Lazard Global Real Estate Securities

US Real Estate Indicators Report

JAN
2018

With one month completed in 2018, US real estate investment trusts (REITs) already lag the S&P 500 Index by almost 9%. In the last three years, REITs have underperformed the S&P 500 Index by 40 percentage points, which includes the impact of dividends. In other words, the price component of the S&P 500 Index has gained 42%, while REIT prices have **declined** by 3% over the last three years. This certainly has been a challenging relative performance period for REITs even though real estate fundamentals including economic growth, capital flows, financing, transaction volume, and new allocations have been strong. Further, 2017 was the ninth consecutive year of positive total returns for the sector.

So, why does the environment feel so negative? Today, REITs are not considered a growth or momentum investment, the bond proxy play is less attractive, the new US tax law is less beneficial for REITs compared to tax-paying corporations that saw corporate taxes reduced from 35% to 21%, and there are concerns of a late real estate cycle play. From a historical context, today's environment strikes a tone similar to that of the late 1990s, notwithstanding the difference in government economic intervention. By the end of 2000, REITs had underperformed equities by 40 percentage points and were trading at steep discounts to net asset value, even though real estate markets were posting good results, overbuilding was minimal, and the sector had more than 30 quarters of positive returns.[1] While some markets and companies were affected by the tech bubble burst, the real estate sector still posted 25 more consecutive quarters of positive returns. 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.

While still early in the reporting season, 94% of real estate companies have met or beat analyst estimates.[2] However, companies continue to be more cautious on 2018 given uncertainties around the tax act impact, length of economic recovery, and the speed of space use changes. As such, investors remain skittish as performance gaps are widening between both sectors and regions as slack demand, new supply, and/or margin pressures have hit some pockets of the real estate market. Earnings results once again confirm that we are in a mature phase of the cycle and likely in the later stages of that phase. Looking ahead, the overall economic climate remains constructive for real estate as GDP and jobs growth have been bolstered by high consumer and business confidence and construction levels have cooled in recent months, which should ease new supply deliveries.

Finally, we believe the new US tax law is generally positive for the real estate industry as it preserves many of real estate's tax benefits including interest expense reductions, the 1031 exchange, and REITs' tax-exempt status. Of note, the limitations on home mortgage interest and state and local tax deductibility is likely to shift demand from high tax states to lower tax states, and from home ownership to rentals. REITs also get a boost from the changes as REIT ordinary income distributions qualify for a potential maximum 20% deduction, subject to the REIT shares being held directly versus being held in a mutual fund.

US Real Estate Market Returns

(%; cumulative)	1 Month	3 Months	1 Year	3 Years	5 Years
SNL US REIT Equity	-3.1	-0.7	4.8	11.1	49.9
MSCI US REIT (RMS)	-4.2	-1.8	0.7	5.0	44.4
S&P 500	5.7	10.3	26.4	50.7	109.2
Russell 3000	5.3	9.8	25.2	48.6	105.8

US Real Estate Market Returns by Property Type

(%; cumulative)	1 Month	3 Months	1 Year	3 Years	5 Years
Diversified/Other	-2.7	-4.1	2.8	7.3	30.0
Healthcare	-6.1	-8.7	-6.7	-14.6	12.0
Hotel	3.1	6.0	11.6	5.2	63.3
Industrials	-1.8	-1.9	24.2	46.5	83.6
Multifamily	-4.3	-6.4	4.4	13.6	64.8
Office	-4.6	-0.1	-3.8	4.5	43.1
Regional Mall	-3.7	9.0	-6.9	-13.8	21.0
Community Retail	-10.1	-3.3	-19.7	-19.1	14.2
Self-Storage	-5.9	-2.2	2.4	15.5	70.0

As of 31 January 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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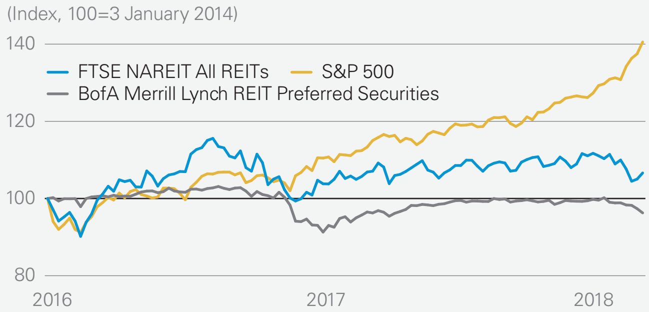
Listed Real Estate Market Performance

Cumulative Returns



As of 26 January 2018

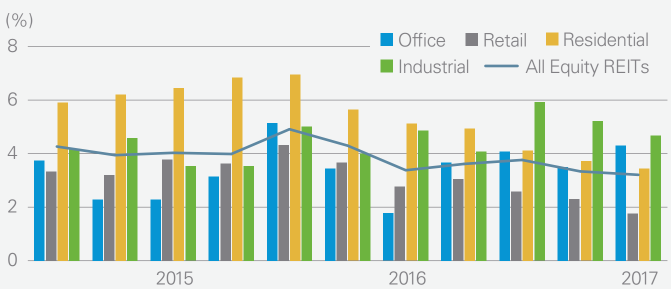
For illustrative purposes only. The performance quoted represents past performance. Past performance is not a reliable indicator of future results.

Source: Bloomberg

In January, REITs encountered a number of macro and sentiment headwinds ranging from higher interest rates to a market preference for growth and momentum. Real estate is in a mature phase of its cycle. Further, REITs have seen significant outflows from both actively managed US mutual funds and mandates from Japan. However, the aggregate numbers hide a wide discrepancy in sector performance with almost a 40 percentage point return difference between the best (industrials) and worst (shopping centers) sectors. Meanwhile, REIT preferred securities declined 2.7% in January.

Real Estate Fundamentals

Same-Store Net Operating Income (NOI) Growth



As of 31 December 2017

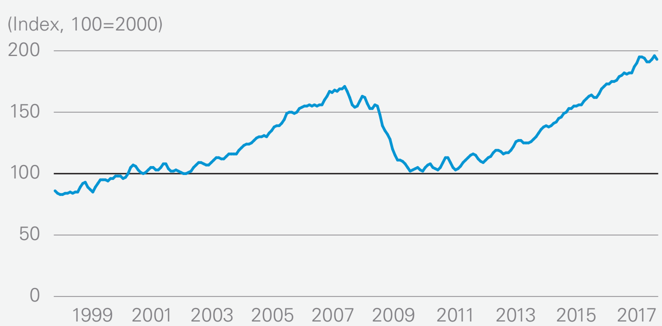
Forecasted or estimated results do not represent a promise or guarantee of future results and are subject to change.

Source: NAREIT 2017, S&P Global Market Intelligence

Indicative of a sector multiple years into its cycle, property-level NOI growth is moderating, though it continues to trend 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 increasing by 3.3% in the second quarter, same-store NOI growth slowed to 3.2% in the third quarter. We believe NOI growth should be sustained around 3%. As can be seen in the chart, not all sectors are at the same point in the cycle. In particular, the retail sector is reporting weaker growth, as lower quality retail centers are performing worse than expected. In contrast, business-orientated sectors are leading with the industrials sector enjoying very strong growth and the office sector is accelerating slightly.

Underlying Property Values

US Investment Grade Composite Index — Equal Weighted



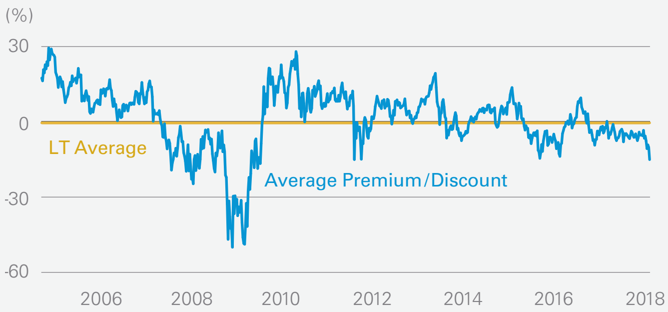
As of 31 December 2017

Source: Real Capital Analytics

According to CoStar's commercial real estate investment grade index, US property prices have been generally flat since May 2017, but ended 2017 (data lags by one month) up 7.1%. This puts property pricing about 10% above prior peak levels and up almost 90% since the recession lows of late 2009. 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 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 5 February 2018

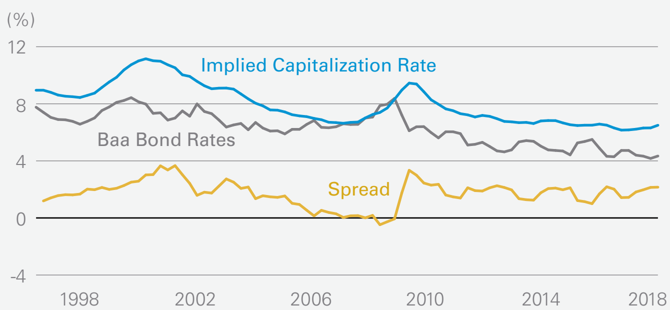
The REIT market as represented is a basket of 53 large and investable REITs across all sectors, as identified and selected by SNL Financial. The basket also includes companies that over time have gone private or merged in order to avoid survivor bias in the historical data.

Source: SNL Financial

After trading at discounts around a 4%–7% to underlying net asset value (NAV) since fall 2016, the further price decline in January has increased that discount to 15%. This is below the sector's 2%–3% long-term average premium and its close to zero average premium since 2005. It is also the largest discount to NAV in two years.

While it is possible that private real estate prices may fall, the evidence from property sales (based on the CoStar US Composite Index) suggests that prices continue to creep marginally higher. Certainly, the discount to NAV in late 2007 preceded a downturn in property prices, but in the three times (current time frame excluded) since then when REITs traded at a NAV discount, a property price correction did not materialize. Looking ahead, 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



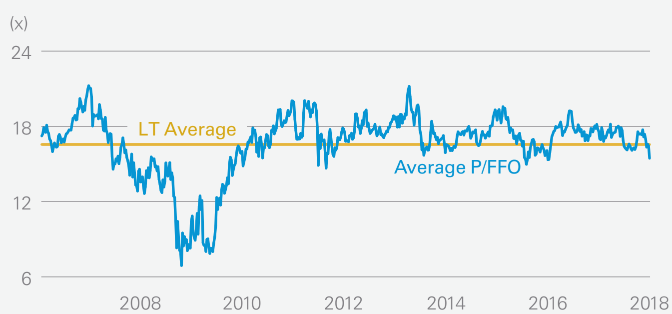
As of 31 January 2018

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

Corporate Baa bond yields have been relatively flat for a few months, even as economic and inflation growth expectations increased causing the 10-year Treasury to climb. Over the last year or so, Baa bond yields have fallen by approximately 40 basis points (bps). This has caused the spread between REIT-implied cap rates and the yield on Baa bonds to widen by approximately 40 bps over the same period. With the weakness in REIT share prices, REIT implied cap rates have risen, and in turn this has widened the spread to Corporate Baa bond yields by approximately 15 bps to 215 bps. This is the widest spread since the second quarter 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)



As of 31 January 2018

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Source: SNL Financial

REIT P/FFO valuations have now fallen one multiple point below the long-term average of 16.5x P/FFO. While the fourth quarter 2017 earnings season is not complete, the results, while solid, indicate that most sectors continue to see growth moderating toward inflation. In general, 2018 company earnings guidance feels conservative due to the uncertain environment and unknown impact from tax reform. The results continue to demonstrate that REIT earnings remain very stable as they are growing in the mid-single digits annually. With dividend payout ratios still low, this earnings growth should translate into comparable dividend growth. Due to tax reform and the strong economy, REIT 5%–7% 2018 earnings growth expectations are a bit lower than the approximate 10% 2018 S&P 500 earnings growth.

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

Notes

1 Source: NCREIF

2 Source: Bank of America Merrill Lynch

3 Source: Hodes Weill 2017 Institutional Real Estate Allocations Monitor

Important Information

Published on 21 February 2018.

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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.

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