Lazard Global Real Estate Securities

US Real Estate Indicators Report

JUL
2017

US real estate investment trusts (REITs) returned 1.25% in July.[1] While falling slightly short of broader US equity returns, another month of positive performance has brought REIT total returns to 6.1% year to date. REIT performance in 2017 has seesawed as investors assess the economic growth and inflation data underpinning the Federal Reserve's plan for further interest rate increases. While the industry has been challenged to keep up with record-breaking equity market returns, most investors allocate to real estate for a number of reasons beyond returns including long-term inflation protection, downside cash flow protection, and differentiated return patterns.

Most commercial real estate sectors are performing quite well. With the second quarter earnings season effectively complete, 2017 expectations have held steady with more than 80% of REITs meeting or beating second quarter estimates and 34% raising full-year guidance.[2] The results also confirm that we are in a mature phase of the cycle, (likely in the later stages of that phase). Most of the core sectors show slowing underlying property net operating income (NOI) growth with estimates for 2017 in the mid-3% range, down from almost 4% in 2016.

However, the response to REITs during earnings season suggests that investors are skittish as performance gaps are widening between both sectors and regions as slack demand, new supply, and/or margin pressures are hitting some pockets of the real estate market. There has historically been a wide yearly performance gap between different sectors, but 2017 is proving to be excessive in this regard with distinct haves and have-nots. On the "have" side, industrials, multifamily and health care have been the leading sectors, though after second quarter earnings, further health care gains may prove difficult. The "have-nots" are primarily retail REITs which are battling negative sentiment and select erosion in some fundamentals due to underlying retail tenant health. We believe investors have painted all retail REITS with too broad a brush, as the pending acquisition of Whole Foods by Amazon underscores the need for a bricks-and-mortar presence while the increase in sales among many Class A/A+ malls highlights the power of good quality real estate to adapt to changing consumer preferences. In short, this is an interesting point in the cycle to tease out sustainable differences in property fundamentals.

REITs seem to have absorbed the lessons of past years and bolstered their balance sheets. Currently, REITs average a 4.5x coverage ratio, 5.8 years average debt maturity, and a sub-4% average interest rate on that debt. Based on the combination of overall solid fundamentals (albeit with pockets of relative weakness), an underpinning of stable economic growth, still-low interest rates, and downside-protected balance sheets, we believe valuations remain fair, if not decent.

US Real Estate Market Returns

(%; cumulative)	1 Month	3 Months	1 Year	3 Years	5 Years	YTD
SNL US REIT Equity	1.3	3.2	-2.3	30.7	60.5	6.1
MSCI US REIT (RMS)	1.3	2.8	-4.6	28.1	55.5	4.0
S&P 500	2.1	4.1	16.0	36.3	99.2	11.6
Russell 3000	1.9	3.9	16.1	35.0	99.3	11.0

US Real Estate Market Returns by Property Type

(%; cumulative)	1 Month	3 Months	1 Year	3 Years	5 Years	YTD
Diversified/Other	1.1	2.4	2.3	25.2	49.2	9.7
Health Care	-2.4	2.2	-4.3	24.1	37.1	9.7
Hotel	1.5	4.2	10.4	11.4	71.7	1.0
Industrials	3.9	9.4	9.0	62.0	118.6	15.1
Multifamily	2.2	5.7	8.8	45.1	66.6	9.4
Office	-0.5	0.3	-2.6	20.5	52.4	0.2
Regional Mall	-2.0	-1.7	-27.8	0.5	20.3	-10.6
Community Retail	7.8	1.7	-24.4	8.4	37.1	-11.1
Self-Storage	-0.4	-0.1	-9.9	38.6	81.6	-3.7

As of 31 July 2017

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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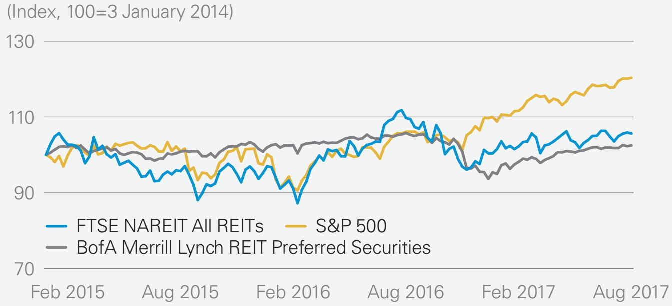
Listed Real Estate Market Performance

Cumulative Returns



As of 4 August 2017

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

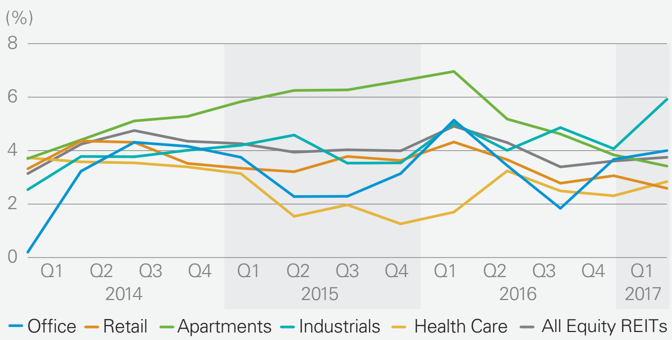
Source: Bloomberg

In July, REITs returned 1.25%, which still fell shy of the 2.1% and 1.9% returns from the S&P 500 and Russell 3000 indices, respectively. REITs continue to struggle as broader equities have not had a down month since Fall 2016 and growth seems to be favored over value (which is where REITs are generally catalogued). As a result, while REITs are up year to date at +6.2%, the returns have substantially lagged broader equities by 500–600 basis points (bps) in 2017 and lagged by approximately 1,800 bps over the last 12 months.

Interestingly, in contrast to prior performance patterns over the past few years, the fact that 10-year Treasury yields are down 15 bps in 2017 has not helped bolster REITs. Meanwhile, REIT preferred securities have benefited from the yield environment, up 7.9% this year.

Real Estate Fundamentals

Same-Store Net Operating Income (NOI) Growth



As of 31 July 2017

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

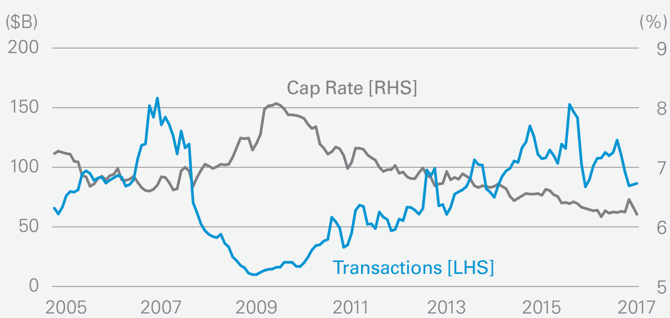
Source: NAREIT 2017, S&P Global Market Intelligence

Even though the real estate sector is multiple years into its cycle, property-level NOI continues to trend above inflation as a combination of solid economic growth and moderate levels of new construction are constructive to further NOI growth. After increasing by 3.8% in the first quarter, same-store NOI growth slowed slightly in the second quarter with estimated growth of approximately 3.6% as we tally the results from the earnings season. This general level seems sustainable, as 34% of companies have raised guidance so far during the earnings season and only approximately 15% lowering.

However, as can be seen in the chart, not all sectors are at the same point in the overall cycle. Business-orientated sectors are leading with the industrials sector enjoying very strong growth and office is accelerating slightly. In contrast, earlier recovering sectors such as apartments are moderating as further rent increases become harder and new supply enters a number of markets.

Capital Markets Activity

Rolling 3-Month US Commercial Real Estate Transaction Volume



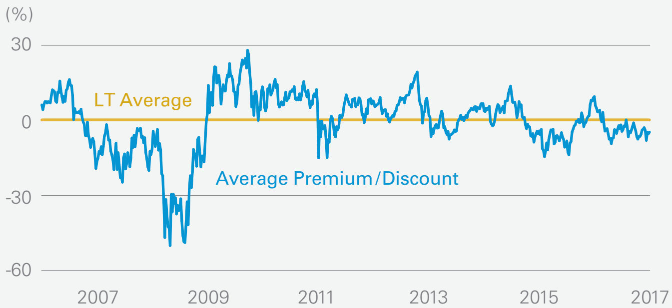
As of 31 May 2017

Source: Real Capital Analytics

Commercial real estate transaction volume has continued to decline throughout 2017 even as investor surveys point to still-large amounts of "dry powder" for real estate investment. The problem is that there is a lack of product for sale, both on the individual and portfolio levels. This has led to lower deal volume where transaction volumes were in the mid-\$400 billion annually and have subsequently dropped to the mid-\$300 billion range, on a month-to-month basis. Even so, capitalization rates are holding in the 6.2%–6.3% range. At current levels, capitalization rates remain at a 400 bps spread to the 10-year Treasury. Interestingly, this spread is within 5 bps of the spread at year-end 2015. While this is still 220 bps wider than at the last peak (2007), it is generally in line with the market's average since 2005.

Listed Real Estate Valuations

Premium/Discount to Underlying Net Asset Value



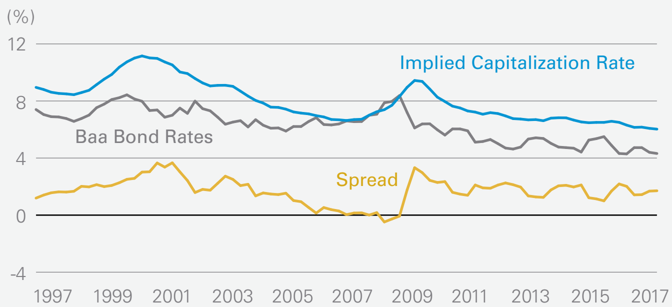
As of 31 July 2017

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

REIT valuations have been generally trending at slight discounts (around a 3%–5% discount) to underlying net asset value (NAV) since fall 2016. This is still below the sector's 2%-3% average premium, which is viewed historically as a reasonable "cost" over private real estate values given listed real estate's higher liquidity and favorable capital markets access. While it's possible that private real estate prices may fall, the evidence from property sales (based on the CoStar US Composite Index) is that prices continue to creep marginally higher. Looking to the back half of 2017, the combination of solid demand for US assets from both foreign and domestic investors and a steadily growing economy should support asset prices even with a moderate rise in yields.

REIT-Implied Capitalization Rate Spread to Baa-Rated Bonds



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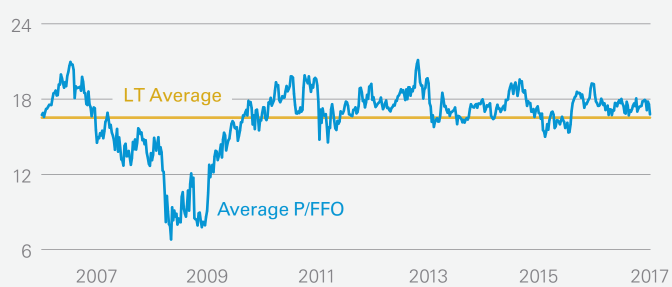
Source: SNL Financial

Corporate Baa bond yields have been generally flat for a few months as economic and inflation growth expectations have moderated from the initial election euphoria. Since the beginning of the year though (through July), both the 10-year Treasury yield, and Baa bonds yields have fallen, by 15 bps and 40 bps, respectively. This has caused the spread between REIT implied cap rates and the yield on Baa bonds to widen by approximately 30 bps. The current spread of 170 bps is 70 bps higher than at the beginning of 2016.

Further rate hikes can jeopardize this cushion, but for now suggests that **relative** value remains solid within the real estate space.

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



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Source: SNL Financial

REIT P/FFO valuations have moderated as earnings have been growing faster than price appreciation and are now trading 0.3 multiple points above long-term averages at 16.8 times P/FFO. The second quarter earnings season has been generally solid with results slightly better than expected, due partially to earnings guidance feeling overly conservative due to the uncertain policy environment.

The results continue to demonstrate that REIT earnings remain very stable and are growing in the mid-single digits annually. This could translate into comparable dividend growth. However, in an era in which the S&P 500 is on track to post +10% EPS growth, REITs are falling a bit short with 5%–7% earnings growth expectations in 2017 and 2018.

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

Notes

1 Source: S&P Global Intelligence

2 Source: Bank of America Merrill Lynch, 4 August 2017

Important Information

Published on 17 August 2017.