Global Real Estate Securities
Market Review | Second Quarter 2017

<table>
<thead>
<tr>
<th>Region</th>
<th>Second Quarter</th>
<th>YTD</th>
<th>1-Year</th>
<th>3-Year</th>
<th>5-Year</th>
<th>10-Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>North America</td>
<td>1.4%</td>
<td>1.8%</td>
<td>-2.6%</td>
<td>7.1%</td>
<td>8.5%</td>
<td>5.3%</td>
</tr>
<tr>
<td>Asia Pacific</td>
<td>1.7%</td>
<td>7.8%</td>
<td>4.5%</td>
<td>0.7%</td>
<td>6.5%</td>
<td>-0.8%</td>
</tr>
<tr>
<td>Europe</td>
<td>11.1%</td>
<td>14.2%</td>
<td>9.2%</td>
<td>2.9%</td>
<td>11.3%</td>
<td>-1.4%</td>
</tr>
<tr>
<td>Total Return</td>
<td>3.0%</td>
<td>5.4%</td>
<td>1.2%</td>
<td>4.6%</td>
<td>8.4%</td>
<td>1.7%</td>
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</table>

**United States**
Market Review

U.S. REITs delivered a 1.71% total return in the second quarter of 2017. While the overall result was in line with our expectations, there was wide dispersion between property sectors. Industrial REITs led the way returning 12.3% while shopping centers lagged, dropping 10.0% for the quarter. REIT returns were primarily driven by the potential for reflations and new government policy, interest rate movements, retail headwinds and continued strong real estate fundamentals.

The economic backdrop remained favorable for REIT fundamentals in the second quarter with the economy averaging approximately 192,000 jobs per month. The pace of jobs growth reversed trend and accelerated from an average of 164,000 jobs in the second quarter of 2016.

The level of jobs growth continues to create ample real estate demand to absorb vacancies and continue pricing power in most property types and markets. However, it was not so much that it created material supply additions, with the exception of certain apartment, self-storage and hotel markets. In many apartment and hotel markets, however, supply is anticipated to decelerate in 2018. REIT aggregate occupancy held firm near a record level of approximately 95% at the end of 1Q 2017, above the 15-year historical average of 93.3%. Same store NOI grew approximately 4.2% in 1Q 2017, well above the long term historical average of 2.8%. We would estimate a deceleration in same store NOI to 3.5% - 4.0% for 2017 from 2016’s level of 4.9%. New supply remains well below historical averages and near historical lows at 1.3% of existing supply. Supply additions for long lease duration properties remain well below long term averages. Supply additions for shorter lease duration properties like apartments, hotels and self storage are more in line with long term historical averages. However, importantly, new construction is down 20% from the post crisis peak in early 2016. We expect deceleration in apartment supply in most markets for 2018.

**MONTHLY GAINS (’000) FOR OFFICE/NON-OFFICE USING JOBS**

![Monthly Job Gains Graph]

REIT dividend payout ratios are near historical lows at 72% versus a long-term average of 80%, providing the potential for high single-digit dividend growth again in the next 12 months.

For professional and institutional investor use only—not for use with the public. Your capital is at risk and the value of investments can go down as well as up.
Large capitalization REITs outperformed small capitalization REITs in the quarter by 150 bps and 450 bps year-to-date, a continuing a reversal of last year’s outperformance by small capitalization REITs. More than 25 large capitalization REITs are members of the S&P 500 index and benefited from flows into S&P 500 ETFs and funds as a result of the reflation trade and S&P 500 outperformance of the REIT market year-to-date. Lower leverage REITs outperformed higher leverage REITs by 600 bps in the quarter and 880 bps for the year on concerns of rising interest rates. Lower dividend yielding stocks outperformed by 470 bps in the quarter on rising rate concerns, reversing a trend that we saw for most of 2016 and the first quarter of 2017.

REITs issued $14 billion of equity year-to-date, a run rate that if sustained would result in the largest annual equity issuance for REITs. We will continue to monitor the level of equity issuance but do not anticipate that the pace will be sustainable throughout the year. Many REITs 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 outflows from U.S. REIT mutual fund and ETF investors totaled approximately $2.3 billion year-to-date as investors sell yield and buy growth. Fund flows from Japanese investors into U.S. REITs turned negative at $3.8 billion.5

The best performing sector in the quarter was industrial. Strong earnings reports and continued secular demand shifts from e-commerce continue to drive demand for industrial shares. Retail stocks, both malls and shopping centers, continued to be large underperformers for the quarter. Retail store closings and bankruptcies as well as negative same store sales weighed on the sector. Amazon’s purchase of Whole Foods negatively impacted the shopping center group as Amazon secures last mile real estate to efficiently deliver e-commerce grocery. Amazon has not signaled its future expansion plans for Whole Foods but the company can fund a large expansion if it so desires. While valuations for certain retail companies appear attractive, there is likely to be continued negative retailer news and store closings. We are awaiting price discovery on certain retail assets and a stabilization of store closings before we get more constructive on the group.

### US Sector P/NAV6

![Sector P/NAV Chart]

<table>
<thead>
<tr>
<th>Sector</th>
<th>P/NAV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Healthcare</td>
<td>19%</td>
</tr>
<tr>
<td>Industrial</td>
<td>-1%</td>
</tr>
<tr>
<td>Multifamily</td>
<td>-4%</td>
</tr>
<tr>
<td>Storage</td>
<td>-5%</td>
</tr>
<tr>
<td>Total US</td>
<td>-5%</td>
</tr>
<tr>
<td>Lodging</td>
<td>-6%</td>
</tr>
<tr>
<td>Malls</td>
<td>-9%</td>
</tr>
<tr>
<td>Office</td>
<td>-13%</td>
</tr>
</tbody>
</table>

### Market Outlook

REITs should experience continued improvement in operating fundamentals and are expected to deliver high single dividend and 5% - 7% cash flow growth in the next 12 months. We expect forward 12-month same store NOI of REITs to be 3.5% to 4.0%, a level above the long-term average. However, given the 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 2.0% discount to NAV, compared to a 2.8% premium historically. Core real estate trades at an 8% discount to NAV. Certain sectors are trading at very wide discounts relative to their historical levels. Regional malls presently trade at a 27% discount to NAV while historically they have traded in-line with NAV. The office sector is at a 10% discount to NAV versus a 3% historical premium to NAV.
Implied cap rate spreads of REITs relative to the 10-year Treasury remain wide at roughly 340 bps. It is important to note that during the last peak in 2007, this spread turned negative with REIT implied cap rates below the 10-year treasury yield. The current 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 remain 2x below the S&P 500 earnings multiple; this is the most attractive level since the credit crisis in 2009.

REIT rental rates are expected to continue to improve for the remainder of 2017. 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, self-storage and certain hotel markets. Apartment supply additions are beginning to moderate and 2018 supply additions are expected to decelerate in many 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. We are more constructive on energy related markets as oil prices show stability and jobs growth in markets like Houston is stabilizing. We are beginning to see transactions in the Houston office market take place at non-distressed pricing, highlighted by a Canadian pension plan taking Parkway Properties private.

With a dividend yield of 4.2% and estimated earnings growth of 5% to 7% in the next 12 months, REITs are poised to deliver a consensus return of approximately 10%, assuming no expansion or contraction in the earnings multiple. However, given continued economic and government policy concerns, volatility spikes remain likely.

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 pension funds and Sovereign Wealth Funds. We will continue to monitor government policy initiatives of the new administration especially tax reform and infrastructure spending. The market seems to be revising its expectations around timing and magnitude of policy change. Additionally, we will continue to monitor high yield debt spreads to see if there are any impacts on real estate debt spreads.

Additionally, Net Asset Value matters and large discounts in the core property types are likely to get resolved or arbitraged. Merger and Acquisition activity has picked up and is expected to continue for the remainder of 2017, particularly if small capitalization REITs continue to trade at discounts to private real estate value. Two of our small capitalization holdings, Monogram Residential Trust and First Potomac Realty were taken private within the last few weeks. Monogram was sold at a 22%+ premium to its prior day traded value. 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 have added to our industrial positions as valuations have reverted to attractive levels relative to growth prospects.

We believe the best opportunities are stock specific across all sectors; however, we remain cautious on the retail sector. It is a stock pickers market and given economic volatility and M&A activity, 2017 is a good environment for active investment management. We have selectively added in the single family housing sector as well as the office sector. We have reduced our apartment overweight post quarter end given recent outperformance and more fair valuation levels.

**Europe**

**Market Review**

The European public real estate market returned (USD gross) 10.6% in 2Q 2017. There was wide variation in country performance but all markets were in positive territory despite the backdrop of political uncertainty around Eurozone elections at the start of this year. Eurozone returns were significantly boosted by USD weakness, with the Euro gaining 7.3% against the USD over the quarter. The USD also weakened 3.7% against the GBP as well during the quarter, helping returns in the UK as well.

Europe outperformed the other global regions by a wide margin in 2Q17. For the YTD period to the end of June, Europe also significantly lead the other regions. Europe’s first half of 2017 total return was 13.5%.

There was significant variance in country-level returns across Europe in 2Q17. Spain was the best performer of the major countries for the quarter with +15.9% as the economy maintained its momentum and the REITs reported good
results. Ireland was close behind with +15.0% as economic indicators pointed to continued strength, real estate fundamentals remained strong and financial occupiers started to announce moves in the wake of Brexit. The occupier and investment markets in Dublin remained strong as corporates search for space in a very low vacancy CBD market. Germany and Sweden also both had strong 2Q total returns of 14.8%. In Germany, the large multifamily residential sector continued its recovery after poor performance in 4Q16 on government bond yield increases.

**EUROPE SECTOR/COUNTRY IMPLIED CAP RATES**

The UK was the weakest performer in 2Q17 but still managed a positive +6.1% total return. The UK real estate market showed remarkable resilience in 4Q16 and 1Q17 as transaction volumes recovered, and rents and capital values stabilized; the currency has recovered somewhat from post-referendum lows. However, doubts surrounding the medium-term implications of Brexit have increased and the indecisive UK election outcome at the beginning of June has only heightened these uncertainties.

**Market Outlook**

The European market has largely emerged from the shadows of political uncertainty in 2017. Elections in the Netherlands and France have not produced any negative surprises for markets, and the only remaining major country election (Germany in September) is expected to broadly maintain political stability there. Eurozone economic indicators continue to improve slowly, and the monetary policy backdrop remains loose. While concerns about the eventual roadmap for unwinding ECB quantitative easing have surfaced recently, pushing down interest rate sensitive stocks, the overall economic and real estate environment in Europe is modestly positive.

The exception to this benign environment appears to be the UK, where the process of the UK’s exit from the EU only began at the end of March. Confusion over the UK’s negotiating position has been heightened by the uncertain election outcome at the beginning of June.

European real estate stocks are still trading at discounts to private market values. Europe is now trading at an average 9% one year forward discount to NAV. While significant discounts to NAV are still available in the UK, we maintain our underweight position to the London office sector, in particular due to the high degree of uncertainty surrounding the process of the UK’s exit from the European Union and its economic (and possibly political) consequences. Rents and values have begun falling slightly in the London office market, and we expect the downward trend to continue as financial services occupiers start to announce plans for job moves following Brexit. Announcements by financial institutions about moving specific functions that will need to remain within an EU country after Britain’s exit have already been made, with Frankfurt, Dublin and Paris the main destinations so far.

We continue to look for attractively valued stocks in continental Europe that will benefit from the positive economic momentum and supportive monetary policy. Signs of rental market recovery in select continental markets that have bottomed out, such as Spanish and French offices, provide interesting return potential in the medium-term. Investment market demand remains strong in Europe from private capital, exerting modest further downward pressure on cap rates, especially in the core and core+ assets in the more liquid markets.

Real estate fundamentals look solid across continental Europe. New supply is generally under control and there is evidence of at least modest rental growth in most markets. The backdrop of monetary policy is expected to remain supportive for some time. We maintain our overweight positions in Ireland,
Germany and Sweden and will look for emerging opportunities in Spain.

**Asia Pacific Market Review**

Asia Pacific rose 0.7% in the second quarter, led by developers in Japan (+9.3%), Singapore (+4.2%) and Hong Kong (+4.1%) in USD terms. For REITs, Singapore REITs rose 7.2% whereas Japanese and Australian REITs fell for the quarter, by 5.5% and 4.6% respectively.

![Graph: JAPAN DEVELOPERS INDEX vs TOKYO OFFICE VACANCY](image)

The strong performance of the Japanese developers in the second quarter reversed the subdued first quarter performance. The strong performance was triggered by better than expected March 2017 fiscal year end results and bullish forward earnings guidance. Mitsui Fudosan and Sumitomo Realty & Development increased projected 2018 dividend payout by 5.9% and 8.3%, respectively. We believe the positive outlook is backed by robust market fundamentals, with office occupancies at Tokyo central 5 wards holding at 96.6% in May 2017, against 95.9% for the same time last year. Recovery in tourist arrivals have also gained traction, with a 24% and 21% year-over-year jump in April and May, respectively. Furthermore, Japan’s GDP in the first quarter of 2017 expanded 2.2% quarter-over-quarter, above the street forecast and also marked the 5th consecutive quarter of positive growth on healthy consumer spending and exports. Japanese REITs’ negative performance in the quarter (-5.5%) was due to concerns that the continued rise in U.S. Fed rates would pressure a hike in the Bank of Japan’s interest rate target. The yield on 10-year JGBs rose to 0.086% at the end of June against 0.07% at the end of March. Nonetheless, such concerns do not reflect the BOJ’s views, based on the minutes from the June 2017 Monetary Policy Meeting. The BOJ stated categorically that the bank would continue with the monetary easing policy in order to achieve the price stability target of 2%, even though the timing is unknown.

For Hong Kong, residential demand remains robust in the quarter, despite higher mortgage rates and new government tightening policy measures. The seventh round of measures (since 2009) include higher bank capital charges for residential mortgages, lowering the maximum loan-to-value ratio for borrowers with existing mortgages, and lowering the debt servicing ratio ceiling (monthly mortgage as a % of income) for borrowers whose income is derived primarily outside of Hong Kong. Liquidity, however, remains in abundance; in May, Henderson Land paid US$3 billion for the Murray Carpark commercial site through a government land tender. The price translates to US$6,460 psf land and would total more than US$7,100 psf on a completed basis (2.9% yield assuming peak monthly rental rate of US$17 psf). Stock prices have been supported by flows from Mainland Chinese investors via both Shanghai- and Shenzhen-HongKong Southbound connect, where cumulative flow to the end of June totaled RMB 560 billion (USD $82 billion).

Hong Kong’s overall retail sales have grown for three consecutive months since March of this year, adding credence to our earlier hypothesis that overall retail sales (after 24 months of decline) have bottomed in February 2017 when jewelry sales recovered by 2.5% year-over-year. More importantly, tenant sales at Wharf’s flagship mall, Harbour City, grew 1.4% in the first quarter, after nine consecutive quarters of decline. The rate of negative rental reversion at Swire Properties’ Pacific Place Mall moderated to -2.3% in the first quarter of 2017 compared to -15% a year ago. Even High Street retail spot rent is showing signs of bottoming; rent was off 2.7% quarter-over-quarter in 2Q17, but the decline has lessened from the 3.7% drop in the preceding quarter.
The latest 2Q17 industry flash data continues to be encouraging in Singapore. Office rents in 2Q17 turned marginally positive across the board. Landlords, especially in the Grade A segment, are becoming more firm with asking rents as new builds increasingly gets filled up. We continue to believe the worst of the rental decline is behind us. The only risk on the horizon we can envisage is that GDP growth remains anemic. On the other hand, retail rents continue to witness broad based decline. According to JLL, the quarter-over-quarter gross rent for prime retail space declined 0.9%, following a 1.2% drop in 1Q17. Overall retail rent on JLL’s numbers shows -12% from the peak in 2014.

The Australian REITs fell 4.6%20 in the second quarter, a major reversal of the 4.7% gain in the first quarter. The disappointing performance was attributable to increased probability of Australia Central bank hiking interest rates much earlier than expected. In its June policy statement, the central bank alluded that Australia’s economic growth is expected to pick up to 3% over 2017 and into 2018. The healthy economic growth projected is supported by a strong employment market (the unemployment rate dipping to 5.7%21 in May from 5.9% in March). The other factors pressuring the sector’s performance in the second quarter included the banks’ credit tightening on the residential market, the expected erosion of bricks and mortar retailers’ market share with the imminent entry of Amazon (projected to gain 3% market share within five years) and the AUD appreciating 2% against the USD, which could curb offshore flows.

**Market Outlook**

The expected synchronized tapering by central banks globally sometime in second half of 2017 is likely to increase equity markets’ trading volatility and cap performance of the property sector, especially given that REITs have benefited from years of Fed quantitative easing. We remain inclined to stay with stocks that offer value – absolute as well as relative to the peer group and historical band.

Japanese developers trade at a significant discount relative to their historical valuations as well as to the JREITs. In terms of implied cap rates, the Japanese developers currently trade at rates 70 to 150 bps higher than their underlying market cap rates, reflecting significant mispricing. We note the developers have presold the majority of their launched condominiums and are achieving higher rents in their new office project completions. We expect this to underpin 6% earnings growth per annum over 2016-18. From a catalyst standpoint, we believe the prospect for quicker Fed hikes (leading to renewed JPY weakness) and a potential CPI turnaround should underpin developer share prices. A more meaningful economic recovery would support incremental office and residential demand which benefits the developers. We remain selective on the JREITs due to expensive valuations and lower expectations of monetary easing. JREITs trade at implied cap rates that are 50 to 80 bps below their underlying cap rates. Our preference is with the hotel and retail JREITs as they benefit most from an improving tourism landscape.

We are positive on Australian core commercial property fundamentals with the passive AREITs trading at an average 1.08x P/NTA, significantly below the 1.2-1.3x P/NTA levels witnessed last year. Recent asset sales by the AREITs were at >10% premium to book values, further reinforcing underlying AREIT valuations. Despite cycle-low risk-free rates, we note that current cap rates are trading at much higher spreads (300 to 400 bps) to the risk-free, providing a significant buffer in the event of any cap rate expansion this year. 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.

Hong Kong developers trade at close to minus one standard deviation from historical mean valuations. However, we maintain an underweight due to negative catalysts. We prefer large cap developers that are significantly discounted relative to asset fundamentals. From a macro standpoint, we envisage increasing uncertainty for China as it navigates between economic rebalancing and the need for stable growth. Incremental home cooling measures imposed by the Hong Kong Government remains the biggest headwind.

In Singapore, we underweight the developers as valuations have priced in a lot of positives. We prefer S-REITs in the office and industrial sector that offer resilient yield despite increasing supply conditions. There is significant new supply across several asset segments (particularly retail) resulting in a negative operating environment for an increasing number of S-REITs.

In the near-term, there remains elevated risk that share price movements will be dictated by macro newsflow, with rising
trade protectionism and potential central bank tapering being the two major drivers. Regional REITs that have benefited tremendously from quantitative easing will likely witness a reversal as that unwinds. A weaker U.S. dollar/stronger Yen could derail economic momentum in Japan and impact underlying demand for condos and office space. On the other hand, lowered expectations of Fed hikes and an easing in monetary conditions would be viewed positively for the Hong Kong developers.
1 Factset, FTSE EPRA/NAREIT Developed Index, As of 30-Jun-2017.
2 U.S. REITs total return taken from MSCI US REIT Index (RMZ)
3 Citi. As of 31-Mar-2017
5 Barclays Research. As of 30-June-2017.
6 ISI, GreenStreet Advisors, 3-Jul-2017.
7 ISI. As of 30-Jun-2017
8 Citigroup. As of 30-Jun-2017
9 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.
10 Green Street Advisors, 3-Jul-2017.
16 Japan Cabinet Office
18 JP Morgan
19 Hong Kong Census and Statistics Department, 30-Jun-2017.
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