.5	11.4	15.5
Health Care	-10.8	0.4	-4.3	-17.1	-7.8	-10.7
Hotel	-0.8	4.0	-4.5	8.7	9.4	42.9
Industrials	0.6	4.9	4.7	15.5	67.1	74.6
Multifamily	-4.8	0.4	0.8	-2.9	16.0	56.0
Office	-10.1	0.8	-4.5	-7.6	3.6	22.9
Residential	-4.1	0.7	1.6	-0.8	22.5	61.1
Regional Mall	-10.1	0.6	-7.3	-3.4	-12.4	0.2
Community Retail	-15.6	-0.6	-6.4	-14.1	-15.6	-6.2
Self-Storage	-0.7	1.9	7.0	7.2	28.1	65.0

As of 30 April 2018

For illustrative purposes only. The performance quoted represents past performance. Past performance is not a reliable indicator of future results. This is not intended to represent any strategy or product managed by Lazard. The indices are unmanaged and have no fees. One cannot invest directly in an index.

Source: FTSE, NAREIT, Standard and Poor's

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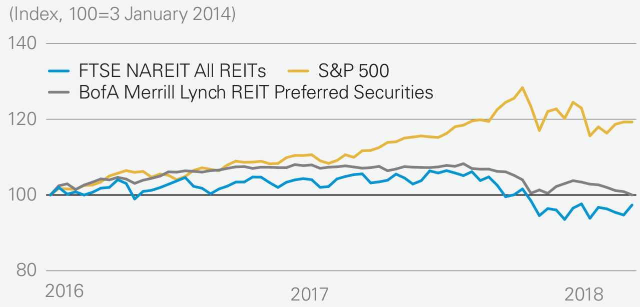
Listed Real Estate Market Performance

Cumulative Returns



As of 30 April 2018

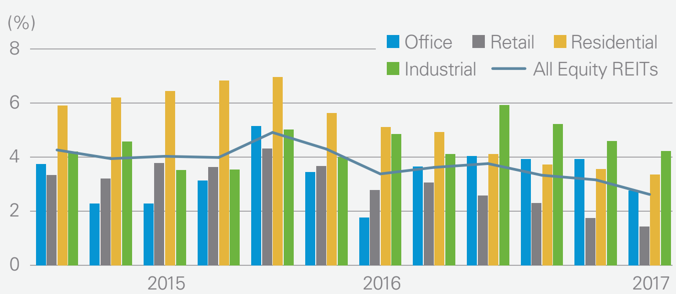
For illustrative purposes only. The performance quoted represents past performance. Past performance is not a reliable indicator of future results.

Source: Bloomberg

April's combination of generally flat yields and a solid REIT earnings season allowed REITs to keep better pace with broader equities, returning 0.6% in comparison to 0.4% returns for broader equities. REITs still lag equities year to date due to overall slightly higher interest rates and substantial outflows from both active and passive real estate funds suppressing prices. The aggregate numbers still hide a wide discrepancy in sector performance with an over 15 percentage point return difference between the best (industrials) and worst (shopping centers) sectors. Meanwhile, REIT preferred securities declined 2.6% in April and are now down 6.3% year to date.

Real Estate Fundamentals

Same-Store Net Operating Income (NOI) Growth



As of 31 December 2017

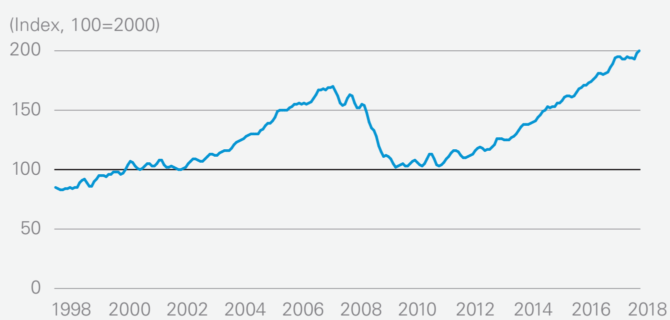
Forecasted or estimated results do not represent a promise or guarantee of future results and are subject to change.

Source: NAREIT 2017, S&P Global Market Intelligence

Indicative of a sector multiple years into its cycle, property-level NOI growth continues to moderate, but still trends above inflation. Looking ahead, a combination of solid economic growth and moderate levels of new construction are constructive to maintaining NOI growth at a rate above inflation. After peaking at 4.9% average same-store NOI growth in the first quarter of 2016, the growth rate has slowed to 2.6% in the fourth quarter of 2017, driven primarily by declines in retail sector performance. With the close of the first quarter 2018 earnings season, we would expect NOI growth to remain around current levels, with the potential for acceleration into the latter half of 2018.

Underlying Property Values

US Investment Grade Composite Index — Equal Weighted



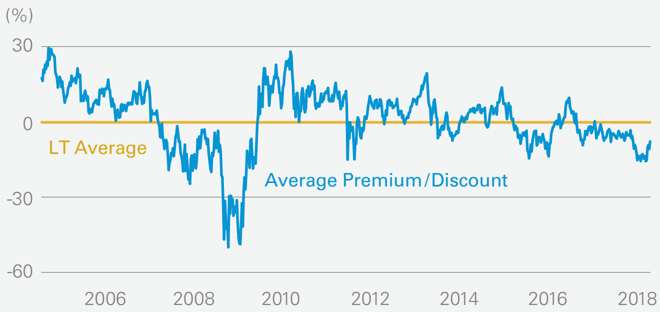
As of 31 March 2018

Source: Real Capital Analytics

US commercial real estate prices were up 3.1% in the first quarter of 2018, after having been generally flat for the second half of 2017 (data lags by one month).[2] This puts property pricing about 13% above prior peak levels and up over 90% since the recession lows of late 2009. Commercial real estate continues to benefit from increased allocations across most investor categories globally, which has translated into still significant amounts of "dry powder," with over 60% of institutions under-invested relative to target allocations.[3] In addition, with lower overall tax rates and a recommitment to real estate's favorable tax treatment, US real estate should be even more attractive to global investors.

Listed Real Estate Valuations

Premium/Discount to Underlying Net Asset Value



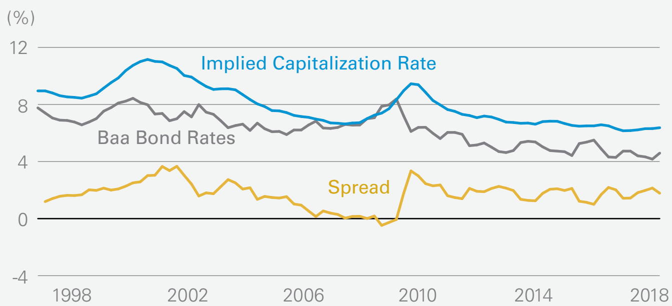
As of 30 April 2018

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

After trading at discounts around 4%–7% to underlying NAV since fall 2016, REIT price weakness during January and February (and subsequent flat performance) has increased that discount to over 10%. This is below the sector's 2%–3% long-term average premium and is close to 0% average premium since 2005. It is also the largest sustained discount to NAV in two years. 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. Certainly, the discount to NAV in late 2007 preceded a downturn in property prices, but in the three times (current time frame excluded) when REITs traded at a NAV discount, a property price correction did not materialize. The steadily growing economy, still low levels 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-Rated Bonds



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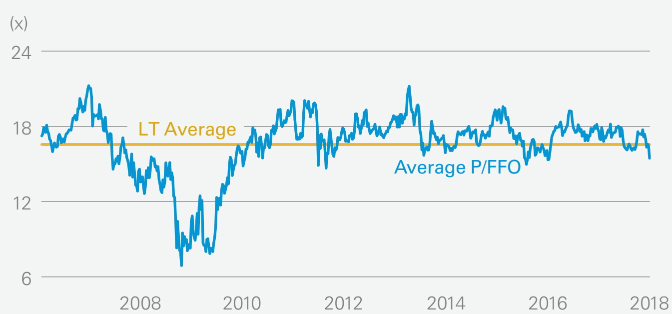
Source: SNL Financial

Corporate Baa bond yields bounced higher by 20 basis points (bps) in April, putting pressure on the spread between bond yields and REIT-implied capitalization rates. With the increase, Baa bonds yields are back up to levels of late 2016, and this has caused the spread between REIT-implied cap rates and the yield on Baa bonds to narrow from approximately 180–200 bps to 150 bps currently. This is the narrowest spread since first quarter 2017, and slightly below the 180-bps average since 2008. Further rate hikes can jeopardize this cushion, but for now suggest that relative value is likely fair.

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



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Source: SNL Financial

REIT P/FFO valuations are now 0.5x below the long-term average of 16.5x P/FFO. With the first quarter 2018 earnings season just concluding, the results can be viewed as positive, and certainly better than low-set expectations. Overall, the vast majority of REITs met or beat analyst estimates and there were no noticeable reductions to full-year 2018 guidance. The results continue to demonstrate that REIT earnings are very stable, and are growing in the mid-single digits annually. With dividend payout ratios still low, this earnings growth should translate into comparable dividend growth.

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

Notes

1 Source: Citi Investment Research

2 Source: CoStar's Commercial Real Estate Investment Grade Index

3 Source: Hodes Weill 2017 Institutional Real Estate Allocations Monitor

Important Information

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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.