

# Global Real Estate Securities

## Market Review | Third Quarter 2016

Region	Index Performance (\$USD) <sup>1</sup>					
	Third Quarter	YTD	1-Year	3-Year	5-Year	10-Year
North America	-1.0%	12.1%	19.7%	13.3%	14.9%	5.9%
Asia Pacific	4.8%	14.7%	17.6%	1.2%	10.5%	1.9%
Europe	4.9%	1.8%	1.9%	8.2%	11.5%	-0.3%
Total Return	1.4%	11.0%	15.9%	8.6%	13.1%	3.2%

### Market Review

#### Bubble, Bubble Toil and Trouble?

As we head into the Halloween season and reflect on REIT performance and real estate valuations, we need to ask ourselves, are we in a real estate bubble? Were the witches of Macbeth portending a downturn in the real estate market<sup>2</sup>? A deeper inspection into the bottom of the cauldron is clearly warranted. Real estate fundamentals are intact. Supply is in check and demand, primarily driven by consistent job growth, is steady. REIT returns have been compelling, but we need to understand the drivers of those returns. As the demonic incantation of the witches of Macbeth presented double meanings and contradictions, a thorough analysis of the real estate market is clearly imperative to understand the investment opportunities or impending doom.

We anticipate that private real estate returns in the United States should decelerate from the stellar performance witnessed over the past five years when returns averaged 11.4%<sup>3</sup>. The appreciation in United States real estate since the bottom of the Great Recession has been an impressive average annualized return of 12.1%<sup>4</sup>, driven by consistent economic and commensurate job growth coupled with a general lack of new supply, partly as a result of rigid debt constraints for new development. We expect that, for the near future, United States private real estate returns may be more in line with the longer term average annualized returns of

7.9%<sup>5</sup>, achieved over the last 30 years. Real estate returns still seem extremely attractive relative to the alternatives of equities and bonds. However, not all REIT returns are created equally.

Why the cautious optimism? We are enjoying the benefits of an economic equilibrium. During the third quarter, we have observed global economic activity decelerate from its 2015 pace, but still positive economic growth. In the United States, the stronger economic data since the start of the quarter has led to increased odds that the Fed will raise rates later this year. There are definite headwinds to growth including a moderation in United States labor market demand, concerns over the pace of global economic growth and low earnings quality<sup>6</sup>. However, the rise in rates is widely anticipated to be modest and measured, dependent on continued economic growth and limited inflation.

Nearly all real estate recessions are exacerbated as a result of excess supply. Since the recession, banks have been rigorous in their implementation of conservative underwriting assumptions for new development loans. Bank construction loans are 53% lower than the peak in 2008<sup>7</sup>. Mortgage loan-to-value ratios have been more conservative and the lenders have required significantly higher debt service coverage ratios for construction financing. As a result, we have seen limited new supply in most markets, in-line with the

sluggish pace of the United States economic recovery. Of course the supply additions have not been distributed evenly and there are signs of stress in some markets; however, resourceful investors can distinguish which markets are in equilibrium and provide opportunities for continued growth.

**Round About The Cauldron Go**

The United States REIT sector trades at a 10% discount to its underlying Net Asset Value<sup>8</sup>. However, this valuation does not appropriately reflect the range of discounts and premiums of individual companies in the space. Many companies, particularly in the office and shopping center sectors, trade at discounts of 25% to 30% to their NAV whereas some companies in the Net Lease and Health Care sectors trade at premiums of 25% to their NAV. The valuations are even more compelling when looking at the sector on a Discount to Cash Flow basis (DCF) where REITs trade at a 20% discount to DCF<sup>9</sup>.

As is usually the case, the idiom “the devil is in the details” is appropriate. We are in the midst of a global hunt for yield. Current yield and income is essential in a low growth environment. At the start of the year, U.S. REIT dividend yields averaged about 3.8%. When evaluated by quintile, the spread between the top and bottom bands was almost 5,100 basis points and a performance differential of almost 24%. Many of these higher yielding REITs offered alluring income streams not because of the success of their business, but on the



*Top Yielding US REITs have substantially outperformed the broader REIT market in 2016 driven by a global thirst for yield with no regard for valuation or fundamentals.*

2016 has completely ignored the concept of “risk adjusted returns” and YTD inflated returns on REITs offering conspicuously higher yields are entirely unwarranted. Fast money and general market

contrary, as a result of lower quality assets that implicitly mandated higher returns to compensate for the underlying risk of the assets or markets. The “junk rally” of

participants exhibited avaricious demand for current income, regardless of asset valuations. These inflated valuations seem to defy logic and straddle the border between reality and the supernatural, as do the Three Witches of Macbeth. Investors have been lured into the bewitching temptations of high yield by market forces, only to realize that they are likely to be consumed, like Macbeth, by superficial ambition.

**EXHIBIT 2: US REIT Market in 2016 – Dividend Yield Driving Performance**

Dividend Quintile	Dividend Yield 31-Dec-2015	2016 Total Return (YTD)
Quintile 1	7.5%	18.9%
Quintile 2	5.2%	9.7%
Quintile 3	4.0%	13.2%
Quintile 4	3.2%	4.8%
Quintile 5	2.4%	-4.9%
US REIT Market	<b>3.8%</b>	<b>5.1%</b>



**Fire Burn and Cauldron Bubble**

Many of these high yielding, high performance REITs are in the non-traditional real estate sectors. The fundamentals of their cash flows and valuations are much more closely tied to the performance of the 10 year treasury than to the fundamentals of supply and demand. Given the impending increase in interest rates, it is imperative to understand the potential risks inherent in some of these stocks.

As we have noted in earlier publications, rising rates are not necessarily a negative for real estate and REITs. Real estate has historically been an effective hedge against high inflation. If rates are rising in a tempered manner and accompanied by economic growth, landlords have the ability to increase rents.

Many investors view REITs like bonds; however, REITs are not just static yield investments. REITs may have bond-like characteristics that offer some defensive qualities, but importantly offer growth and have the potential to create value from improving operations, refinancing accretively, investing wisely and harvesting

value when appropriate, independent of the interest rate environment. REITs' portfolio cash flows are expected to continue to rise over the next few years, and REITs' low dividend payout ratios mean that companies are retaining significant free cash flow lifting NAVs<sup>10</sup>.

Historically, out of the 23 interest rate increases by the US Federal Reserve since June 1999, US REITs have delivered positive returns on 19 occasions and have averaged a total return of 6% in the three months subsequent to the rate rise. Additionally, during this same period, REITs outperformed US equities by approximately 200 basis points<sup>11</sup>.

REIT values, like those in most other asset classes, experience downward pressure as interest rates increase. Interest rates, however, only partially determine the value of a REIT's underlying real estate assets. It might seem counter-intuitive that REIT returns have proven to be resilient to interest rates increases, but the following factors can be at work:

- Economic fundamentals: rate increases coupled with a stronger economy should have a muted effect on real estate values, as property income streams improve;
- Real estate valuations have responded to a varying degree to interest rate increases by sectors, since they are driven by different demand and supply fundamentals;
- Stable income returns from real estate properties are little affected by interest rate movements.

The relationship between bond yields and real estate cap rates is not straightforward. Property pricing is influenced by a number of additional factors, including growth of net operating income (NOI), debt financing costs and investors' risk appetite. As a result, the gap between real estate returns and the returns on risk-free Treasuries – the property risk premium – is unlikely to be constant over time.

Rising Treasury yields typically occur in periods of improving economic activity. As economic momentum accelerates, this feeds through into stronger real estate NOI growth and a lower property risk premium, both of which help to offset the negative impact on pricing from rising Treasury yields. In fact, since NCREIF began tracking institutional real estate in 1978, real estate cap rates have generally fallen during periods in which

Treasury yields rose for a sustained period of time<sup>12</sup>. However, there are clear downside risks to pricing should policy tightening move too quickly.

While cap rates in the direct market are smoothed based on 90-day trailing averages of actual transaction activity, REIT shares have varied over time to interest rates and bond spreads. In fact, the spread today between the REIT implied cap rate, interest rates and bond yields is wider than its history. That would indicate real estate is cheap, or bonds are overpriced. Said another way, there is room for the spread to contract as rates on the 10 Year treasury move up, and real estate holds firm<sup>13</sup>.

**EXHIBIT 3: Private Real Estate Cap Rate Spreads to Treasuries (bps)<sup>14</sup>**



*The spread today between cap rates and interest rates is wider than its history.*

*With REITs current implied cap rates at 5.8% and a 10% discount to NAV, there is room for spread compression with rising rates.*

**And Now The Cauldron Sing**

In the short term, we expect that when the Federal Open Market Committee (FOMC) raises rates, the initial market impulse will be a modest downturn in the REIT market. As this step has been extensively telegraphed and widely anticipated by the market, we do not expect an appreciable market reaction. When the dust settles (although at this point it is hard to believe that anyone would be blindsided by this move), investors should realize that, in the long term, a moderate rise in rates will not be detrimental to the real estate industry.

- REITs are modestly levered (around 30% debt)
- Increasing cost of capital should attenuate potential new construction (limit competition)
- Most REITs have the ability to increase rents commensurate with (and above) inflation
- Duration matters: Renewal rents next year are dependent on the initial term of the lease
- Duration matters: REIT performance will vary by property type and underlying lease duration

However, not all REITs are structured equally. In the past year, we have witnessed an unprecedented performance bifurcation between long duration, high yielding REITS (many of these in non-traditional REIT sectors) and traditional REIT securities. In the quest for income, many short-term investors have neglected valuation metrics and propelled these yield stocks to untenable levels. Fundamentals matter. As evidenced by past market movements, we anticipate that these high yielding REITs should underperform as interest rates rise. These long duration asset classes will decrease in value as rates rise.

During the “Taper Tantrum” in 2013, a 100 basis point rise in the 10-year treasury resulted in a disproportionate downturn in the REIT market. The initial shock to the market, after an extended period of declining rates, created a negative return for the entire REIT market. It is important to observe the analogy to today’s market. Prior to the “Taper Tantrum” outperformance was generated by the higher yielding dividend quintiles. However, the disproportionate negative performance of these same segments clearly demonstrate the return volatility of the high yield segment of the REIT market. The relative outperformance of the lower yielding quintiles is dramatic.

When we analyze the relative performance of these same quintiles during the “Taper Tantrum” of 2013, we clearly see that REITs that exhibited significantly higher yields going into a period of rising rates.

**EXHIBIT 4: High Yielding REIT Underperformance During Taper Tantrum<sup>15</sup>**

Dividend Quintile	Performance Total Return	Taper Tantrum Total Return	Performance 6 Months Post Taper Tantrum
	Jan – May 2013	May – Dec 2013	Jan – June 2014
Quintile 1	22.4%	-14.3%	16.5%
Quintile 2	20.2%	-21.0%	18.4%
Quintile 3	12.2%	-8.7%	19.3%
Quintile 4	10.9%	-9.6%	18.3%
Quintile 5	13.1%	-1.7%	17.7%
<b>US REIT Market</b>	<b>14.8%</b>	<b>-11.5%</b>	<b>18.2%</b>

Following the rate rise of 2013, REITs exhibited compelling performance. Although the 10-year declined from a peak of 3% to 2.6% in the first half of 2014, rates were significantly higher than the 1.72% where we began 2013. We don’t require a prophecy from the Three Witches to predict the future of the REIT market as rates rise. Non-dedicated and momentum investors will likely abandon the higher yielding equities in search of income elsewhere. Investors will return to a focus on fundamentals. We have seen this Act before.

**Fair is Foul and Foul is Fair**

All may not be as it seems on the surface. Appearances are deceptive. Sometimes there is inconsistency between appearance and reality. Rising rates are not necessarily a negative for REITs and real estate. A REIT is a tax structure, not an operating philosophy. Fundamentals matter.

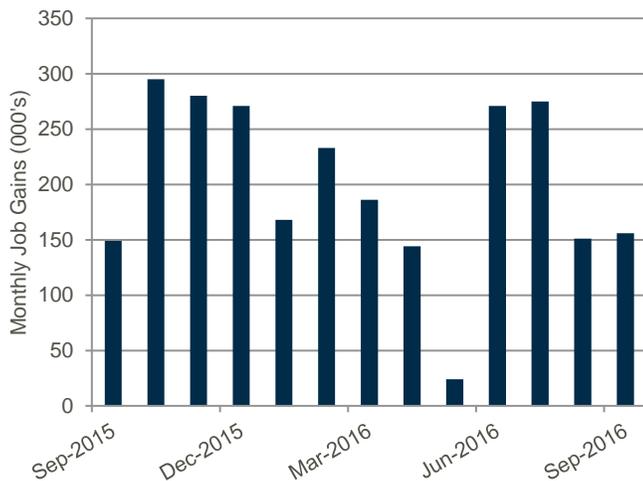
The herd can be deceptive. Sometimes it pays not to follow the crowded trade.

**United States  
Market Review**

U.S. REITs delivered a -1.44% total return in the third quarter of 2016.<sup>16</sup> Year to date, through the end of the third quarter, U.S. REITs were up nearly 12%. REIT returns were primarily driven by shifting views on global economic growth, interest rates, concerns over where we are in the real estate cycle as well as continued strong real estate fundamentals.

The economic backdrop remained favorable for REIT fundamentals in the third quarter with the economy averaging approximately 156,000 jobs per month. After strong performance in the first half of the year, REITs gave back some gains in the third quarter as renewed concerns over interest rate increases provided a formidable headwind.

**EXHIBIT 5: MONTHLY GAINS ('000) FOR OFFICE/NON-OFFICE USING JOBS<sup>17</sup>**



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 near a record level of approximately 95% at the end of 2Q 2016, above the 15 year historical average of 93.3%.<sup>18</sup> Same store NOI growth was approximately

4.5% in 2Q 2016, well above the long term historical average of 2.80%, but a deceleration from 5% over the last four quarters. We would estimate 4.6% same store NOI growth for 2016 and estimate 4.0% for 2017. New supply, remains well below historical averages and near historical lows at 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 74% versus a long term average of 80%, providing the potential for double-digit dividend growth again in the next 12 months.

Small capitalization REITs outperformed large capitalization REITs in the quarter by 680 bps, reversing a valuation gap that we identified in our annual outlook. Much of this valuation gap has been eliminated, and we expect with the inclusion of REITs as a GIC sector in September, large cap REITs will perform relatively well. Higher leverage REITs outperformed lower leverage REITs by 820 bps. Higher dividend yielding stocks outperformed by 310 bps in the quarter and by an astounding 1,350 bps year to date. We are in a junk rally within REITs where yield starved investors indiscriminately chase yield without regard to real estate value, quality, leverage or liquidity. This dichotomy between yield, growth and real estate value cannot be sustained and is vulnerable to any rise in interest rates, which would result in a shift to outperformance of high quality real estate companies with good relative organic growth prospects.

REITs continued to take advantage of the availability and relatively low cost of capital. REITs issued \$68 billion in equity and debt capital year-to-date, a run rate that would result in a peak level of capital issuance.

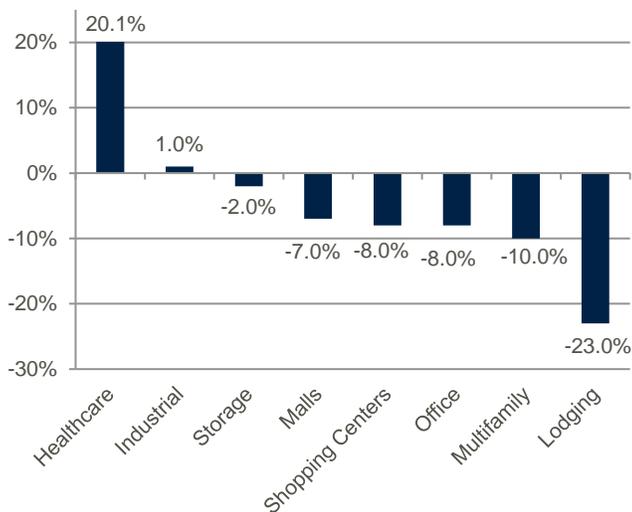
Given the run up in REIT prices year-to-date, REITs total equity issuance reached \$20 billion, a level not seen since 2013. We suspect that a good portion of equity issuance provided a convenient entry point into the REIT sector for any funds looking to gain exposure to the newest GIC sector. If REIT 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 and REITs need to be careful not to flood the market with new equity issuance. 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 \$4.2 billion for the quarter as investors sought yield and safety. Fund flows from Japanese investors into U.S. REITs remained strong at \$6.7 billion.<sup>19</sup>

The best performing sectors in the quarter were the industrial, office and healthcare sectors. Industrial benefitted from improving fundamentals due to e-commerce distribution. Office companies benefitted from a San Francisco sentiment reversion as investors realized real estate fundamentals remained solid and expectations were too low -- a theme we highlighted at the beginning of the year and benefitted from with an overweight to San Francisco office. Healthcare companies outperformed as investors chased yield-oriented investments with little regard for quality of real estate, balance sheets and organic growth prospects.

**EXHIBIT 6: US SECTOR P/NAV<sup>20</sup>**



Year-to-date, the magnitude of out-performance by income focused and non-core real estate property types remains significant and unlikely to be sustainable in the long term.

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. We believe these concerns are now overdone.

**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 4.00% 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 at an attractive 7% discount to NAV, compared to a 2.8% premium historically.<sup>21</sup> Certain sectors are trading at very wide discounts relative to their historical levels. Regional malls presently trade at a 19% discount to NAV while historically they have traded in-line with NAV. Hotels are at a 23% discount versus a 6% discount historically, and Office is at an 11% 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.<sup>22</sup> 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 for the remainder 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 remainder 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 4.7% 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. Additionally, Net Asset Value matters and large discounts in the core property types are likely to get resolved or arbitrated. 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 U.S.

## Europe<sup>23</sup>

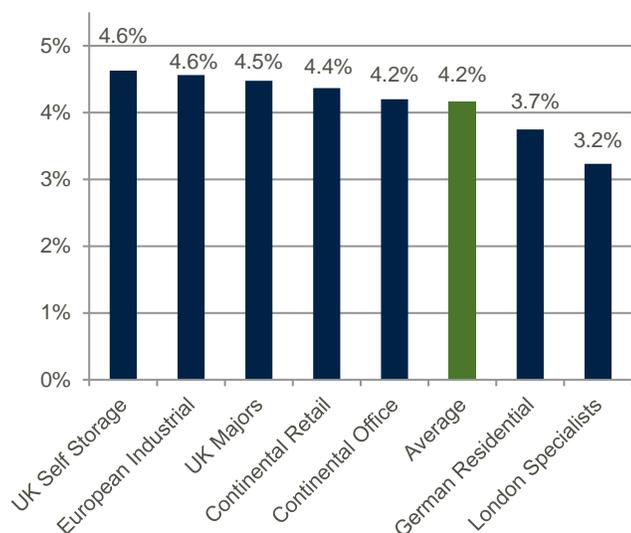
### Market Review

The European public real estate market index returned -1.5% (USD gross total return) in September. For the third quarter, Europe led the other regions with a USD total return of 5.0%. However, on a year-to-date basis, the European total return of 1.8% still trails far behind North America and Asia Pacific. Over the third quarter, the USD lost 1.2% against the Euro but gained 2.5% against the GBP and 1.3% against the SEK.

In the third quarter, the Nordic markets led the field with a very strong quarterly performance, with USD gross total returns of 21.3% for Norway, 7.6% for Sweden and 15.6% for Finland. Austria also had a very good third quarter, returning 17.4% after underperforming for much of the last year. Expansion of the ECB quantitative easing measures gave a major boost to returns in the Eurozone area during the quarter. The Netherlands (8.2%), Spain (8.1%), France (7.1%), Ireland (5.4%) and Germany (4.5%) all demonstrated impressive returns in the third quarter. Germany remains the best major European performer year-to-date with 22.2% (trailing only much smaller Norway with 41.1%) thanks to the high level of investor demand for German multifamily residential stocks. The only Eurozone country with a negative return for the quarter was Italy with -4.8% on concerns over the banking sector, slow economic growth and the political situation.

The UK managed only a modest positive total return in 3Q as some share price recovery following the Brexit result was partially offset by further slippage in the GBP against the USD. However, the UK remains the worst performer for the year-to-date period in Europe with a total return of -19.8%. Switzerland was largely flat for the third quarter (0.6%) but still saw a 16.2% total return for the year-to-date period as both stocks and currency benefitted from its safe haven status.

**EXHIBIT 7: EUROPE SECTOR/COUNTRY IMPLIED CAP RATES<sup>24</sup>**



**Market Outlook**

Investor fears over the impact in the UK of the Brexit referendum result have calmed considerably and shares have recovered a good proportion of their losses incurred immediately following the vote. However, there is still a high degree of uncertainty, in our view, in terms of what the UK will apply for, what the EU is willing to accept and what the economic (and possibly political) consequences will be for the UK.

We, therefore, maintain our underweight position in the UK (especially in the stocks with the highest London office exposure) until there is greater visibility on the political and economic environment. While share prices have recovered part of their post-Brexit losses, that recovery has recently started to reverse as details of a more hard-line UK negotiating approach start to emerge and the currency has continued to plunge against the USD. From a pre-Brexit level of \$1.49 on June 23, sterling has fallen to \$1.24 (October 7). We have shifted from the UK into defensive names such as German multifamily and office names in continental Europe. We continue to look for attractively valued stocks in continental Europe that will benefit from the recently expanded quantitative easing measures of the European Central Bank as investors search for yielding assets.

**Asia Pacific  
Market Review**

In Asia Pacific, Hong Kong and Singapore developers and REITs outperformed their counterparts in Australia and Japan in the third quarter of 2016. In USD terms, Hong Kong developers rose 15.6%<sup>25</sup>, followed by Singapore (+5.3%), while Japanese developers fell 1.8%. The impressive performance of Hong Kong developers was triggered by robust residential sales pick up, supported by pent-up demand and three mortgage rate cuts year-to-date (at an effective mortgage rate of 1.64% by banks). As for the REITs, Singapore REITs rose 2.9% in the September quarter, followed by Japan (0.7%) and Australia (0.1%). The better performance by S-REITs could be attributed to its attractive yield spread of 446 bps<sup>26</sup> at end-September, higher than J-REITs (349 bps) and A-REITs (267 bps).

In Japan, Abe's effort to pull the economy out of deflation continues to be an uphill task; spending by household contracted -4.6%<sup>27</sup> year over year in August after declining by 2.3% and 0.5% in June and July, respectively. Despite that, the BOJ refrained from taking interest rates deeper into negative territory in its latest monetary meeting in September. Instead, it tweaked its QQE (Quantitative and Qualitative Monetary Easing) with Yield Curve Control, an objective to maintaining 10-year JGB yields around zero percent without incremental change for the annual purchase of J-REITs at 90 billion yen.

Notwithstanding the lack of new catalysts from the BOJ announcement, Japan's commercial real estate fundamentals continued to improve in the third quarter as evidenced by: 1) commercial land prices in Tokyo, Osaka and Nagoya rose 2.9%<sup>28</sup> as of 1-July this year, the fourth consecutive yearly increase and the fastest pace since 2008 (+3.3%), 2) office vacancy in Tokyo's central 5 wards improved further to 3.90%<sup>29</sup> in August, from 4.03% at the beginning of this year, 3) average rental rose 0.3% month-on-month in August and 3.6% in the first eight months of this year. Condominium sales, however, is a dampener. Monthly condominium sales have been seeing year-on-year percentage declines since the beginning of the year, and the market is currently witnessing the highest unsold inventory level in the past six years.

In Hong Kong, class-A office transactions continued to be robust at compressed cap rates. Henderson Land sold The Golden Centre office property for US\$564 million or a gross cap rate of 1.9%. News is rife that Cheung Kong Property is looking to sell its office property, The Center, for US\$4.8 billion, or a 2.5% cap rate. Demand for Hong Kong commercial assets continues to be strong, especially from mainland China; in fact, two-thirds of class-A office properties sold in Hong Kong in the first half of this year were acquired by mainland companies<sup>30</sup>. They have spent a total of US\$2.9 billion in the first half (against a 10 year average of US\$6.4 billion). The leasing market, on the other hand, is witnessing a slowdown in Central by mainland Chinese corporates - new leases signed fell 70%<sup>31</sup> month-on-month in July. The Government forecasts 2016 annual GDP growth to be 1-2%, lower than the 10-year historical average annual growth of 3.5%. With the softer economic outlook, corporate expansions or upgrading to class-A office space may moderate going forward.

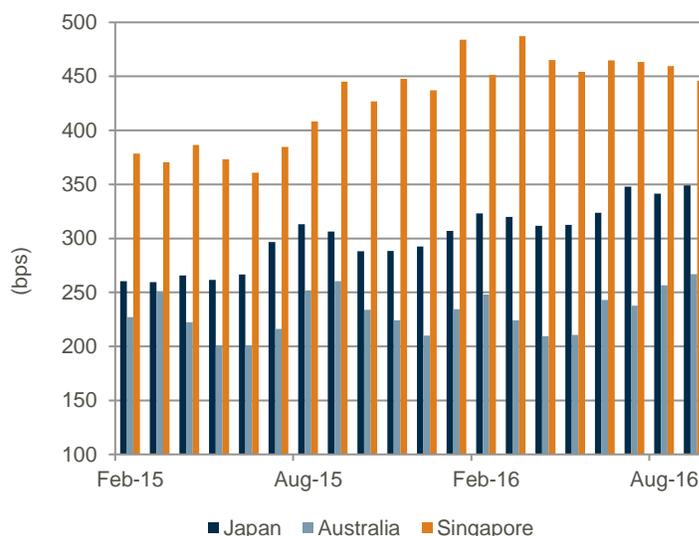
Hong Kong's retail sales performance remains in a state of flux - falling 10.5%<sup>32</sup> year-over-year in August, materially worse than July's 7.8% decline. Weakness was attributed to continued weak spending on luxury items which contracted more than 26% year-over-year in both July and August. On the other hand, retail sales (excluding the luxury sales) fell 6.3% in August, after the improvement of only a 3.2% decrease in July. Tourist arrivals in Hong Kong grew 2.6%<sup>33</sup> year-over-year in July but declined 9.4% in August, the swing factor being Mainland Chinese arrivals. It's not a case of mainland Chinese reducing their overseas travelling but traffic being diverted away from Hong Kong to markets such as Japan (which have been seeing consistently positive growth in the past eight months of this year).

In Singapore, the office market saw a spate of sales transactions (strata and en bloc) in the quarter, with both local institutional and foreign buyers from China and Indonesia. While an oversupply of new office space in 2017 and 2018 remains a headwind, some of the new sizable office buildings are seeing improving pre-commitment rates at the expense of tenant relocations from older buildings. Downward pressure on rentals is therefore expected from these older buildings, less so for new ones given pre-commitment rates are fast approaching 50%.

Singapore's retail market remains challenging - monthly retail sales (excluding motor vehicles) have been seeing negative year-over-year growth since February of this year - a sign consumers continue to tighten their purse strings in view of the anemic economic prospects. We believe landlords will have to be more realistic in their rental expectations going forward and would not be surprised if rental reversions turn negative. On the residential market, the latest government price index shows island-wide residential prices falling 1.5% quarter-over-quarter, ending September, which translates to 12 consecutive quarterly decreases totaling -9.8%. Such price decline is perhaps deemed moderate, and we therefore do not expect the property cooling measures to be relaxed in the foreseeable future.

In Australia, the central bank has left the cash rate unchanged in their meetings in September and October, alluding that the easing in May and August are adequate to keep the economy growing sustainably. Indeed, retail sales for August were up 2.6%<sup>34</sup> year-over-year, similar to July (+2.7%), a sign that the Australian consumers are still willing to spend. In the office market, Sydney's gross effective rents were reported to be up about 5%<sup>35</sup> quarter-over-quarter in the September quarter. Incentives for prime assets were said to be 25% and trending lower. Both Melbourne and Brisbane are seeing subdued demand while Brisbane was further impacted by the incoming new supply.

**EXHIBIT 8: REIT Dividend Yield Spread (basis points)<sup>36</sup>**



## Market Outlook

Continued improvement in real estate fundamentals notwithstanding, the spreads between the public market implied cap rates and private real estate values continue to widen. This is particularly so in Japan where developers remain weak on a perceived lack of momentum in Abenomics and the country's attempts to reflate the economy. In addition, recent weak data in condominium sales and office net absorption have added to the pessimistic outlook. On the back of firmer US payrolls data, the market has raised its expectations of a December Fed hike. If that eventuates, renewed Yen weakness will be perceived positively for the economy and should lead to a recovery in developer share prices. In the interim, we are adhering to a more cautious stance in developers given the lack of positive catalysts. We also remain selective in the JREIT sector, owing to their strong relative performance to the developers and the spike in 10-year JGB yield from -30bps to -6bps, resulting from lesser expectations that negative interest rates will go lower. Our preference remains with the hotel and retail JREITs on the premise they are prime beneficiaries of improving tourism landscape, offering growth either through organic means or acquisitions.

We like the Australian REITs given their attractive yield spread (267 bps) and reasonably strong EPS growth (c4%) potential. In addition, the RBA's continued easing cycle (12 rate cuts since 2011 peak, to a record low cash rate of 1.5%) has underpinned asset value growth. The attractiveness of Australian core commercial property is reflected by the intense bidding by foreign groups eager to deploy capital. Our preference is with the prime office names that benefit from improving fundamentals and retail AREITs that either offer international growth or domestic non-discretionary retail resilience.

We remain defensively positioned in Hong Kong largely due to economic uncertainty and rising residential supply amidst cooling measures. Hong Kong's economy seems to be at a crossroads - sandwiched by an increasing reliance on mainland Chinese economy and a direct import of US monetary policy. We envisage increasing uncertainty for China as it navigates between economic rebalancing and the need to ensure stable growth. The impact on the Hong Kong developers is two-fold: greater volatility in terms of sales and volumes for their residential portfolios and negative investor perception on their China exposure. Other headwinds include: political disaffection with the elected Hong Kong administration, which could lead to China curbing tourist visas to Hong Kong, and HKD strength discouraging tourist arrivals. We prefer the large cap developers that are significantly discounted relative to their asset fundamentals.

In Singapore, we are underweight the developers given a lack of positive catalysts and growth drivers for a rerating. We prefer SREITs in the office and industrial sector that offer resilient yields despite increasing supply conditions. There is significant new supply across most asset segments, and this has resulted in a negative operating environment for an increasing number of SREITs.

<sup>1</sup> Factset, FTSE EPRA/NAREIT Developed Index, As of 30-Sept-2016

<sup>2</sup> Hopefully Shakespeare will forgive us for adapting his original prose of “double, double toil and trouble”.

<sup>3</sup> NCREIF Property Index, five years ending 30-June-2016

<sup>4</sup> NCREIF Property Index, from 31-Dec-2009 through 30-June-2016

<sup>5</sup> NCREIF Property Index, thirty years ending 30-June-2016

<sup>6</sup> Evercore/ISI, 14-October-2106, Portfolio Strategy Report

<sup>7</sup> Bloomberg

<sup>8</sup> PGIM Real Estate. Evercore/ISI, 14-October-2106, Portfolio Strategy Report

<sup>9</sup> Evercore/ISI, 14-October-2016, REIT Valuation Handbook

<sup>10</sup> Citi Research. Free Fallin’ – Real Estate Is Much More Than Just Interest Rates

<sup>11</sup> PGIM Real Estate. Bloomberg. UBS. Morningstar.

<sup>12</sup> PGIM Real Estate, Rising Treasury Yields: Assessing the Impact on Commercial Real Estate, July 2013

<sup>13</sup> Citi Research. Free Fallin’ – Real Estate Is Much More Than Just Interest Rates

<sup>14</sup> Federal Reserve Board, NCREIF, PGIM Real Estate. As of October 2016

<sup>15</sup> Bloomberg. FTSE EPRA/NAREIT Developed Index from April 30, 2103 – December 31 2013

<sup>16</sup> U.S. REITs total return taken from MSCI US REIT Index (RMZ)

<sup>17</sup> Bloomberg. As of 30-Sept-2016.

<sup>18</sup> Citi. As of 30-Sept-2016

<sup>19</sup> Barclays Research. As of 30-Sept-2016.

<sup>20</sup> ISI, GreenStreet Advisors, 1-Oct-2016.

<sup>21</sup> ISI. As of 30-Sept-2016

<sup>22</sup> Citigroup. As of 30-Sept-2016

<sup>23</sup> 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.

<sup>24</sup> Green Street Advisors, 1-Oct-2016

<sup>25</sup> Bloomberg. As of 30-Sept-2016.

<sup>26</sup> Bloomberg. As of 30-Sept-2016.

<sup>27</sup> Statistics Bureau, Ministry of Internal Affairs and Communications

<sup>28</sup> Ministry of Land, Infrastructure , Transport and Tourism

<sup>29</sup> Miki Shoji. As of 30-Sept-2016

<sup>30</sup> South China Morning Post. As of 16-Sept-2016

<sup>31</sup> JLL

<sup>32</sup> Hong Kong Census and Statistics Department

<sup>33</sup> Hong Kong Tourism Board. As of 30-Sept-2016

<sup>34</sup> Australia Bureau of Statistics

<sup>35</sup> Cushman & Wakefield

<sup>36</sup> Bloomberg, 30-Sept-2016.

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Holdings in a particular strategy can vary significantly from broad market indexes. As a result, performance of an individual strategy can deviate from the performance of such indexes. As a strategy invests in stocks, there is the risk that the price of a particular stock

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The S&P Developed Property Index is a free-float weighted index comprised of public real estate companies in North America, Asia and Europe that meet certain free-float market capitalization, trading volume and other criteria. The Developed Property Index, (formerly known as the World Index) excludes emerging markets. The return series is calculated daily using both gross and net cash dividends reinvested. Cash dividends are normally applied on the exdate of the dividend. Net return reinvested is reflective of the return to an investor where dividends are reinvested after the deduction of withholding tax. The net index excludes foreign withholding taxes. The tax rate applied is the rate to nonresident institutions that do not benefit from double taxation treaties. Source of the benchmark: Standard & Poor's.

The FTSE EPRA/NAREIT Real Estate Index Series reflects the stock performance of companies engaged in specific aspects of the of the major real estate markets/regions of the world - Americas, EMEA (Europe, Middle East and Africa) and Asia. The Index Series is designed to represent general trends in eligible listed real estate companies and REITS worldwide, covering Global, Developed and Emerging indices, as well the UK's AIM market. Relevant real estate activities are defined as the ownership, disposure and development of income-producing real estate. Dividends, using their exdividend dates, are used to calculate the Total Return Indices on the FTSE EPRA/NAREIT Global Real Estate Index Series.

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