Global Real Estate Securities

Market Review | Second Quarter 2016

	Index Performance ($USD)[1]					
Region	Qtr	YTD	1-Year	3-Year	5-Year	10-Year
North America	6.5%	13.3%	22.8%	12.6%	11.6%	12.5%
Asia Pacific	3.4%	9.4%	0.5%	1.8%	5.0%	7.5%
Europe	-4.9%	-2.8%	0.9%	9.9%	4.9%	8.5%
Total Return	3.8%	9.5%	12.7%	8.9%	8.6%	10.3%

Market Review

Brexit - when the improbable becomes reality. The results of the referendum and ensuing week of market activity overshadowed most economic events of the second quarter. Although a majority of the forecasts projected a "remain" vote, the unanticipated outcome of the "leave" vote will likely result in some ongoing volatility in the global financial markets. The scope of the economic impact is unlikely to be fully understood for quite some time. However, the uncertainty of the eventual outcome is expected to result in heightened market anxiety and increased volatility as market participants attempt to predict the final outcome of years of negotiations.

Despite the market turmoil, global real estate securities have continued to demonstrate the characteristics that make real estate an attractive asset class in a diversified portfolio. Globally, public real estate has returned 9.5% through the end of the second quarter. Returns were varied by geography with returns in North America, Asia and Europe at +13.3%, 9.4% and -2.8%, respectively, for the six months ending 30-June.

Real estate returns are primarily driven by private market valuations. Public real estate securities are priced to anticipate the future movements in the private markets. The private market fundamentals of supply and demand and the availability and cost of capital usually are the primary factors influencing asset pricing. Real Estate fundamentals still remain stable due to limited supply pipelines and limited capital availability for new development. While we anticipate that the global economic slowdown will subdue rental rate increases in some markets, dividend and earnings growth remain on track for most REIT markets and return expectations appear quite attractive relative to other investment alternatives.

Our colleagues at Prudential Fixed Income have advocated for quite some time that rates are going to be "lower for longer". Given an environment characterized by political uncertainty, muted growth and inflation, and widespread high debt and deficits, there are too many structural headwinds to alter this forecast in the near term. It seems that rates are likely to be "lower lower for longer longer". Return expectations for almost all asset classes globally continue to decline.

Real estate returns will not be immune from global macro events. We anticipate that the returns from global real estate securities next year will unlikely match the exceptional returns that we have witnessed last year (+11.5%)[2] and will likely diminish due to decreased opportunities for cap rate compression, lower inflation and lower growth rates. However, in this environment of limited capital availability for significant new supply and the importance of income streams from contractual lease obligations, we anticipate that public real estate returns should provide a compelling investment opportunity, especially in comparison to other investment alternatives. Within the REIT sector, strong corporate balance sheets combined with a positive fundamental outlook should result in visible and sustained income growth. Real estate securities are a hybrid between equities and bonds. The bond like nature of dividend income streams combined with the visibility of growing income streams due to contractual lease escalations and new leases being signed at significant premiums to expiring rents, should be attractive investments in a diversified portfolio.

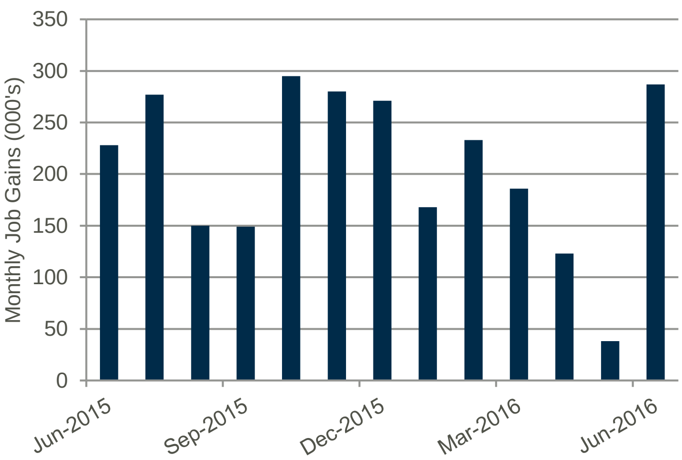
United States

Market Review

U.S. REITs delivered a 6.81% total return in the second quarter of 2016.[3] From the Brexit vote to the end of the quarter REITs returned 3.55%. REIT returns were primarily driven by shifting views on global economic growth, interest rates, concerns on where we are in the real estate cycle as well as continued strong real estate fundamentals. In the last week of the quarter, investor focus shifted to the impact of Brexit as they sought safety in high quality income stocks like REITs.

The economic backdrop remained favorable for REIT fundamentals in the second quarter with the economy averaging approximately 147,000 jobs per month. There was, however, volatility in the monthly reports with May revised to 11,000 new jobs but June delivering a robust 287,000 jobs. This volatility, combined with Brexit's impact on global economic growth, has clouded the Fed's interest rate direction. What is a bit clearer is that jobs growth is decelerating, down just over 100,000 jobs from the same period last year. The Brexit decision sunk U.S. 10 year yields to near record low levels and renewed investor appetite for yield driven investments like REITS.

EXHIBIT 2: MONTHLY GAINS (‘000) FOR OFFICE/NON-OFFICE USING JOBS[4]



The level of jobs growth continued to create ample real estate demand to absorb vacancies and create pricing power in most property types and markets. However, it was not so much that it created material supply additions, with the exception of apartments and select industrial and hotel markets. REIT aggregate occupancy held firm at a record level of approximately 95% at the end of 1Q 2016, above the 15 year historical average of 93.2%.[5] Same store NOI growth reached nearly 6% in 1Q 2016, well above the long term historical average of 2.80%. New supply, while trending up, remains well below historical averages and near historical lows at 1.1% of existing supply. Supply additions across property types remain well below long term averages with the exception of multifamily, which is in line with its long term average. Additionally, REIT dividend payout ratios are near historical lows at 72% versus a long term average of 80%, providing the potential for double-digit dividend growth again in 2016.

Small capitalization REITs outperformed large capitalization REITs in the quarter by 90 bps, partially reversing a valuation gap that we identified in our annual outlook. Much of this valuation gap has been narrowed, and we expect with the inclusion of REITs as a GIC sector later in the year that large cap REITs will perform relatively well. Higher leverage REITs outperformed lower leverage REITs by 820 bps. Higher dividend yield stocks outperformed by 720 bps and lower AFFO multiple REITs outperformed by 560 bps for the quarter. This was driven by the net lease and healthcare sectors which outperformed as investors sought safety in a risk-off environment.

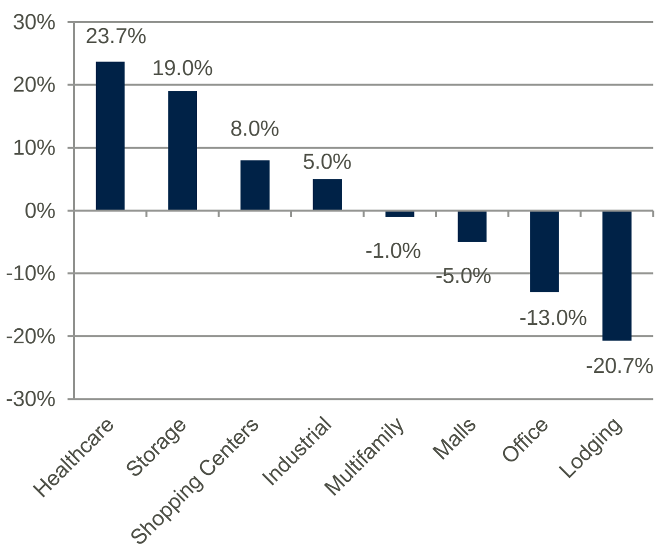
REITs continued to take advantage of the availability and relatively low cost of capital. REITs issued $32 billion in equity and debt capital during the quarter, a run rate that would result in the highest level of capital issuance since 2013.

Given the recovery in REIT prices to levels that are, on average, in-line with Net Asset Value (NAV), REITs have increased their equity issuance from $6 billion in the first quarter to $8 billion in the second quarter. Subsequent to quarter end, REITs issued another $2.6 billion of equity. Additionally, we have seen an increase in preferred equity issuance with $4 billion issued year to date as companies call higher interest rate preferred stock and refinance into lower rate preferred stock. As REIT prices continue to rise, we would expect to see an increasing level of equity issuance as there exists pent up demand to fund development and re-development pipelines and a reduction in debt given the low level of equity issuance last year. Many REITs, however, are at their target balance sheet structure and are maintaining a disciplined approach to acquisitions in a competitive environment. Attractive acquisition opportunities remain very limited. Many companies continue to use the capital raising opportunity to refinance into longer-term, lower-rate debt and to redevelop, develop or acquire properties to improve earnings per share growth rates.

Fund flows from U.S. REIT mutual fund and ETF investors totaled $1.8 billion as investors sought yield and safety in response to Brexit and global growth concerns. Fund flows from Japanese investors into U.S. REITs however remained strong at $6.4 billion.[6]

REITs that specialize in non-core real estate property types were significant outperformers for the quarter. The best performing sectors in the quarter were the net lease, industrial and data center sectors. The magnitude of out-performance by non-core real estate property types was significant with data centers outperforming the benchmark by approximately 14,000 bps and net lease companies outperforming the benchmark by approximately 1,000 bps. These sectors benefitted from investor risk-off sentiment and in the case of industrial, improving fundamentals due to e-commerce distribution.

EXHIBIT 3: US SECTOR P/NAV[7]



Self storage was the worst performing sector for the quarter. Concerns over decelerating revenue and income growth due to peak occupancy levels and a marginal increase in supply weighed on self storage shares.

As we anticipated, office REITs focused on San Francisco and New York City outperformed in the second quarter. In both cases, we believe the market had overreacted to softening demand trends, as office real estate fundamentals remain strong in both markets and investor appetite for properties is robust. While there likely will be a deceleration or flattening in rent growth in both New York City and San Francisco, REITs focused on these markets began the second quarter trading at historically wide discounts to NAV (20%-30%), implying that the market had priced in significant rent declines.

Market Outlook

REITs should experience continued improvement in operating fundamentals and are expected to deliver double-digit dividend and high single digit cash flow growth in the next 12 months. We expect forward 12 month same store NOI of REITs to be 4.25% to 4.50%, a level above the long term average, but given peak occupancy levels, we would expect much of the growth to come from rental rate increases and not occupancy gains.

From a relative valuation perspective, REITs ended the quarter trading in-line to NAV, compared to a 2.8% premium historically.[8] Certain sectors are trading at very wide discounts relative to their historical levels. Regional malls presently trade at a 14% discount to NAV while historically they have traded in-line with NAV. Hotels are at a 19% discount versus a 6% discount historically, and Office is at a 12% discount versus a 3% historical premium to NAV. Implied cap rate spreads of REITs relative to the 10-year Treasury remain wide at roughly 400 bps, well above the long term historical average of 360 bps.[9] It is important to note that during the last peak in 2007, this spread turned negative. This level of spread provides REITs with a cushion if interest rates increase, as spreads could contract without any deterioration in real estate value. Additionally, REIT cash flow multiples are slightly above the S&P 500 earnings multiple, an attractive level relative to the 2011-2013 period, and given relatively attractive earnings growth rates for REITs, versus the S&P 500 in 2016.

REIT rental rates are expected to continue to improve in the second half of 2016. At this point in the cycle, we would expect the majority of revenue growth to come from rental growth versus occupancy gains. Supply is expected to remain muted in most markets and property types, with the exception of apartments, industrials and certain hotel markets. Employment centers that focus on technology, healthcare, and media/entertainment are expected to deliver relatively strong jobs growth. We will continue to monitor technology dependent markets for any signs of decelerating demand growth. In 2015 we saw a bottoming and improvement in markets that are dependent on government employment like Washington DC and expect to see accelerating improvement in market conditions in the second half of 2016. We are underweight energy related markets as the impact of lower oil prices weighs on demand and keeps private real estate investors on the sidelines. We continue to see an impact on hotel revenue growth and apartment revenue growth as well as marginal demand for office space in energy dependent cities like Houston.

With a dividend yield of 4.2% and estimated earnings growth of 6% to 8% in the next 12 months, REITs are poised to deliver a consensus return of approximately 11%, assuming no expansion or contraction in the earnings multiple. However, given continued economic concerns, volatility spikes remain likely.

A slow growth, lower rates for longer environment bodes well for U.S. REITs. U.S. REITs offer a valuable combination of income and growth in a volatile market. We will continue to monitor the real estate cycle as well as demand for real estate from Sovereign Wealth Funds to determine if oil prices and China headwinds are weighing on investor appetite for real estate. Additionally, we will continue to monitor high yield debt spreads to see if there are any impacts on real estate debt spreads. The wall of capital to be invested in U.S. real estate remains high with $231 billion targeted for global commercial real estate but un-invested. Additionally, Net Asset Value matters and large discounts in the core property types are likely to get resolved or arbitraged. We are positioned to focus on companies with strong relative internal cash flow growth and strong balance sheets that trade at reasonable valuations relative to their private market value.

We believe the best opportunities are stock specific across all sectors. It is a stock pickers market and given economic volatility, we are not making major over or underweights to property sectors within the US.

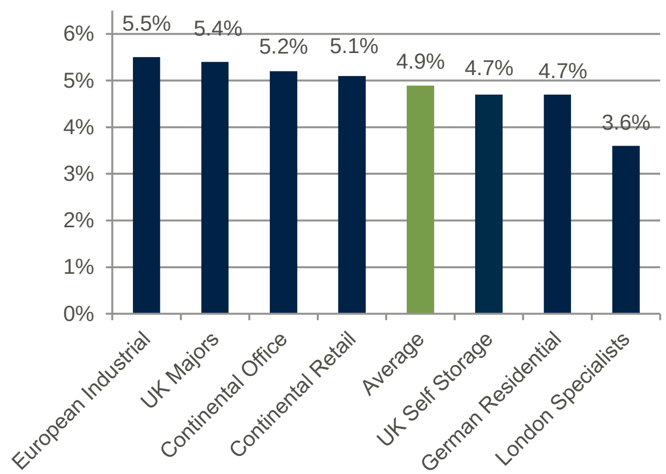
Europe[10]

Market Review

The European public real estate market was again the worst performing global region during the second quarter, just as in the first quarter. The European public real estate market index returned -5.1% (USD gross total return) in the second quarter and -3.0% for the first half of the year. Europe's poor second quarter performance was largely due to the vote by the UK to leave the European Union on June 23rd, taking the market by surprise. The UK market index plunged 17.5% in June alone in USD terms and 21.4% in the first half.

Currency played a big role in the first half UK returns as Brexit fears and then the negative referendum result sent the GBP spiraling down. The GBP lost 7.3% against the USD in 2Q and 9.7% in the first half. This sharp currency decline added to the major correction in local currency terms by the UK real estate stocks.

EXHIBIT 4: EUROPE SECTOR/COUNTRY IMPLIED CAP RATES[11]



The UK was by far the worst performing market in 2Q in USD terms with -13.4%, but Italy (-12.1%), the Netherlands (-11.8%) and Spain (-8.2%) also had poor performance quarter. The shock of the Brexit result hurt peripheral markets such as Italy and Spain in the flight to safety that ensued, though Ireland held up well with only -2.0% in 2Q on strong domestic economic development despite close trade links with the UK.

The only markets to perform well in 2Q were safe haven markets such as Switzerland (+4.0%), Norway (+4.0%) and Germany (+4.1%). Germany's large multifamily sector, with its solid but modest rental growth, low risk and high diversification, remains very much in demand as government bond yields continued their downward progress.

Market Outlook

The vote by the UK to leave the European Union took the market by surprise and caused an immediate and severe sell-off in the UK market. The UK real estate index plunged 21.9% in the two days following the result (in local currency) before hitting its low. This fall was made worse by an immediate 11% drop in the value of the currency against the USD. The UK real estate index has since recovered somewhat, and, as of market close on July 11, was 12.4% below its close on June 23 (in local currency).

The shock of the Brexit result has sent government bond yields plunging, even in the UK (the UK 10 year yielding 76 bps on July 11). The German 10 year has now fallen into clearly negative territory and yields (-17 bps as of July 11). In theory, the cheaper UK currency and drop in bond yields should make UK prices and the real estate income yields even more attractive.

The UK stocks, particularly those with London office exposure, were very hard hit in the immediate aftermath of the vote and were probably pricing in the market's estimate of the worst case scenario. However, the political and economic uncertainty in the UK is likely to persist for some time. A new prime minister will have to take office and formulate a negotiating strategy with the EU. The process of negotiation is likely to be long and complicated and the outcome and economic effects are unclear.

We substantially reduced the size of our UK position leading into the referendum as both the stock market and the currency recovered before the referendum to levels that no longer adequately priced in the risk of a vote to leave. We will maintain our underweight in the UK until there is greater visibility on the political and economic environment. We have shifted from the UK into defensive names such as German multifamily and office names in continental Europe.

Asia Pacific

Market Review

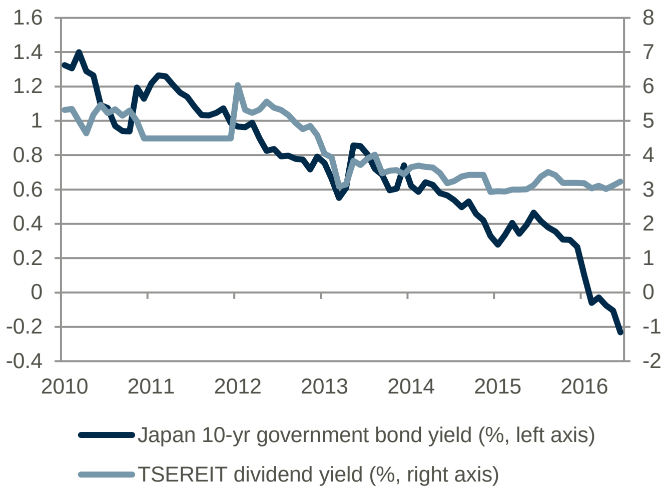
The market volatility Brexit brought to the Asia Pacific equity markets was short-lived. Across the region, the markets fell between 3% and 5%[12] (in USD terms) when the unexpected Brexit 'LEAVE' result was announced. Calm has since returned and markets rebounded 2.5% to 3.5% in the last week of June to levels above pre-Brexit.

Overall for the second quarter in USD terms, the REITs performed better than developers. Japanese REITs rose 6.0%[13] in the second quarter, followed by Australia (+4.6%) and Singapore (+2.5%). On the other hand, Hong Kong developers rose 2%, followed by Singapore (+0.8%), while Japanese developers fell 3.8%. We believe the outperformance of the REITs was due to flight to certainty and the quest for yields by investors in the current low interest rate environment.

Central banks are likely to continue with their monetary easing policy in light of the inflation downtrend across the region. In Australia, the unexpected 0.2% fall in the core CPI - the first decline since the fourth quarter of 2008 - has prompted the RBA to cut rates by 25 bps. In Japan, the BOJ left the monetary policy unchanged and expects inflation to be somewhat negative or around 0%, which is far from its target rate of 2%. Inflation in Singapore fell 1.6%[14] year over year for the month of May, the 19th consecutive monthly decline. In such a low interest rate environment, REITs and institutional investors are likely to become more motivated in re-deploying their cash, resulting in further yield compression.

Real estate fundamentals across Asia continue to be healthy, especially the office sector. Japan's office vacancy in Tokyo's central 5 wards improved to 4.05%[15] in May, from 4.34% in March. Average rent rose 0.7%[16] in May compared to March. Overall tourist arrival in Japan increased 29%[17] year over year for the first five months of this year, underpinned by 45% higher mainland Chinese arrivals. In Hong Kong, the average office vacancy in Central remained low at 1.3%. In Australia, the office cap rate in Sydney CBD remains compressed at about 5%, which is still among the highest in the region and continues to attract foreign capital.

EXHIBIT 5: Japan Long Term Interest Rate vs J-REITs Dividend Yield[18]



There is also positive development in the Singapore office leasing market - pre-commitment at new office building, Marina One reached 30% (550,000 sq ft out of the 1.88 million sq ft in total). Demand is mostly driven by flight to quality. Investment sales activity in the Singapore office market has also picked up. Qatar Investment Authority paid about US$2.5 billion for the Asia Square Tower 1 (Leasehold with 90 years remaining) at an estimated cap rate of 2.8% while another 1.26 million sf class-A office building (Freehold) was transacted at net yield of 3.2%. The buyer of the latter building is said to be a Middle Eastern Fund. Pricing looks very aggressive, especially compared to CapitaCommercial Trust's acquisition of the remaining 60% stake in CapitaGreen Office building that they do not own at 4.1%.

In Japan, consumer spending remains muted, prompting the Abe government to postpone the 2% consumption tax to October 2019, from April 2017. This is despite the overall economy expanding 1.9%[19] quarter-on-quarter in 1Q16, higher than the first preliminary estimate of 1.7%. In Hong Kong, while the retail market remained weak, the rate of decline peaked in February (-20.6%[20]) and has moderated in March (-9.8%) and April (-7.5%). In fact, if we strip out the retail sales of jewelry, watches and valuable gifts (which fell by 17% in April), the drop in retail sales in April was 5.7%, better than March's 7.7% decline. The decline in visitor arrivals in Hong Kong from the mainland China has also narrowed to 4%[21] in April, from 6.9% in March.

Market Outlook

In hindsight, the initial fear stirred up by Brexit in the region's equity markets was well absorbed, and calm has apparently returned to the markets.

Our favored markets remain Australia and Japan. In Australia, the cap rate compression theme remains intact and the market continues to attract foreign capital. Despite the compression, cap rate remains the highest among other developed markets such as Japan, Hong Kong and Singapore. Furthermore, the cash rate in Australia has the possibility to trend lower (given the lower inflation) and would be a boon for investors to add core assets into their portfolios. Japan's negative interest rate environment is designed to motivate yield driven investors to J-REITs, which in turn would enable the latter to enlarge their asset portfolio via acquisitions.

We have turned cautious on the Hong Kong office market at the margin and more positive on retail. Central office rents continue to trend upwards, but the pace of increase has slowed. In fact, we are concerned that demand from PRC firms will fade moving forward and low vacancy, coupled with increasing rents, will make it difficult for tenants to enter or expand. On the other hand, although consumer demand continues to be slow, we believe the rate of negative growth has peaked. Apart from the big ticket items which are still seeing double digit sales decline, sales of other goods have declined less.

In Singapore, the investment activity in the office market has picked up despite the looming large new supply (3 years of historical demand) in the next 12 months. We would also not rule out the potential shift in office space demand from UK to Singapore.

The risks to our relatively positive view on Japan would be a strengthening yen, which would lead to lower profitability of the Japanese corporate sector, and the absence of further stimulus measures by the government, which appears to be increasingly priced in by the market.

[1] Factset, FTSE EPRA/NAREIT Developed Index, 30-Jun-2016.
[2] FTSE/EPRA NAREIT Developed Property Index (TRNGLU)
[3] U.S. REITs total return taken from MSCI US REIT Index (RMZ)
[4] Bloomberg, 30-Jun-2016.
[5] Citi. As of 06/30/2016
[6] Barclays Research. As of 06/30/2016
[7] ISI, GreenStreet Advisors, 30-Jun-2016.
[8] ISI. As of 06/30/2016
[9] Citigroup. As of 06/30/2016
[10] All performance data appearing in this "Europe" section is sourced from the S&P Developed Property Gross Total Return Index and regional constituent indices. The country returns quoted below in this section are quoted from the individual country indices within the S&P Developed Property Index using gross total returns (ie S&P United Kingdom Property Index, etc.). Investors cannot invest directly in an index. Please see end of document for index definitions.
[11] Green Street Advisors, 1-June-2016.
[12] Bloomberg (as of 30 June 2016)
[13] Bloomberg (as of 30 June 2016)
[14] Singapore Department of Statistics
[15] Miki Shoji
[16] Miki Shoji
[17] Japan National Tourism Organization
[18] Bloomberg, 30-Jun-2016.
[19] Japan Cabinet Office
[20] Hong Kong Census and Statistics Department
[21] Hong Kong Tourism Board (as of 30 June 2016)

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