



REITS, RISING RATES AND THE REAL ESTATE CYCLE



Scott Crowe
Chief Investment Strategist,
CenterSquare Investment Management

EXECUTIVE SUMMARY:

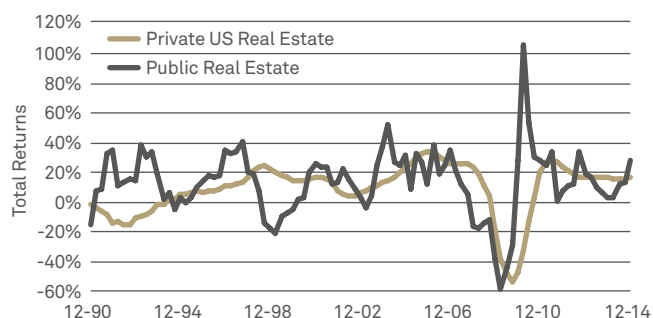
In 2015, REIT shares experienced elevated volatility due largely to ongoing uncertainty about the timing of an increase in the Fed Funds rate and investor worries that higher rates would disrupt the economy and real estate markets.¹ While the Federal Reserve's December rate hike announcement clarified US interest rate policy, real estate markets and REIT share prices are driven by a multitude of underlying factors, of which interest rate policy is only one. In addition, real estate cycles are not identical and the factors that most influence them change as our economy changes. In this paper, we highlight the five most relevant trends to REIT values and the real estate market this cycle, and propose that REIT investors may benefit from a slow tightening cycle with moderate growth, lower long term interest rates, supportive spreads to debt costs and modest levels of new development.

We believe the five most important factors relevant to REITs this cycle² are:

- 1) Real estate may benefit from its correlation to overall economic growth;
- 2) Conventional wisdom regarding REITs, bond yields and Fed tightening may create an oversold condition for investors to exploit;
- 3) Modest supply coupled with growing demand supports the outlook for solid fundamentals;
- 4) Healthy yield spreads should insulate property valuations from modest increases in bond yields; and

- 5) Millennials, a bifurcated economy and urbanization trends create compelling return potential for discerning investors.

FIGURE 1 – PRIVATE VS. PUBLIC REAL ESTATE TOTAL RETURNS



Source: Green Street Advisors, as of September 2015. Private U.S. Real Estate is represented by NCREIF Property Index rolling 1 year quarterly returns adjusted for leverage based on historical REIT leverage ratios and a cost of debt equal to Treasuries + 175 bps. Public Real Estate is represented by FTSE NAREIT Equity REIT Index rolling 1 year quarterly total returns. Refer to index disclosures at the end of this document. Past performance is not a guide to future performance.

REAL ESTATE MAY BENEFIT FROM ITS CORRELATION TO OVERALL ECONOMIC GROWTH

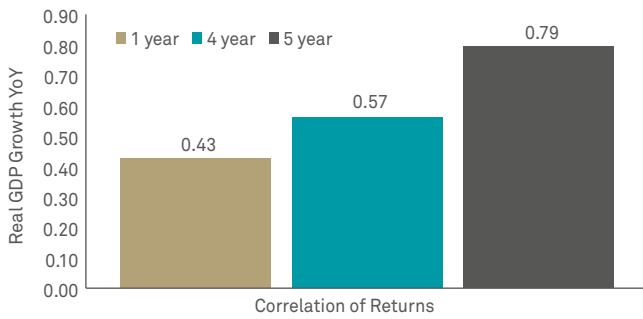
The value of a REIT is derived from the ownership of high quality commercial real estate. In fact, REIT returns tend to lead direct real estate returns by approximately 12 months (see Figure 1) and the correlation between REIT returns and direct real estate steadily improves the longer the time period we examine (see Figure 2). REIT returns may continue to fluctuate around the direction of the underlying real estate cycle, the prognosis for which, as we outline below, remains healthy.

¹ Shown by a widening in corporate credit spreads during the "Taper Tantrum" of 2013 and the "Fed Lift Off" of 2015. See Figures 4 and 5.

² In this paper, "the cycle" represents the current real estate cycle. In general, a real estate cycle can be defined by four distinct phases of recovery, expansion, hyper supply and recession. Historically, the length of the real estate cycle has varied significantly, however it is generally considered to take 7-15 years for a real estate cycle to complete.

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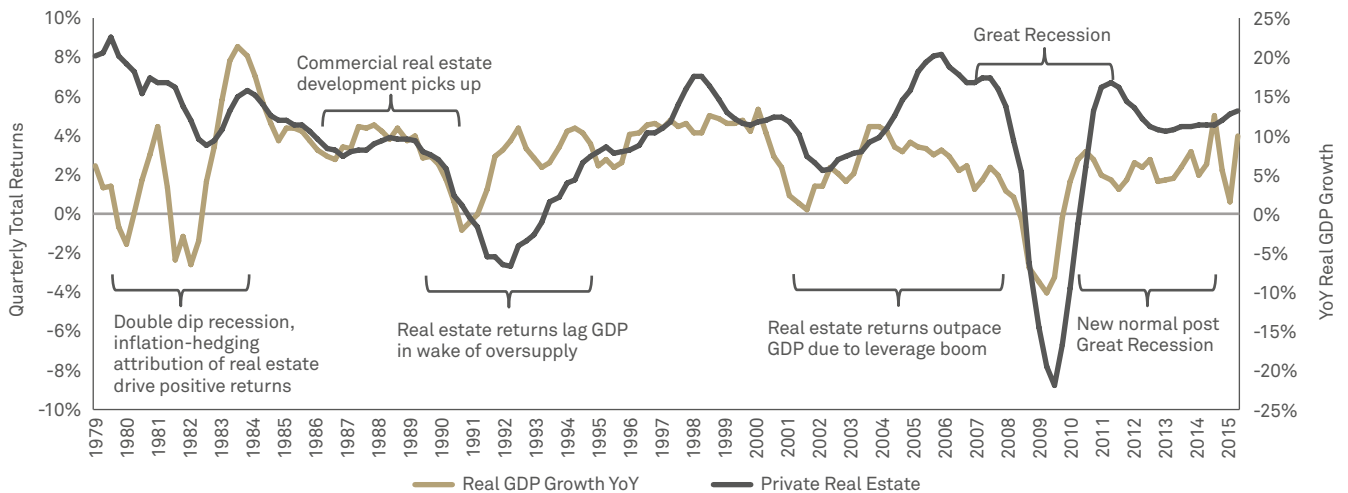
FIGURE 2 – PRIVATE VS. PUBLIC REAL ESTATE CORRELATIONS



Source: Green Street Advisors, as of September 2015. Correlations calculated using NCREIF Property Index rolling 1 year quarterly returns adjusted for leverage based on historical REIT leverage ratios and a cost of debt equal to Treasuries +175 bps, and FTSE NAREIT Equity REIT Index rolling 1 year quarterly total returns. Refer to index disclosures at the end of this document. Past performance is not a guide to future performance.

The commercial real estate market tends to cycle closely in connection to GDP (Figure 3), although the relationship is not always perfect.³ While currently concerns exist regarding the outlook for 2016 GDP, we note that fluctuating expectations (between strong recovery and potential recession) have been the norm since the global financial crisis. Our experience has shown that neither extreme has tended to be correct and that instead, the post-crisis economy has produced slow but positive growth that has been much less robust than before the crisis.⁴ However, the real estate markets have benefited from this in two ways: low supply (due to risk aversion) and low interest rates.

FIGURE 3 – COMMERCIAL REAL ESTATE RETURNS AND ECONOMIC GROWTH



Source: Bloomberg and NCREIF Property Index quarterly data for Private Real Estate from June 1979 through June 2015, as of September 2015.

We believe that unlike the last real estate cycle (2001–2007), which was short and sharp, the current cycle may resemble something closer to those of previous decades, which were more than 10 years in length and had within them a number of mini cycles. Our thesis is that after a long and pronounced downturn beginning in 2008, this private real estate cycle is likely to be longer than its predecessor.

CONVENTIONAL WISDOM REGARDING REITS, BOND YIELDS AND FED TIGHTENING MAY CREATE AN OVERSOLD CONDITION FOR INVESTORS TO EXPLOIT

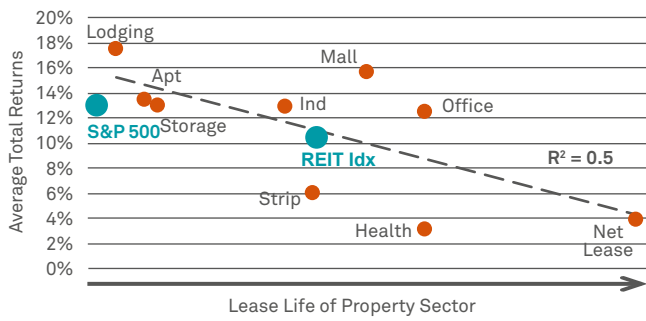
We believe that the abnormally high sensitivity of the REIT market to expectations around a changing Fed posture (such as we saw during the “Taper Tantrum” of 2013 and the “Fed Lift Off” of 2015⁵) has been less about concern over interest rates and more about economic growth and financial stability. Contrary to popular concerns, a higher 10 year bond yield has on average coincided with positive REIT returns (see Figure 4).

3 For instance, even though the economy was in a recession from 1979 to 1982, real estate returns were positive, as investors put their money in real estate in order to hedge inflation risk. When GDP picked up in the mid 1980’s, real estate development activity picked up as well, and returns in real estate decreased in the wake of oversupply, reaching a low in the recession of the early 1990’s. As GDP growth picked up once again, it took some time to absorb the oversupply. Eventually, real estate returns cycled up again before dipping with GDP in the early 2000’s; but remained positive until the Global Financial Crisis (“GFC”) in 2009. Returns fell sharply, and then rebounded just as quickly with the recovery given low supply.

4 Source: Post Global Financial Crisis nominal GDP has average 2.75% per year, versus the prior 10 years of just over 5%.

5 Taper Tantrum refers to the period of May 2013 through December 2013; and Fed Liftoff refers to the period of April 2015 through September 2015.

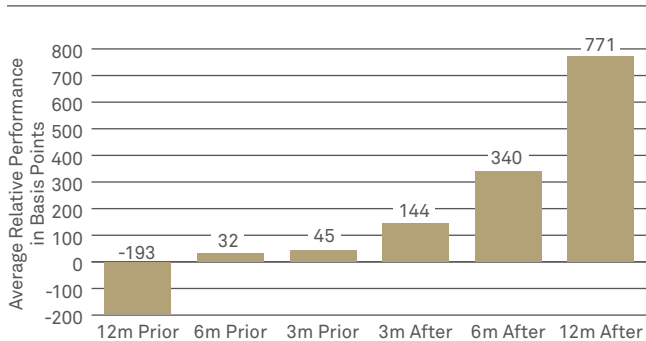
FIGURE 4 – PREVIOUS PERIODS OF INCREASED GOVERNMENT BOND YIELDS⁵



Source: Green Street Advisors, as of September 2015. Period examined is December 1993 – September 2015, and total returns represent the average returns of each sector for periods during which the US 10 year government bond yield was increasing. Sectors are based on FTSE NAREIT sub sector indices, for example, the FTSE NAREIT Apartment Sub Sector Total Return Index for “Apartments”. The R2 value represents the coefficient of determination relevant to the data set. Past performance is not a guide to future performance.

Historically, higher interest rates have accompanied an improving economy, rent growth, lower spreads and higher LTVs, which have offset higher bond yields. Historically, REITs have tended to underperform equities entering a Fed rate hiking environment because the “conventional wisdom” that REITs should underperform during a rate hiking cycle means they are often under-owned at these times. Likewise, REITs tend to outperform following the event, as investors see the negligible impact of the early stages of rate hikes on an improving real estate market (see Figure 5).

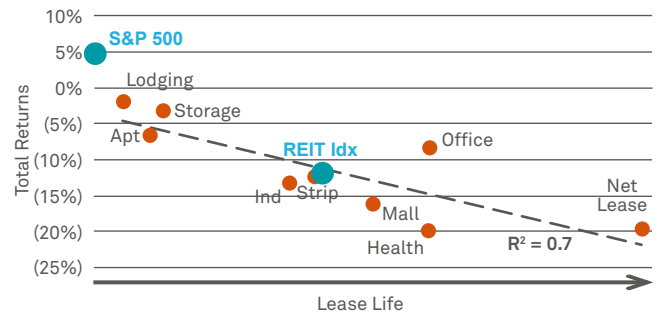
FIGURE 5 – REIT RETURNS RELATIVE TO S&P 500 DURING PERIODS OF INCREASING FED FUNDS RATES⁶



Source: Citi Research, FactSet, Haver Analytics, as of September 2015. Chart shows the average relative performance of MSCI REIT Index vs. the S&P 500 for each instance of a Fed Funds Rate increase during the period from October 1993 to September 2015. Past performance is not a guide to future performance.

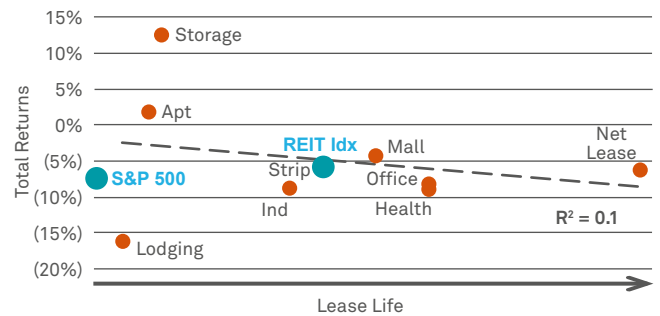
However, today the relationship between asset values and interest rates is likely to be different than in the past due to the extended period of ultra-low interest rates. Investors during the current cycle are concerned that higher rates may disrupt the economy and derail the real estate markets.

FIGURE 6 – THE ‘13 TAPER TANTRUM



Source: Green Street Advisors, as of September 2015. Taper Tantrum refers to the period of May 2013 through December 2013; and Fed Liftoff refers to the period of April 2015 through September 2015. Sectors are based on FTSE NAREIT sub sector indices, for example, the FTSE NAREIT Apartment Sub Sector Total Return Index for “Apartments”. The R2 value represents the coefficient of determination relevant to the data set. Past performance is not a guide to future performance.

FIGURE 7 – ‘15 FED LIFTOFF

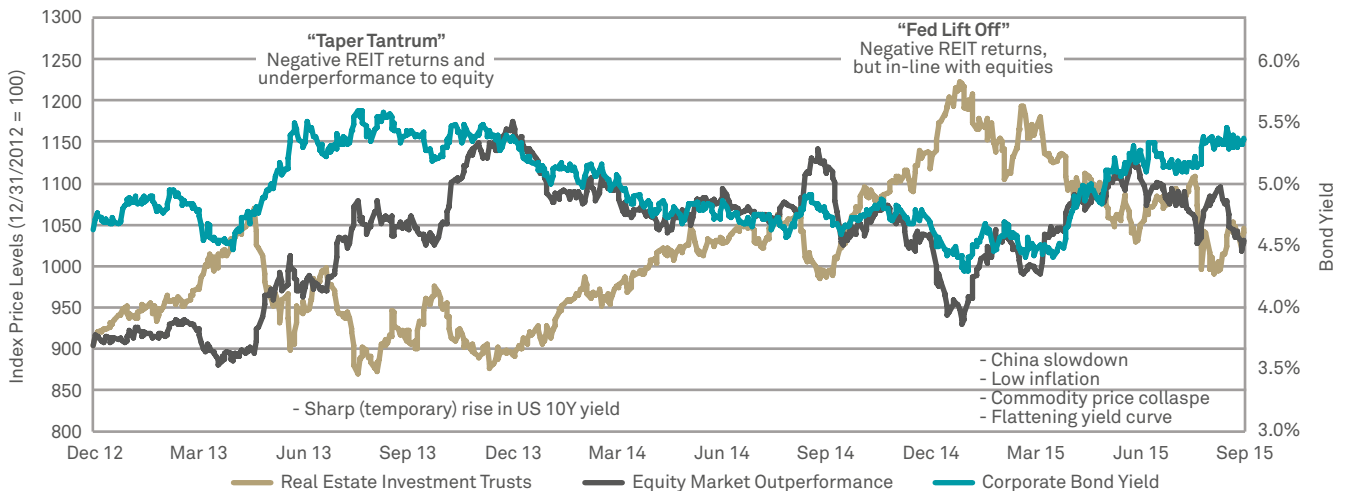


Source: Green Street Advisors, as of September 2015. Taper Tantrum refers to the period of May 2013 through December 2013; and Fed Liftoff refers to the period of April 2015 through September 2015. Sectors are based on FTSE NAREIT sub sector indices, for example, the FTSE NAREIT Apartment Sub Sector Total Return Index for “Apartments”. The R2 value represents the coefficient of determination relevant to the data set. Past performance is not a guide to future performance.

⁵ Taper Tantrum refers to the period of May 2013 through December 2013; and Fed Liftoff refers to the period of April 2015 through September 2015.

⁶ Sources for selected periods: Oct 93 – Dec 94, Feb 96 – Sep 96, Oct 98 – Feb 00, Nov 01 – Apr 02, Jun 03 – Jun 04, Jun 05 – Jun 06, Jan 09 – Jan 10, Oct 10 – Apr 11, May 13 – Dec 13, Apr 15 – Sep 15

FIGURE 8 – CORPORATE BOND YIELDS AND REIT PERFORMANCE

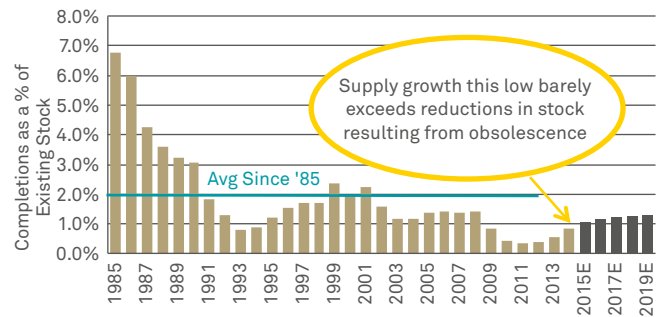


Source: Bloomberg, Moody's Bond Indices Corporate BAA Index, S&P 500 Index, FTSE NAREIT Equity REITs Index from January 2012 through September 2015. Equity Market outperformance shows the relative outperformance of the S&P500 Index relative to the FTSE NAREIT Equity REITs Index. Past performance is not a guide to future performance.

The relationship between REIT performance and corporate bond yields underscores our belief that total debt costs inclusive of spread, not just government or “risk free” bond yields, are a key factor. Because spreads increase due to concerns around economic growth and financial market stability, REIT performance is driven by concerns about decreased growth and capital availability, not the level of government bond yields, which remains very low relative to historical levels. As shown by Figure 8, we see that both the Taper Tantrum and Fed Lift Off led to a sharp rise in credit spreads and a subsequent negative REIT return. The earlier episode was also characterized by REIT underperformance (versus equities) given the sharp rise in longer term rates, while in the more recent period REITs have performed in-line with equities. Our view is that the current tail risk with regard to Fed tightening is less about a subsequent large move in longer term interest rates and more linked to concerns that a tightening into a slow growth/low inflation environment will have a negative impact on the economic (and hence real estate) cycle.

Tail risks aside, our belief is that the Fed will likely hike rates slowly. If we are correct, REIT investors should continue to benefit as moderate growth coupled with low supply delivers strong real estate fundamentals and low longer term interest rates support valuations. In addition, previous episodes of interest rate volatility (such as the taper tantrum) have in hindsight led to attractive investment opportunities in US REITs. Following poor performance in August and September 2015 amid the latest round of interest rate concerns, U.S. REITs are now trading at a -2.25% discount to Net Asset Value (NAV).⁷

FIGURE 9 – NEW COMPLETIONS OF REAL ESTATE (AS A % OF EXISTING STOCK)



Source: Green Street Commercial Property Outlook as of August 2015.

MODEST SUPPLY COUPLED WITH GROWING DEMAND SUPPORT OUTLOOK FOR FUNDAMENTALS

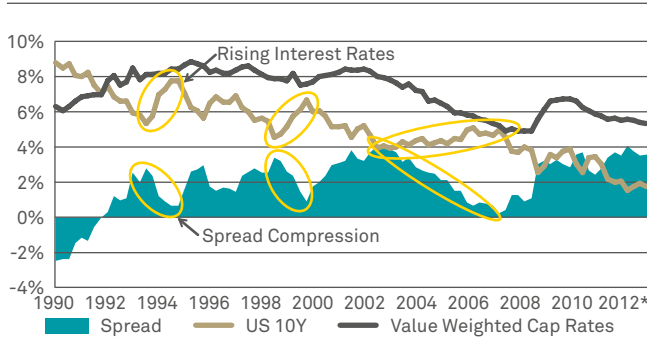
Supply is unusually low during the current recovery, reflecting prolonged risk aversion following the global financial crisis, and commercial real estate has not seen a major supply cycle since the mid 1980’s (see Figure 9). Yet the economy and society are changing significantly, which we believe necessitates the construction of new real estate infrastructure. Low supply is driving increased rental growth as the economy builds steam and this rental growth is leading to the beginnings of an increase in construction. We believe new development could mark the end of this cycle, though we appear to be some years away from such an event given the time it takes to bring inventory to market and the need for higher rents to precede this.

⁷ Source: Green Street Advisors, as of 10/31/2015.

HEALTHY YIELD SPREADS SHOULD INSULATE PROPERTY VALUATIONS FROM MODEST INCREASES IN BOND YIELDS

It is our view that the interest rate which has the most importance for real estate is the longer term (7-10 year) cost of debt, which is the term structure underlying the majority of real estate financing. This cost of debt matters to a real estate investor because the interest payment is usually a real estate owner’s largest cost variable, and a lower cost of debt means investors have the ability to purchase real estate at lower implied yields (higher values) and maintain an attractive internal rate of return (IRR), especially relative to other investment classes, such as fixed income. Intuitively, real estate values are positively affected by lower interest rates (see Figure 10). However, higher government bond rates usually accompany an improving economy, which is characterized by shrinking credit spreads, growing rents and higher LTVs. These factors historically have overcome the negative impact of an increase in the underlying risk free rate.

FIGURE 10 – INTEREST RATES AND REAL ESTATE

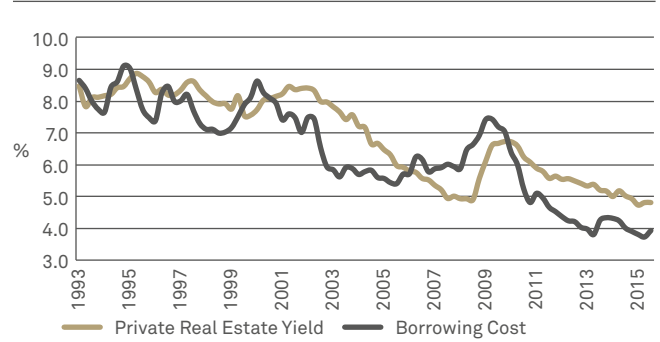


*Through 9/30/12.

Source: CenterSquare, as of December 2014. Value Weighted Cap Rates are represented by NCREIF current value cap rates for properties revalued in the quarter using market value weights from the quarterly ended periods of March 90’ through September 14’.

The healthy gap between real estate yields and debt costs is supportive of current real estate values (see Figure 11). This contrasts to prior cycles — such as the 2001–2007 — where debt costs rose higher than real estate yields, resulting in a “negative carry” and a tumultuous end to the cycle. However, the current conundrum for investors is that while spreads between real estate yields and debt costs remain high and healthy, the absolute levels of yields are quite low, at levels seen at the “prior peak”. Given an outlook for lower long term bond yields on the back of low inflation and moderate growth, the implied continuation of healthy spreads should support real estate values.

FIGURE 11 – REAL ESTATE YIELD AND BORROWING COSTS

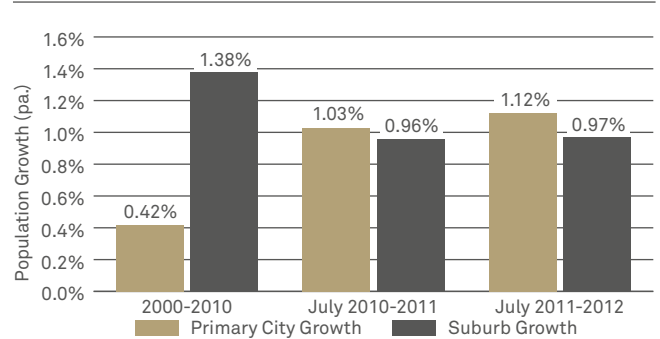


Source: NCREIF, ACLI, as of September 2015. Private Real Estate Yield is represented by the NCREIF Quarter Ending Current Value Cap Rate and Borrowing Costs are represented by the Average of Monthly Fixed Rate Contract ACLI Commercial Mortgage Rates from 1993 to September 2015.

MILLENNIALS, A BIFURCATED ECONOMY AND URBANIZATION TRENDS CREATE COMPELLING RETURN POTENTIAL FOR DISCERNING INVESTORS

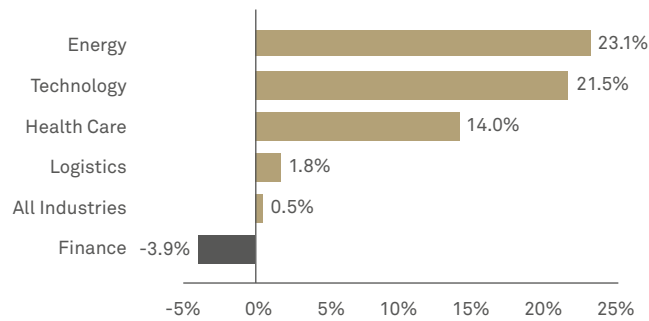
We see important structural themes continuing to play out in the US real estate markets. The post-global financial crisis recovery is bifurcated, with major metropolitan areas, prime real estate and coastal markets performing the best, reflecting a more narrow recovery in the industries producing jobs and a preference for skilled labor. In addition, we see a continued trend of urbanization in society, shown by growth in primary cities now exceeding those of suburbs (see Figure 12). We believe some of the most interesting real estate investments cater to one or both of these themes: markets with leverage to skilled job creation and assets that facilitate the urbanization trend in society. Against this macro backdrop, our outlook is most favorable for central business district office, high quality retail, the west coast, apartments and distribution warehouses.

FIGURE 12 – URBANIZATION



Source: Source: Moody’s Analytics, Clarion Partners Investment Research, as of August 2014.

FIGURE 13 – EMPLOYMENT GROWTH BY INDUSTRY (2008-2014)



Source: Source: Moody's Analytics, Clarion Partners Investment Research, as of August 2014.

In spite of the REIT market's higher sensitivity to interest rate increases in recent years, a gradual change in Fed interest rate policy will unlikely derail the real estate cycle. While we recognize the tail risk of economic and financial instability from a flattening yield curve, we believe REIT investors should benefit from a slow tightening cycle with continued low long term interest rates and moderate growth. The primary driver of REIT returns over the medium term is the underlying real estate market, which is supported by a growing economy, low supply and above average property yield spreads to debt costs. More immediately, we believe that short term market volatility in the REIT market driven by fears of higher interest rates may present an attractive investment opportunity in real estate assets at discounted valuations.

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