Lazard Global Real Estate Securities

US Real Estate Indicators Report

OCT
2018

From a day-to-day perspective, real estate investment trust (REIT) stock prices would suggest very turbulent times for the real estate industry, with heated debate around the future of the sector. For example REITs have been either up or down by more than one percentage point on eighty-eight trading days through the end of October, with ten of those in October alone. However, REITs outperformed broader equities in October even though the sector declined 2.8%, and are down marginally for the year, at -1.3% (which isn't exactly suggesting gloom and doom). In fact, as we have discussed in past reports, the fundamentals for real estate across multiple metrics remain quite solid.

The just completed third quarter REIT earnings season should be viewed as better than expected, in our view, with broad guidance raises in multiple sectors including residential, industrials, and self-storage. The results support the general stability of US real estate across sectors and add weight to expectations that growth will continue into 2019. Certainly there are always some areas of concern, and it is likely we will remain in the mature phase of the cycle, but even some sectors where there had been increasing concern (retail shopping centers and self-storage) look to have stabilized heading into 2019. For the third quarter earnings season, 87% of companies met or beat estimates (same percent as second quarter earnings) while 83% raised or maintained 2018 guidance.[1] This builds on trends earlier in the year as real estate continues to be propelled by strong GDP growth and both consumer and business confidence numbers. As such, and when combined with slightly rising inflation (which is good for real estate rents), real estate demand is impacted positively. In addition, the notion that net asset valuations are an important valuation metric for REITs continues to be proven through both M&A activity and increased share buybacks across many sectors. Over time, this should help to support a valuation "floor" for many companies and at least for now, highlights the extent of the theoretical valuation disconnect across real estate.

The sector is still battling the trifecta of potentially higher rates, an aging real estate cycle, and the market's focus on growth over value (though this last leg of the trifecta is showing signs of weakening). This has kept REITs perennially chasing broader equity returns with the sector underperforming broader equities by 25% since the end of 2016 and slightly in excess of 4% year to date. Based on this trifecta, REIT mutual funds have experienced outflows through the year, which now stand in excess of $19 billion in fund outflows year to date and could reach $22 billion when Japan-based funds' over distribution of dividends is included (this is on top of the approximate $16 billion in outflows in 2017).[2]

We believe the strong relative performance in October should serve as a reminder of the support an allocation to REITs can provide a portfolio over time, especially when market conditions change. In a volatile world, we believe that durability of cash flows and in turn, dividends, should become valued. Past may not be prologue, but looking back to another time of uncertainty, 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. As we have referenced before, "real estate cannot be lost or stolen, nor can it be carried away" (as stated by Franklin D. Roosevelt). That is, to rephrase less elegantly, real estate has a durability and a link to local economics (and not to mention a contractual aspect to its cash flows … leases) which does insulate it from shorter-term swings thereby making real estate cash flows less exposed to the global environment. Hopefully more value will be ascribed to that ballast role. Based on increasing real estate allocations by institutional investors, this value is seen by investors, just not yet transferred to the listed real estate markets.

Real Estate Indexes (SNL)

(%; cumulative)	YTD	1 Month	1 Year	3 Years	5 Years
US REIT Equity	-1.27	-2.80	1.01	17.56	46.31
Global Real Estate	-8.39	-5.52	-5.67	18.16	27.51

Broad Market Indexes

(%; cumulative)	1 Month	YTD	1 Year	3 Years	5 Years
S&P 500	3.01	-6.84	7.35	38.70	71.11
Russell 3000	2.43	-7.36	6.60	37.76	67.08

US REIT Property Focus Indexes (SNL)

(%; cumulative)	1 Month	YTD	1 Year	3 Years	5 Years
Diversified/Other	-7.07	-6.25	-8.37	15.05	21.36
Health Care	5.06	1.74	2.90	17.46	22.33
Hotel	-1.92	-10.23	-0.46	18.51	34.47
Industrial	3.51	-3.62	2.93	59.39	84.21
Multifamily	2.74	-1.98	0.24	18.53	75.47
Office	-11.29	-5.24	-8.14	1.61	26.95
Retail Enclosed Mall	1.86	1.02	17.36	-8.49	28.09
Retail Shopping Center	-8.44	-3.78	-0.36	-15.11	8.47
Self-Storage	2.71	2.19	7.04	7.57	63.78

As of 31 October 2018.
Source: SNL

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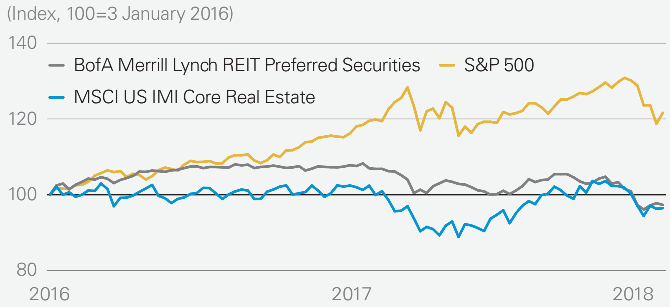
Listed Real Estate Market Performance

Cumulative Returns (Indexed to 100)



As of 31 October 2018

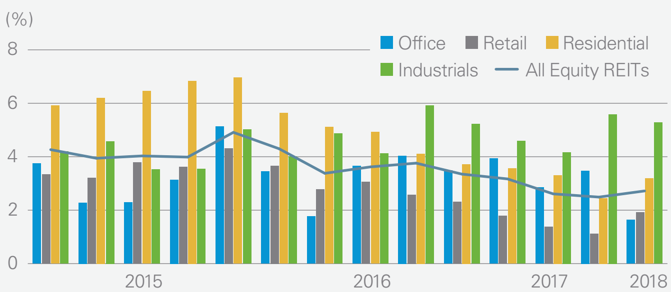
For illustrative purposes only. The performance quoted represents past performance. Past performance is not a reliable indicator of future results.

Source: Bloomberg

While US REIT absolute returns were weak in October (-2.8%), the sector outperformed the S&P 500 by approximately 400 basis points (bps). Combined with strong performance in the second quarter, REITs have narrowed the underperformance gap, but the sector's -1.3% year-to-date return is lagging S&P 500 returns by 430 bps in 2018. The recent strong relative performance was due to a reversal of the market's earlier "risk-off" perspective and a shift toward value, but as we have witnessed for some time, REIT fortunes remain tied to movements in the 10-year Treasury yield. The market seems to be discounting REIT growth as investors contemplate an end of a decade-long real estate "up cycle." Lastly, the aggregate numbers still hide a wide discrepancy in sector performance with an approximate 25 percentage point return difference between the best (Regional Malls) and worst (Diversified) sectors over the last 12 months.

Real Estate Fundamentals

Property Net Operating Income (NOI) Growth



As of 31 October 2018

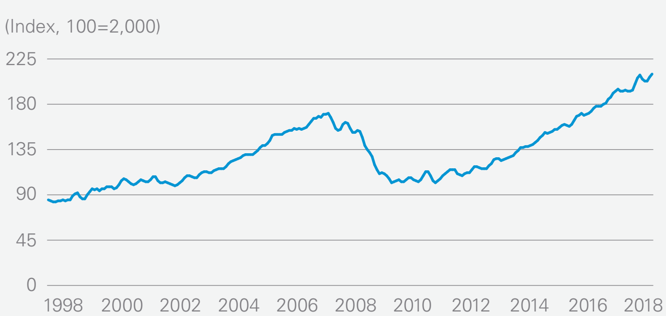
Forecasted or estimated results do not represent a promise or guarantee of future results and are subject to change.

Source: Green Street Advisors

Indicative of a sector multiple years into its cycle, property-level NOI growth has moderated (from 4.9% in Q1 2016 to 2.6% in Q1 2018), though it continues to trend above inflation. 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 Q2 is any indication, the sector has hit an NOI growth base in the mid-to-high 2% range as the residential and retail sectors witness a mild acceleration in growth rates.

Underlying Property Values

US Investment Grade Composite Index (Equal Weighted)



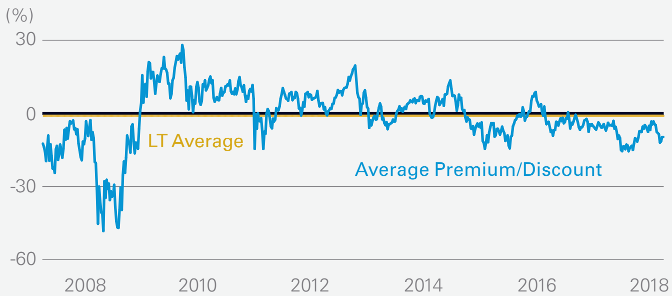
As of 31 October 2018

Source: Real Capital Analytics

US commercial real estate prices are up 5.1% through the first ten months of 2018, after having been generally flat for the second half of 2017 (data lags by one month).[3] This puts property pricing about 19% above prior peak levels and almost 100% up since the recession lows of late 2009. Importantly, the price gains have been recorded across all core property sectors with transaction volume also increasing. 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 allocations 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.[4]

Listed Real Estate Valuations

Premium/Discount to Underlying Net Asset Value (NAV)



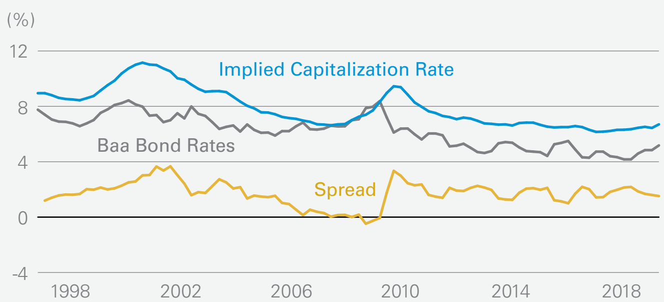
As of 31 October 2018

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

REITs are back to trading at double-digit discounts to underlying NAV at -10%, and continues the sector's longest continual valuation below NAV since the financial crisis. This is substantially 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 par with NAV. While private real estate prices may fall prospectively, the evidence from property sales[5] suggests that prices remain strong across most sectors. The steadily growing economy, still lower rate 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



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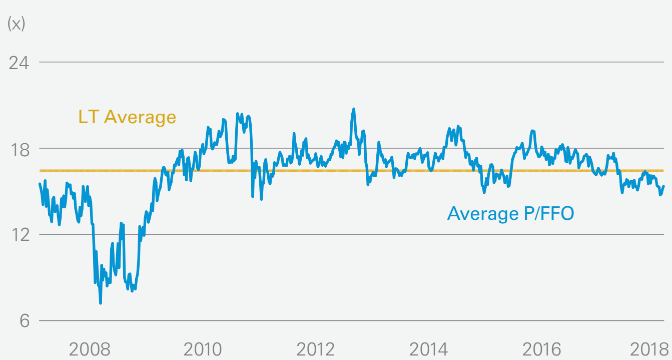
Source: SNL Financial.

After bouncing higher by approximately 70 bps through the first four months of 2018, Corporate Baa bond yields remained in a narrow range for a few months until starting an upward march in September. Yields have now increased by 100 bps for the year. With REIT prices generally range bound during the back half of 2018, the spread between bond yields and REIT implied cap rates narrowed by approximately 40–50 bps to 150 bps from the end of 2017. This level is approximately 30 bps narrower than the average spread since 2009. Further rate hikes can jeopardize this cushion, but for now suggests that *relative* value is likely fair, but certainly no longer "cheap" as a bond proxy.

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



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Source: SNL Financial.

REIT P/FFO valuations are now a full multiple turn below the long-term average of 16.5x P/FFO. With the third quarter 2018 earnings season just concluding, the results can be viewed as good for many of sectors (multifamily, office, industrials, retail), but with only a few pockets of weakening same-store growth heading into 2019 (health care). Overall, the vast majority of REITs have either met or beat analyst estimates, but few companies have issued 2019 expectations. The results continue to demonstrate that REIT earnings are very stable, and are growing in the mid-single digits annually. In addition, REIT earnings are more "local economy dependent" rather than "global economy dependent" given REITs' lower earnings volatility compared to other sectors. With dividend payout ratios still low, this earnings growth should translate into comparable dividend growth. Through September, 78 US real estate companies have announced dividend increases.[6]

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

Notes

1 Source: Bank of America Merrill Lynch
2 Source: Citi Investment Research
3 Source: CoStar's Commercial Real Estate Investment Grade Index
4 Source: 2018 Institutional Real Estate Allocations Monitor
5 Based on the CoStar US Composite Index
6 Source: S&P Global Intelligence

Important Information

Published on 16 November 2018.

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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.