

White Paper

# Approaching Growth: U.S. REIT Investment Strategy

*By*

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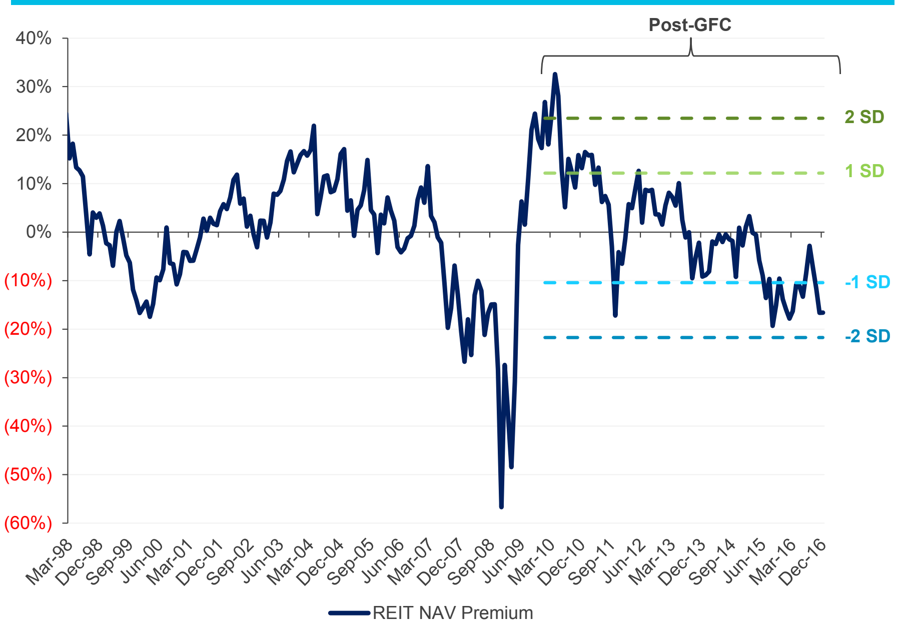
## First Quarter 2017

REIT valuations position the sector as a compelling investment option as we enter 2017, as REITs have already discounted the factors that should moderate returns in the underlying real estate markets this year. For private real estate markets, 2017 is a transitional year as we shift away from low interest rates assisting cap rate compression and low supply assisting NOI growth. Instead, U.S. real estate markets now face a backdrop of higher interest rates and the first meaningful supply response since the Crisis[1]. In addition, certain sectors face structural challenges, including the negative impact of technology on retail and hospitality, and of spending reform on healthcare. Combined, these factors should lead to a reduction in real estate returns from the double digits we have witnessed post-GFC, to mid-single digits in 2017. While we do not foresee any significant increase in capitalization rates, given the cushion offered by the significant risk premium to bonds and the benefit of declining credit spreads, we do believe cap rate compression is over for the time being.

Looking past 2017, REITs are an inexpensive entry point into the reflation cycle, as real estate will be a beneficiary of U.S. domestic expansion. NOI growth is likely to re-accelerate as the economy improves and the real estate markets digest the near term supply. Looking out even further, we believe that there are still many years left in this real estate cycle, with the ultimate conclusion likely marked by a significant supply increase as a result of strong economic growth, looser lending standards and the fundamental need for new commercial real estate infrastructure to accommodate our new economy. However, between now and the inevitable end of the cycle, we forecast higher real estate values, as we move through a transitional 2017 and into more interesting times ahead. In the meantime, REIT investors have the benefit of a discounted entry point (see Figure 1) that offers the potential for returns significantly in excess of a moderating position in the private real estate cycle.

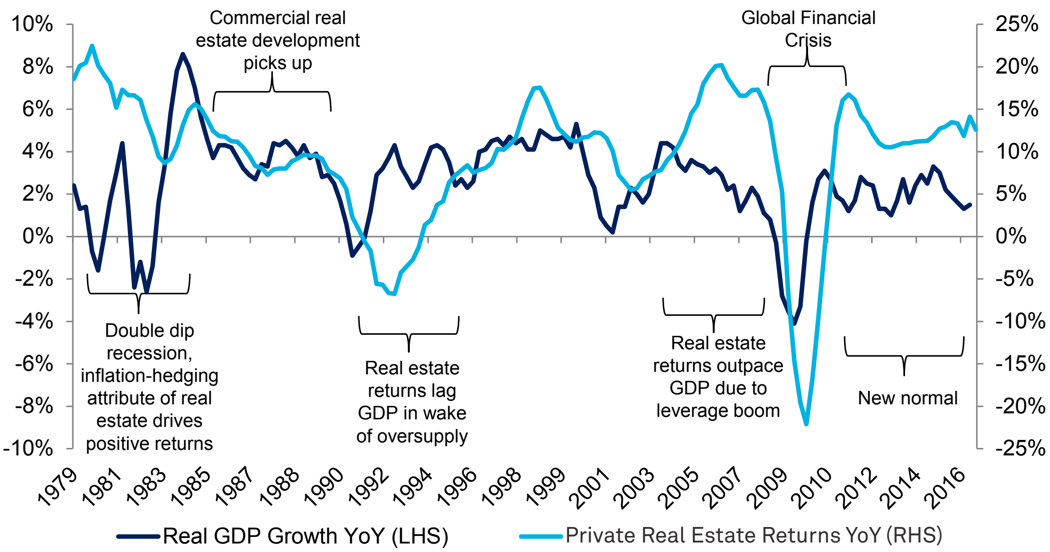
Figure 1 - U.S. REIT Market Discount to NAV




*Source: GreenStreet Advisors (core sectors), as of January 2017*

[1] *The Global Financial Crisis, or GFC*

Figure 2 - Commercial Real Estate Returns and Economic Growth




| The New Normal (post-GFC) | Second Half of the Cycle |
|---|---|
| Low interest rates | More inflation |
| Low growth | Higher growth |
| Low supply | Policy shift from monetary to fiscal |
| Urbanization | Millennials middle-aging |
| Technology Penetration | Continued Technology Penetration |
| Investor concentration in gateway markets | Broadening focus to major non-gateway markets and development |

*Source: Private Real Estate is represented by the NCREIF Property Index. Bloomberg and NCREIF quarterly return data is from June 1979 through September 2016.*

## The Real Estate Cycle - Halfway There

At the beginning of last year we described the year ahead as a mid-cycle slowdown. Markets are now exiting this phase and are entering the second half of the real estate cycle, which will present a very different investment environment. One of the most important changes that we highlighted pre-election is the policy shift from monetary to fiscal, happening at a time when the U.S. economy has already begun to re-accelerate and the worst is behind many emerging market economies.

The higher level of economic growth now anticipated has historically represented good news for property investors. Economic growth and inflation equate to more occupier demand and higher rents. Better growth also tends to lead to better lender confidence, which could now be assisted by less regulation, leading to lower credit spreads. The one important negative ingredient in this equation is higher base interest rates (or underlying government bond rates, for instance, the 10-year U.S. Treasury yield). Between these different factors, however, as shown in Figure 2, over the last 30 years an improving economy has meant better real estate returns[2].

> "Regardless of the outcome of the election, important ramifications await the economy and markets, as we anticipate policy focus moving from monetary to fiscal. One implication of more fiscal spending may be the catalyst for a change in inflation expectations over time, as fiscal policy has a solid chance of increasing inflation through consumption of goods and services."
>
> *- CenterSquare Listed Real Estate Market Commentary November 2016*

The defining factors of the post-GFC real estate market (i.e. The New Normal) from a cyclical perspective have been low interest rates, low supply and low growth, and from a structural standpoint, urbanization, technology, and investor concentration on gateway markets. We may be at the cusp of material change to these factors. The defining cyclical factors are now likely to become better growth and more inflation, the policy shift to fiscal stimulus, the middle aging of millennials, continued technology penetration and a broadening of investor focus to non-gateway markets and development.

While many of these factors will play out over years to come, we summarize our views on the most pertinent factors below, and also present our expectations on a sector by sector basis in the pages that follow.

## Investment Positioning

As we enter the second half of the real estate cycle, we think that the best returns for REIT investors will be found in those sectors with exposure to cyclicality, shorter lease durations, development on the asset side of the balance sheet, and longer-term fixed debt on the liability side. From a REIT property sector standpoint, taking into account both

[2] *The deviations between these two series is also instructive, including the inflation-driven outperformance of real estate in the early 1980s, the prolonged supply induced downturn of the early 1990s, and the leverage-induced deviation of the mid-2000s, culminating in the Global Financial Crisis, but followed by a quick commercial real estate snap back assisted by undersupply. The housing market, by way of contrast, faced a physical oversupply and did not recover until 2012.*

fundamentals and valuation, our outlook favors office, hotels, data centers and single-family rentals. Health care, retail and net lease will likely face structural headwinds and also pressure from rising bond yields due to longer-term leases. Investors will also increasingly look “Beyond the Gateway”[3] when considering the best cities to invest in, looking for better growth outside of Gateway markets that offer very low yields, to other primary cities in the U.S.

Infrastructure is also likely to gain from the new investment environment and many of the listed infrastructure companies globally are likely to be conduits for much of the new spending on infrastructure, continuing to fuel “Americas Quiet Infrastructure Boom”[4]. For those investors unfamiliar with this investment sector, we believe it is one worth exploring.

## Growth Offsets Higher Interest Rates

Although higher interest rates can be a headwind for real estate - in a vaccuum they negatively affect values through upward pressure on yields - the REIT market is already showing encouraging evidence of resilience, with REIT share prices up 6.6% since the U.S. Presidential election despite one of the fastest increases in 10-year Treasury yields in decades[5]. This is because higher interest rates imply higher growth, which is positive for real estate cash flows. Also, despite base rate increases, credit spreads have narrowed reflecting less perceived risk via lending when inflation is expected to boost asset appreciation. Therefore, a moderate increase in interest rates over the next couple of years should not be a hindrance to real estate and REIT markets continuing to post positive returns.

We also expect a greater demand for and supply of credit to help propel the real estate cycle. If expected deregulation policies are enacted, access to debt capital will improve as lending rules are loosened, increasing capital flows from the financial system, proving positive for real estate values and development.

## Technology - Danger and Opportunity

Technology is providing both opportunities and threats for real estate investors. Opportunities exist from the accelerating use of data driving demand for data centers. The growth of e-commerce is necessitating the development of a whole new supply chain to facilitate this new economy, driving demand for sophisticated distribution warehouse assets. New creative employment opportunities have dominated job growth, leading to the development of office assets to facilitate the collaborative culture of these firms. Urbanization, a trend at the intersection of demographics and technological innovation, is creating opportunities in the multifamily industry to meet the evolving pattern of housing demand.

Figure 3 - CenterSquare's REIT Market Outlook

| Improving Fundamentals | | |
|---|---|---|
| **Sector** | **Valuation** | **Comment** |
| Office | Neutral | Positive cyclicality |
| Industrial | Unattractive | Potential trade risk |
| Hotels | Neutral | Positive cyclicality |
| Data Centers | Attractive | Secular demand growth |
| Single-family Housing | Neutral | Ageing millennials drive demand |
| Infrastructure | Attractive | Fiscal spending conduit |
| **Geography** | **Valuation** | **Comment** |
| Prime ex-Gateway markets | Attractive | Broadening recovery |
| **Factors** | | |
| Cyclicality | | |
| Development | | |
| Short duration leases | | |
| Fixed debt | | |

| Declining Fundamentals | | |
|---|---|---|
| **Sector** | **Valuation** | **Comment** |
| Apartments | Attractive | Supply concerns |
| Retail | Attractive | E-commerce threat |
| Healthcare | Neutral | Spending reform is a threat |
| Storage | Neutral | Some supply |
| Student Housing | Neutral | Low growth |
| Net Lease | Neutral | Long duration leases |
| **Geography** | **Valuation** | **Comment** |
| Gateway markets | Attractive | |
| **Factors** | | |
| Long-term leases | | |
| Floating Debt | | |

*Source: CenterSquare Investment Management, January 2017*

[3] *See “Beyond the Gateway”, a paper published by CenterSquare in August 2016*
[4] *See “America's Quiet Infrastructure Boom”, a paper published by CenterSquare in October 2016*
[5] *Returns based on the FTSE NAREIT Equity REITs Index for the period from 11/8/2016 - 1/20/17. The 10-year U.S. Treasury yield increased by 61 bps in the same period.*

## Figure 4 - The First Half vs. the Second Half of the Cycle

*This table is an illustrative underwriting example of a real estate asset in a low growth, low rate environment (the first half of the cycle, represented by 2010-2016 below) and in a shorter more normalized environment (what we expect to be the second half of the cycle, represented by 2016-2020 below). The changes in underwriting assumptions are highlighted in the third column. Assuming the spread between cap rates and debt costs remains constant (historically it has compressed), and cap rates expand, value growth and returns are still expected to be positive.*

| 2010-2016 | | 2016-2020 | | |
|---|---|---|---|---|
| **2010** | | **2016** | | |
| Acquisition value | $100.00 | Acquisition value | $142.33 | |
| Net Operating Income | $6.75 | Net Operating Income | $7.83 | |
| Capitalization rate | 6.75% | Capitalization rate | 5.50% | |
| 10 year bond yield | 3.25% | 10 year bond yield | 2.25% | |
| Credit spread | 2.00% | Credit spread | 1.75% | |
| Cost of debt | 5.25% | Cost of debt | 4.00% | |
| *Cap rate spread* | *1.50%* | *Cap rate spread* | *1.50%* | |
| **2016** | | **2020** | | **Change** |
| Net Operating Income | $7.83 | Net Operating Income | $8.68 | |
| *NOI growth p.a. 2012-2016* | *2.50%* | *NOI growth p.a. 2016-2020* | *3.50%* | ***1.00%*** |
| 10 year bond yield | 2.25% | 10 year bond yield | 3.25% | **1.00%** |
| Credit spread | 1.75% | Credit spread | 1.25% | **-0.50%** |
| Cost of debt | 4.00% | Cost of debt | 4.50% | **0.50%** |
| *Cap rate spread* | *1.50%* | *Cap rate spread* | *1.50%* | ***0.00%*** |
| Capitalization rate | 5.50% | Capitalization rate | 6.00% | **0.50%** |
| Disposition value | $142.33 | Disposition value | $149.71 | |
| Value growth p.a. | 5.55% | Value growth p.a. | 1.45% | |
| Income p.a. | 6.75% | Income p.a. | 5.50% | |
| Return p.a. | 12.30% | Return p.a. | 6.95% | |

*Source: CenterSquare Investment Management, January 2017*

However, technology is also disrupting real estate markets. One of the largest threats is to retail, particularly department stores that are housed within most malls, which continue to bleed market share to e-commerce and more tailored and experiential physical retail. Suburban office is now less valuable as the workforce has shifted to large urban centers and remote access technology has unchained workers from a physical location. Hotels are also seeing an increase in virtual supply from Airbnb as well as the disruption from online booking tools. While the initial impacts are already apparent, the second half of this cycle poses the question of when we will see peak technological penetration. If we look at retail spending as an example, about 11% is facilitated through the internet and is growing at more than 15% per annum[6]. Our estimates suggest that this could reach 50% before we reach maximum saturation, especially as demographics evolve, suggesting that we are less than halfway there. We are likely only seeing the beginning effects of the relationship between our virtual and physical infrastructure.

## New Supply for a New Economy

Since the Crisis, real estate NOI growth has been relatively strong at 3-4% per annum despite a tepid recovery, due in part to constrained development. A near term challenge for some U.S. real estate markets, however, is the emergence of new supply. This supply has been concentrated in a few

## Figure 5 - REITs and Technology

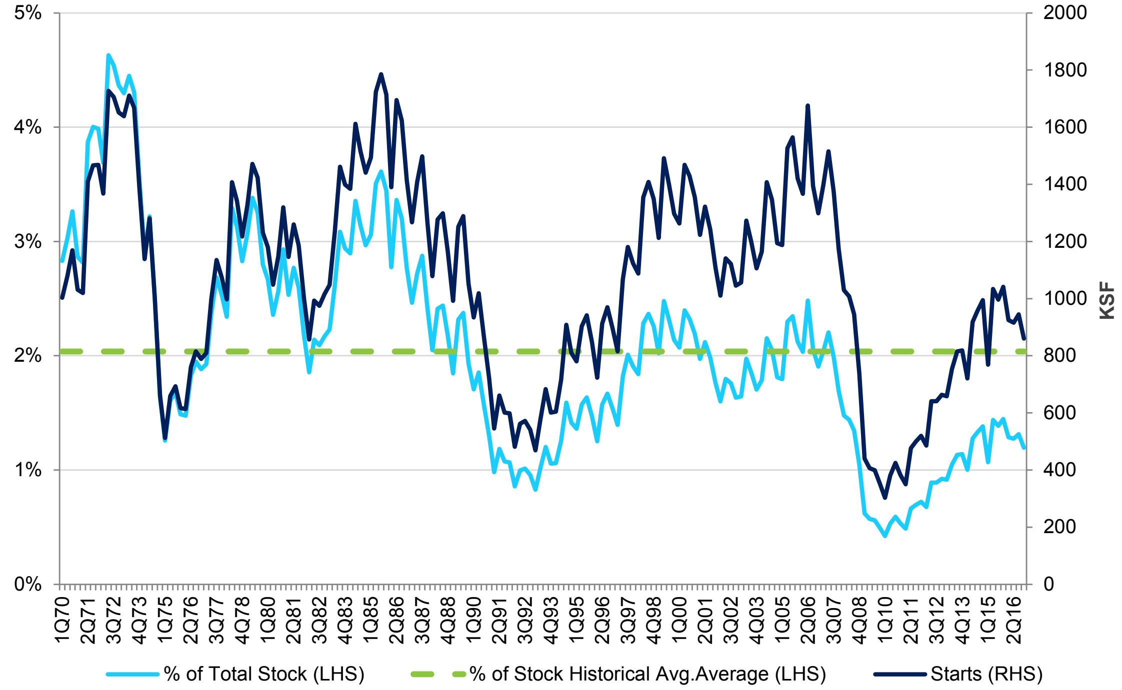
| Sector | Technological Disruption Winner/Loser | Investment Implication |
|---|---|---|
| **Apartment** | **Winner** | • Technology is helping to facilitate the increased propensity to rent as urbanization fuels demand<br>• Structural demand trends most pronounced in larger cities<br>• As cap rates have compressed, incremental returns available from development (although supply increasing) |
| **Industrial** | **Winner** | • Ecommerce necessitates the need for an entire new supply chain of modern logistics assets<br>• Focus on new assets and ability to create value through development<br>• Enjoys a yield premium to more traditional property types |
| **Data Centers/ Cell Towers** | **Winner** | • The physical infrastructure that allows the virtual world to exist<br>• Specialists in the operation and development of technically complex assets<br>• Attractive development opportunities |
| **Storage** | **Winner** | • Leveraging the internet and pricing systems has led to huge market share and efficiency gains<br>• Platform value, enhanced by technology, creates attractive acquisition growth opportunities |
| **Office** | **Mixed** | • Opportunities favor larger cities with a creative workforce demand base<br>• Need for more creative office from the new generation of tenants and the evolving needs of traditional tenants<br>• Lower floor space ratios from more efficient use of space necessitates less real estate per unit of demand<br>• Suburban office assets increasingly obsolete given remote connectivity |
| **Healthcare** | **Mixed** | • Technology is creating more testing and leading to higher costs, putting incremental pressure on margins. However, technological disruption is minimal. |
| **Retail** | **Loser** | • Retail has seen a significant increase in virtual supply<br>• Bifurcation of retail real estate: destination malls/convenience retail is winning, commodity retail is losing<br>• Convenience includes grocery anchored centers with ancillary services (lower competition from the internet)<br>• Destination malls have high demand from omni-channel retailers (i.e. Apple) and can reinvent themselves through service-based offerings |
| **Hotels** | **Loser** | • Inability to reliably forecast occupancy given last minute cancellations from online booking tools<br>• Airbnb a longer term threat |

*Source: CenterSquare, as of September 2016*

[6] *Source: Internetretailer.com, U.S. Commerce Department, as of September 30, 2016*

sectors and geographies that have benefited from secular demand, but have also proven a magnet for capital. From a geographical standpoint, this has included gateway markets[7] and from a sector perspective, lodging, apartments, senior housing, self storage and industrial.

Figure 6 - Supply as a % of Existing Real Estate




*Source: Citi Research, as of January 2017*

After this initial wave, supply growth into 2018 peaks, implying better NOI growth as the economy also improves. However, although this first wave of supply will abate, it may prove a precursor to a more significant future wave as the cycle progresses, due to continued value and rent growth coupled with improved capital availability. More fundamentally, new commercial real estate infrastructure is needed as our physical infrastructure catches up with the new way that we live and work. An important consideration is that the economy uses real estate much more efficiently than in the past and for that reason, we may need less of it (i.e. less floor space per unit of demand). This means supply has a more significant dampening impact on rent growth than in past cycles. The good news for real state owners and developers is that a significant wave of supply remains many years in the future and by definition necessitates further real estate value growth and development opportunities.

## Valuation - The Private Market to REIT Arbitrage

The REIT market currently offers real estate investors a "value add" return profile for "core" investment risk, available due to the 16.6% discount to NAV (see Figure 1), which will likely prove to be an attractive entry point for an allocation. The reason for this opportunity is that REITs are an abandoned sector - the equity markets have a strong preference for higher levels of NAV growth, and at which times this exists, price REITs at premiums to NAV. When real estate value growth is more muted, as we postulate underlying real estate markets face over the next year, short term focused equity investors look elsewhere. This however presents an opportunity for longer term real estate investors, as the economy moves in 2017 through the phase of rebased rate expectations into the good news of improved cash flows to real estate owners. For longer term investors, we believe now is a discounted entry point into a real estate cycle that will see growing real estate values over the coming years.

*[7] REITs with a gateway focus in 2016 saw diminished returns relative to those of their low-barrier market peers, especially in the apartment sector, implying decelerating returns for private-market gateway investors.*

## SECTOR BREAKDOWN

## OFFICE: Tech, Trump, and R&D

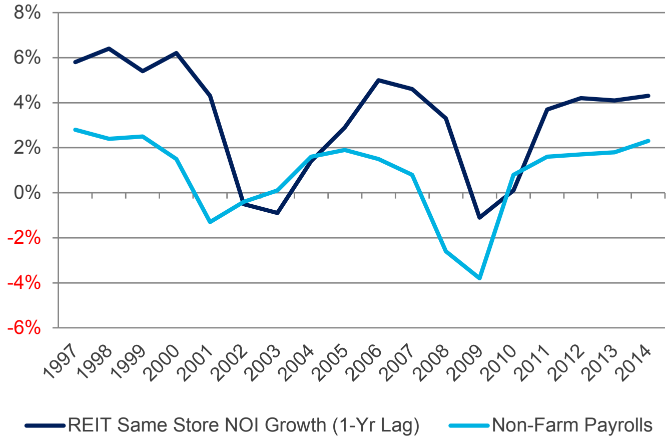
The year will likely present a mixed bag of performance across the office sector, with strong NOI and muted cash flows. Traditionally, office NOI holds up well late in the cycle due to long-term leases that build up a large mark-to-market on the delayed ability to fully participate in a rising market. Mitigating the cash flow are outsized leasing concessions and capital requirements that are likely getting worse for landlords as we enter 2017.

The submarkets of West Los Angeles may be the best in the country in 2017, performing well on perpetually compressed supply and very strong demand from tech and media. Seattle is absorbing elevated supply, due in part to tech behemoths like Amazon with insatiable appetites. San Francisco exposure via the REIT market is trading at a discount and looks attractive, although it remains a higher risk market. In fact, San Francisco, Denver, and Austin—all tech markets—have seen a deceleration over the past year. While the job growth remains high enough for supply to be absorbed in these markets, if deceleration continues, these cities will experience challenges. Infill Sunbelt locations should thrive under most Trump policies, such as protectionist trade agreements and small business tax cuts. The D.C. metro area has a history of substantially upping its use of office space when a federal administration is politically aligned. Northern Virginia and Ft. Meade in Maryland may be beneficiaries from the incoming administration's expected prioritization of defense spending. Banks, particularly those in New York City and Charlotte, will likely also see a renaissance due to a raising rate environment and decreased financial regulation. Additionally, recent passage of the 21st Century Cures Act will pump almost $6 billion into research for life sciences and streamline the FDA approval process, buoying names exposed to this field. Conversely, commodity suburban office space and midtown Manhattan property will remain less desirable, as will complex long-term projects delivered into what will likely be a tenant-friendly atmosphere in 2018 and beyond.

Urban vs. Suburban Job Growth


*Source: U.S. Bureau of Labor Statistics, Goldman Sachs Global Investment Research, 2016.*

Job Growth and Why it Matters




*Source: U.S. Bureau of Labor Statistics, Company Documents, December 2016. REIT Same Store NOI Growth based on all office companies in the FTSE NAREIT Equity REITs Index.*

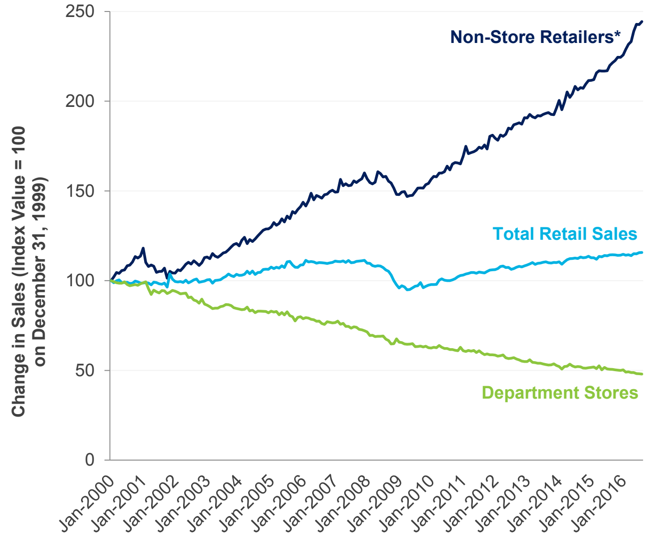
## SECTOR BREAKDOWN

## INDUSTRIAL: Secular Demand and Supply Chain

Industrial surprised to the upside in 2016 on measured supply, strong transaction volumes, and some rate compression in specific markets. Traditionally, positive macroeconomic data benefits industrials and healthy domestic consumer spending, GDP growth, etc. should all should improve with the promised tax cuts and fiscal spending in the Trump administration. The primary drivers for last year's industrial REIT performance, though, were secular demand and supply chain development, both of which are expected to become even greater contributors in 2017.

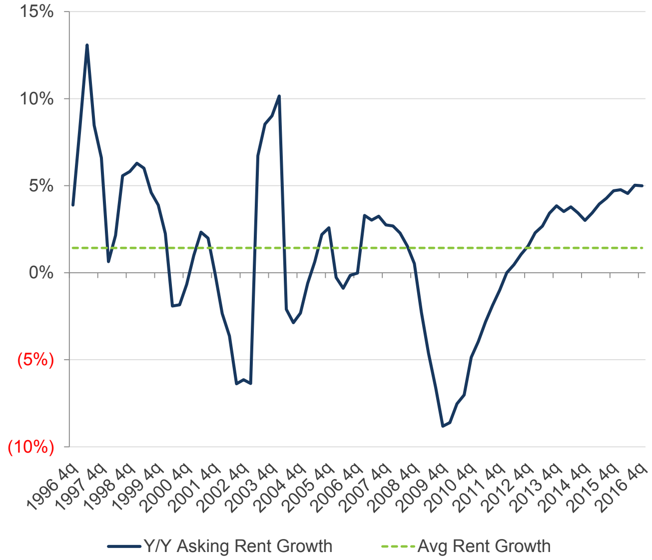
Typically, e-commerce sales require three times the square footage than traditional bricks-and-mortar retailers. With online sales expected to grow at a robust 15% per annum , the demand cycle for warehouse fulfillment space is likely still in the early stages. Additionally, because successful e-commerce needs to be closer to populations, large regional warehouses, last-mile infill, and concentration of facilities near major cities for same-day delivery will continue to thrive. Driven by this demand, rent growth is besting forecasts, with overall rents up 3%-5% and some REITs expecting 5%-6% given tight market conditions. Although foreign investment may slow due to uncertainty surrounding the Trump administration's trade policies, additional drivers in 2017 may be heightened consumer spending via tax cuts and job growth, measured supply, and loosened lending restrictions.

Change in Retail Sales since January 2000




* *Primarily online sales*
*Source: Commerce Department via Fed, FIVE THIRTYEIGHT, as of 2016.*

Industrial Market Rent Growth




*Source: Evercore ISI, as of December 2016*

## SECTOR BREAKDOWN

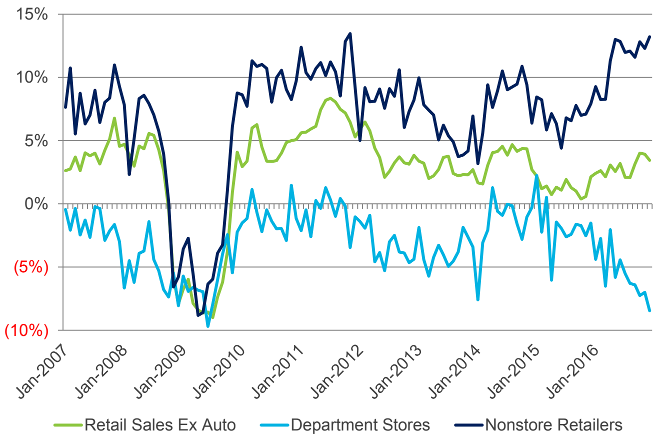
## RETAIL: Consumers Begin to Spend

Despite remaining at historically and cyclically healthy levels, a shift in consumption patterns has led to sluggish retail spending at traditional brick-and-mortar retailers. However, as 2017 progresses, consumers are expected to reignite outlays to this sector. Consumer sentiment is on an uptick, post-election. This jump is attributable to the expectation of lower taxes, fiscal stimulus, and the promise of domestic job creation, particularly in the Rust Belt.

E-commerce, which estimates state will garner 10%-25% of overall sales in the next few years, continues to display an accelerating trend within the overall retail landscape. In fact, e-commerce accounted for 25% of consumer spending during the Black Friday 2016 period, up from 18% last year and nearly double four years ago. Certain e-commerce retailers are also expanding some services via brick-and-mortar locations—Amazon's grocery concept, for example—providing an additional tailwind to the sector.

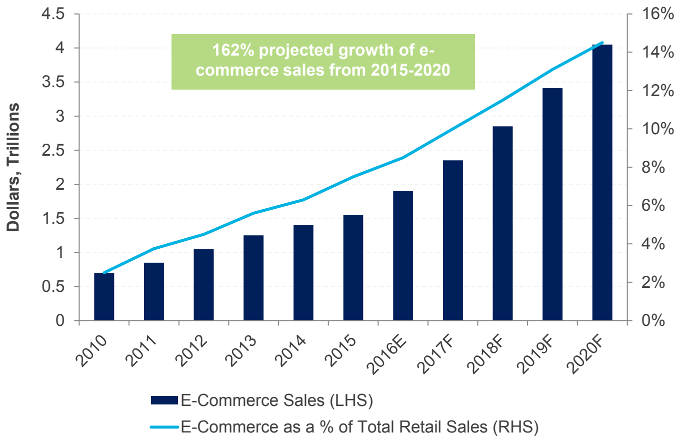
Although retail fundamentals remain strong overall, the largest secular headwinds are expected to come from department store closures and a continued shift to online sales. Over-retailed and over-built, large department stores such as Sears and, to a lesser extent, Macy's and JCPenney, struggle for relevance in an increasingly online and specialized retail landscape. Shadow supply from store closures, will need to be absorbed going forward for fundamentals to materially improve. In contrast, high-quality shopping centers and regional malls are expected to remain a critical part of retailers' broader omni-channel strategy. Going forward, many traditional retailers will likely look to rationalize their overall store count in response to changing consumer spending patterns and utilize the savings to further invest in their online presence. Additionally, retail centers that focus on necessity or service-based consumption (e.g. grocery stores, hair salons, restaurants, etc.) should benefit from their resilience in the face of underlying e-commerce threats. In response to these trends, landlords will invest in the redevelopment of their assets to better curate their properties and generate yields that pencil to 8%-12%. In 2017, given the aforementioned trends and threats, high quality locations and tenant bases will likely outperform their lower quality peers.

E-commerce Swallowing Market Share




*Source: Census Bureau, December 2016*

Global E-Commerce Sales




*Source: e-Marketer, Prologis Research, 20162016*

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# SECTOR BREAKDOWN

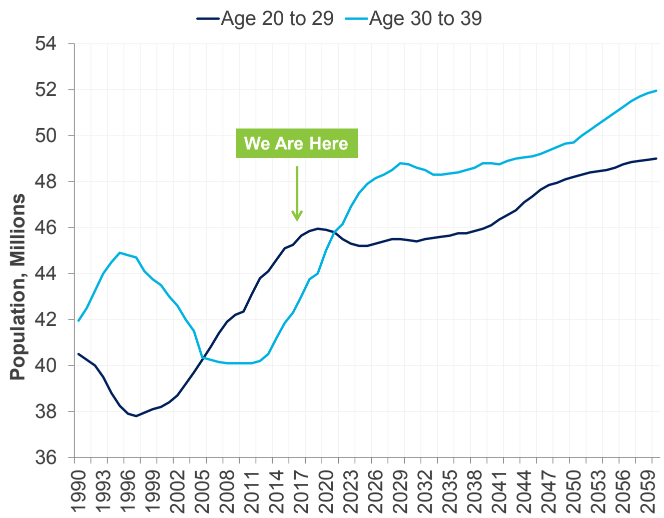
## RESIDENTIAL: Urbanization Soon Peaking?

The secular trend of urbanization continues to benefit the multifamily subsector and demographics remain favorable as the prime renting population—those aged mid-20s to mid-30s—have yet to age out. Unbundling of households is still a major driver of multifamily as the percentage of young adults living at home remains precipitously higher than the long-term historical average. Affordability is the main concern of these unbundled households, with the rent-to-income ratio achieving a new peak of 28% nationally.[8] Though the supply and demand balance is still healthy and hovering near the long-term average, its trajectory is causing some concern. Overall fundamentals will likely continue to moderate through 2017 as new, costlier urban supply is slated to come online, particularly in Gateway markets, and ahead of projected job growth. Merchant developers offering generous lease concessions may put additional pressure on stabilized assets as 2017 progresses.

However, positive impacts are anticipated in the multifamily industry as proposed tax cuts and less regulation bode well for job growth and the short lease duration of apartments. Basel III requirements, first enacted in 2016, may be a governor on supply and benefit REITs via constraints on merchant developers, although alternative financing may offer outlets to restricted bank lending.

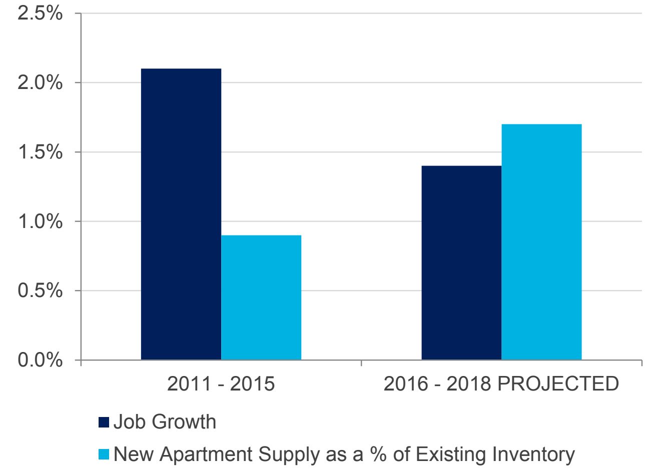
Single family homes are beginning to benefit from the front edge of secular demand, as Millennials look to home ownership for the next stage of life, i.e., marriage and family. Supply in this subsector is low, demand is healthy (particularly in the Sunbelt region), and operational improvements and efficiencies have supported the oncoming trend. Despite the favorable backdrop, the Trump administration may open the door to increased ownership rates, as financial reform is expected to ease restrictions on mortgage issuance.

U.S. Population for Selected Age Group, BLS Actual and Projections




*Source: U.S. Bureau of Labor Statistics, December 2016*

Annualized Actual and Projected Job & Apartment Supply Growth




*Source: AvalonBay Communities, 2016*

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*[8] UBS Investment Research estimates, BLS, Census Bureau, Axiometrics, CBRE, as of September 2016.*

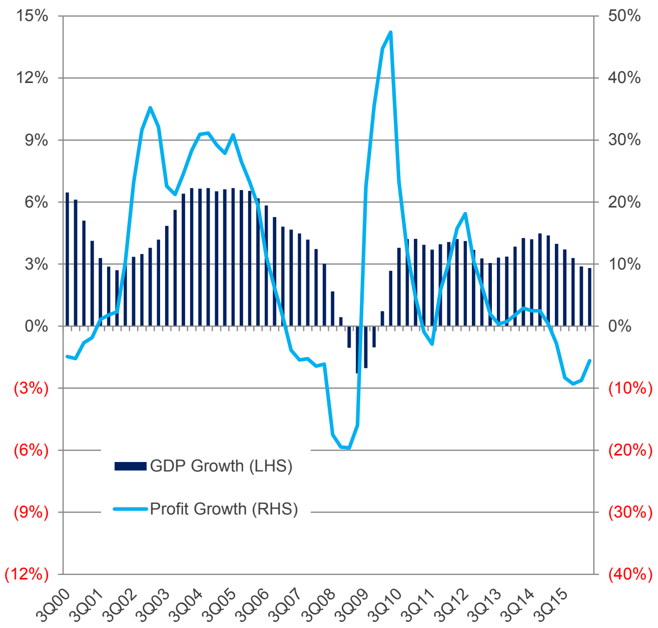
# SECTOR BREAKDOWN

## HOTELS: Business Transient Reignites

Hotel occupancy rates are highly correlated to the strength of corporate profits, as three-quarters of demand is business transient. Corporate profits in 2016 were weak due to dropping oil prices and a stronger dollar; however, improving sentiment may be partially attributable to projections for increased corporate profits for the first time in six consecutive quarters of year-over-year declines. Proposed corporate tax reform by the Trump administration may also further buoy business transient volumes.

There are some secular headwinds on the sector, however. Despite peak occupancy, rent growth has been weaker than historical levels owing to pricing transparency. Online travel agencies such as Expedia and Hotels.com allow for easy price comparison and simplified fee-free cancellations and rebooking. Additionally, supply continues to be elevated, particularly in New York City where 14.4% of stock is under construction, and is slated to increase over 2017 ahead of expected demand growth (see table below).

GDP / Corporate Profit Growth
(Trailing Four Quarter Avg)




*Source: St. Louis Fed, CenterSquare, as of December 2016*

Aggregate Supply Growth by Market

| MSA (Metropolitan Statistical Area) | Under Construction | Active Pipeline | Active + Pre-Planning |
|---|---|---|---|
| Orlando, FL | 0.9% | 6.2% | 6.4% |
| Norfolk-VA Beach, VA | 1.2% | 2.3% | 2.3% |
| Atlanta, GA | 1.7% | 9.4% | 10.6% |
| Oahu Island, HI | 2.0% | 3.2% | 5.1% |
| Las Vegas, NV | 2.3% | 5.3% | 5.3% |
| St Louis, MO-IL | 2.5% | 5.7% | 5.9% |
| Detroit, MI | 2.5% | 13.7% | 14.6% |
| Phoenix, AZ | 2.7% | 9.2% | 10.5% |
| San Diego, CA | 3.0% | 8.1% | 9.9% |
| San Fran-San Mateo, CA | 3.1% | 11.8% | 13.1% |
| Washington, DC-MD-VA | 3.2% | 9.1% | 10.4% |
| **US** | 3.3% | 1.7% | 11.4% |
| Anaheim-Santa Ana, CA | 3.4% | 10.6% | 11.5% |
| Chicago, IL | 3.5% | 8.9% | 9.6% |
| New Orleans, LA | 3.5% | 11.6% | 12.7% |
| Boston, MA | 3.9% | 15.0% | 16.4% |
| Tampa-St. Pete, FL | 4.2% | 10.7% | 11.9% |
| **Top 25** | 4.7% | 13.9% | 15.1% |
| Philadelphia, PA-NJ | 4.8% | 12.7% | 13.4% |
| Minn-St Paul, MN-WI | 4.8% | 12.7% | 14.1% |
| Miami-Hialeah, FL | 5.7% | 23.5% | 26.7% |
| LA-Long Beach, CA | 5.7% | 14.8% | 16.9% |
| Dallas, TX | 6.3% | 19.8% | 21.2% |
| Houston, TX | 6.8% | 22.2% | 22.3% |
| Nashville, TN | 7.0% | 32.2% | 36.6% |
| Seattle, WA | 7.8% | 23.1% | 23.9% |
| Denver, CO | 9.7% | 21.9% | 22.3% |
| New York, NY | 14.4% | 27.1% | 28.9% |

*Source: STR, Wells Fargo Securities LLC, 2016*

## SECTOR BREAKDOWN


## HEALTHCARE: A Political Mess

Healthcare is under pressure and full of uncertainty due to the ability of political pens to cause sudden and massive shifts in the landscape. The most obvious of these concerns is the potential repeal of the ACA (Obamacare), which would hurt hospital and medical offices reliant upon Medicare and ACA reimbursement. There is likely to be industry-wide expense pressure in 2017, due to competition for healthcare workers and upward movement in wages. Additionally, this interest-rate sensitive group is at the threshold of a Federal Reserve tightening cycle. With interest rates rising, cost of capital headwinds, and uncertainties surrounding the future of government-sponsored health insurance, we expect healthcare REITs to hunker down, conserve capital, and focus on eking out organic growth.

There are few places to hide, as fundamental risks are inherent in nearly every sub-sector. In senior housing, supply has grown to be around 7%-8% of existing stock, which will likely accelerate declines in rent growth. Skilled nursing facilities have experienced pressure from reduced lengths of stay, and being cut out of the picture entirely as hospitals favor home health in an effort to cut costs. Hospitals will suffer if the ACA is repealed, and medical office buildings depend to some degree on the health of hospitals. Lab space is the only area without immediate and mounting pressures.

But positives may unfold over 2017. If the Trump administration supplies a replacement to the ACA immediately, this could bring a positive bounce for the healthcare sector as investor uncertainty would be removed. The front-end of an aging baby boomer population creates a significant and long-term tailwind for the healthcare industry, though the bulk of the benefit won't hit for another 5-10 years. In aggregate, we believe this strange environment will create numerous investing opportunities in the healthcare space as fear and uncertainty often lead to mispriced stocks.

Affordable Care Act (AKA Obamacare)

**GOP wants to repeal *and* replace. Likely ~80% of Obamacare will remain**

***Individual mandates* are under the most scrutiny – will be #1 aspect stripped out**

- Healthy won't get insurance, sick will → cost per person goes up
- GOP will attempt to counter rising insurance costs by allowing providers to do business across state lines

**Transition from fee for service to value based payments**

- Fee for service: Services unbundled and paid for separately. Hospitals and doctors paid on the amount of treatments / procedures given → incentive towards quantity rather than quality of care.
- Value based: Hospital / skilled nurse is responsible for the patient for 60 – 90 days after they leave the facility. Readmission results in a penalty payment.

**GOP wants to move toward *block grants* for states**

- Federal block grants to state will be a fixed amount, thus requiring individual states to tighten their belts

**Expansion in the availability of HSAs (Health Savings Account)**

**Cut drug pricing by allowing global "entry into free markets for drug providers"**

*Source: RCA., NIC, Federal Reserve, 2016*

# SECTOR BREAKDOWN

## NET LEASE: The 10-Year Leaves a Mark

Despite the sharp increase in the 10-year Treasury yield late in the year, the net lease sector performed well in 2016 from strong acquisitions and record setting spreads on those acquisitions. Net Lease REITs took advantage of higher valuations by issuing equity to fund acquisition pipelines and reduce leverage, which caused a few companies to receive credit upgrades. While the expectation is for minimal tenant bankruptcies in 2017, credit risk remains a focus, in particular with the oversaturation of the casual dining industry. We believe fractured markets and small deal sizes will continue to allow retail net lease avenues of growth when companies have the cost of capital.

Within net lease, industrial is a favored industry because of secular tailwinds, tenant health, and accretive spreads. Additionally, freestanding retail net lease remains attractive due to its focus on service and e-commerce-resistant retail. Finally, despite increases to the 10-year Treasury yield, net lease cap rate spreads are in line with the historical average and represent healthy levels for continued external growth.

Major Equity Capital Market Themes

| 4.0%-5.5% YIELDS CORE FUNDS | 5.0%-7.75% YIELDS REITS | 5.0%-7.75% YIELDS NNN COMPANIES | 4.0%-6.5% YIELDS FOREIGN INVESTORS | 4.0%-6.5% HNW INVESTORS/1031 |
|---|---|---|---|---|
| • Class “A” product<br>• Investment grade credit<br>• Scale is largely not an issue<br>• Focused on long-term total return and can be less sensitive to initial yield<br>• Highly sensitive to locations<br>• Not seller in today’s market | • Traditionally most active players in the traditional NNN space<br>• Becoming highly selective<br>• Reduced “lease term requirements” to 10-15+ years<br>• Focused on credit quality (select sub-investment grade deals are challenging) | • Credit profile is primary focus<br>• Lease term 10+ years is paramount<br>• Becoming much more active<br>• Lease structure is important (NNN vs. NN vs. FSG)<br>• Heavily dependent upon asset-level mortgage market<br>• Becoming more active in today’s market | • Most active for Class “A” office<br>• Investment grade credit<br>• Scale is largely not an issue<br>• Focused on long-term total return and can be less sensitive to initial yield<br>• Highly sensitive to locations<br>• For industrial and retail, there is significant demand to add positions<br>• FIRPTA issues remain for some | • Structured market has returned with expanding debt market<br>• Seeking bond-like alternatives<br>• Focus on lease structure to ensure low cost of ownership<br>• Less activity versus 2005-2007 cycle<br>• 1031 market still offers pricing premium |

*Source: Eastdil Secured, September 2016*

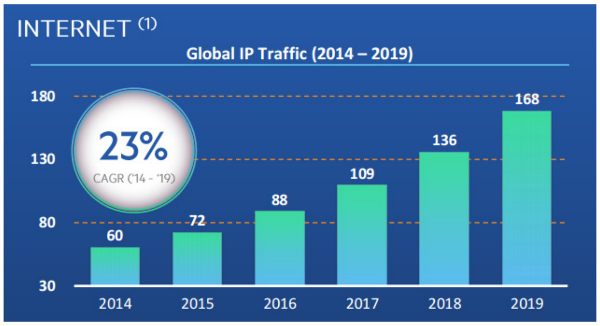
# SECTOR BREAKDOWN

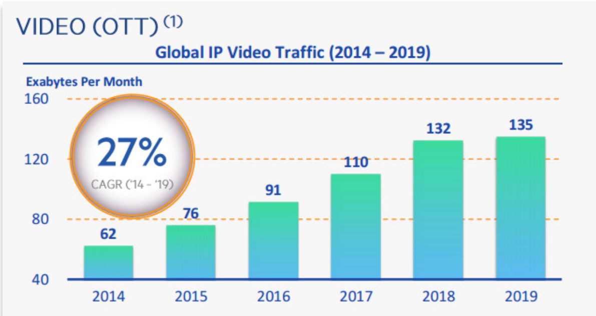
## DATA CENTERS: The Cloud and E-commerce

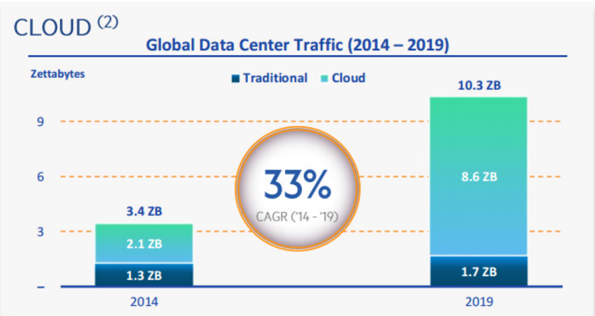
The strong fundamentals exhibited by data centers in 2016 are expected to continue through 2017. Driven primarily by the build-out of e-commerce and hyper-scale cloud providers, this sector also saw increased integration as well as investment in land and expansion plans. Enterprise outsourcing, a trend that has ticked up to 20%, and continuing digitalization of the world via mobile and the Internet of Things continues to aid this sector. A final main propellant to the sector in 2017 is the potential enactment of data sovereignty laws, which require data to stay within the country of origin, further boosting net demand for domestic data centers.

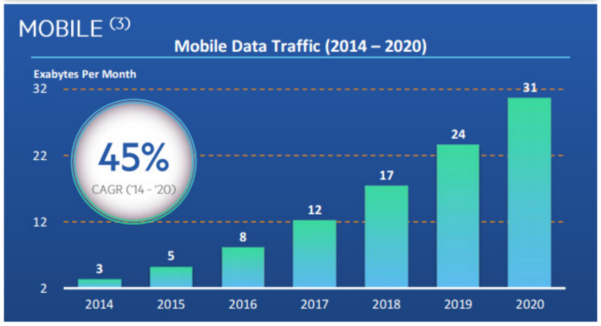
Long-term data center needs remain strong in the long-term with global IP traffic, cloud, video, and mobile traffic expected to hit between 20% and 45% growth through 2019. Supply and demand will stay roughly in equilibrium as capacity can quickly ramp up via the sector's just-in-time delivery model. Pricing improvements will continue to remain steady, particularly for retail and smaller wholesale co-location, and large leasing deals and pre-leasing will continue to be cooperative. Modest improvement in pricing on rental rates is expected, as well as increased merger and acquisition activity, contributing to reasonable valuations. Development yields are expected to stay healthy as companies implement flexible product design while improving development cost.

Traffic Growth




*Source: Digital Realty Investor Presentation*
*(1) Source: Cisco Visual Networking Index: Forecast and Methodology, 2014-2019*
*(2) Source: Cisco Global Cloud Index, 2015*
*(3) Source: Cisco Visual Networking Index: Global Mobile Data Traffic Forecast update, 2015-2020*

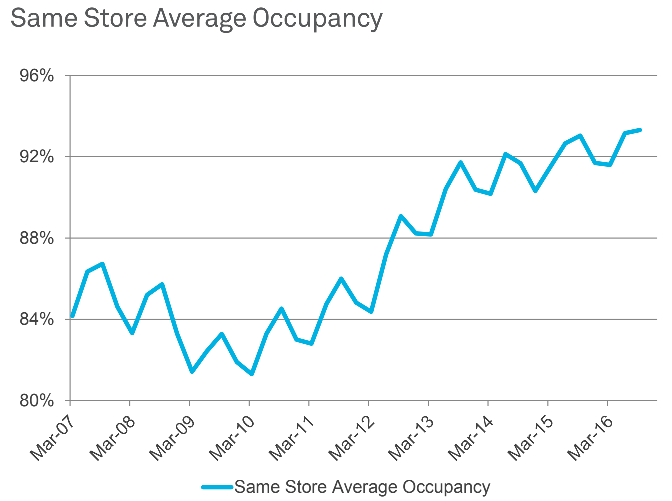
# SECTOR BREAKDOWN

## STORAGE: Peak Occupancy Weighs Heavily

As we expected, fundamentals in the storage sector began to crack in 2016 after a four-year performance run. NOI growth slowed on an increase of supply, rising expenses, above-peak occupancy, and increased discounting. Although the storage sector posted faster same-store operating income over the past four years versus the overall REIT market, the market is now slowing and we expect earnings growth will fall to the REIT average or even below over the next year or two.

Despite these cracks, the sector still holds opportunities in 2017. The power of brands is unlikely to abate and the "network effect" from third-party management will help the best-in-class storage REITs. Strong balance sheets with low leverage and very limited near-term maturities are other virtues of the sector.


*Source: Company Documents, CenterSquare, as of December 2016. Sector Average Same Store NOI Growth based on all storage companies in the FTSE NAREIT Equity REITs Index.*




*Source: Company Documents, CenterSquare, as of December 2016. Sector Average Same Store Occupancy based on all storage companies in the FTSE NAREIT Equity REITs Index.*

## Conclusion

2017 will be a transitional year for private real estate as the market absorbs increased supply in gateway markets and the shift to increasing interest rates. Private market investors would do well to target strategies that will be adept at navigating this environment, and consider the potential for an allocation to REITs as an alternative, discounted entry point into U.S. real estate exposure. In the medium and long term, REITs and real estate will be subject to a number of fundamental and secular drivers, but amid the uncertainly, growth in real estate values is ahead. For investors with a strategic REIT allocation, the sector holds long term growth across property types and through continuation of secular trends, increased economic growth, loosening fiscal spending, as well advantageous supply and demand balances. These fundamental and structural developments will impact the various real estate sectors in disparate ways, providing pitfalls and opportunities for the nimble, experienced REIT manager.

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**Within this presentation, asset class risk and returns are presented using established indices as proxies. A full list of these indices is below:**

U.S. REITs: FTSE NAREIT Equity REITs Index
U.S. Equities: S&P 500
Technology: S&P 500 Information Technology Sector (GICS Level 1)

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## Definition of Indices

FTSE NAREIT Equity REITs Index
The FTSE NAREIT U.S. Real Estate Index includes all tax-qualified real estate investment trusts ("REITs") that are listed on the New York Stock Exchange, the American Stock Exchange and the NASDAQ National Market List. The index constituents span the commercial real estate space across the US economy and provides investors with exposure to all investment and property sectors. The performance presented is based on total return calculations which adds the income a stock's dividend provides to the performance of the index, and is gross of investment management fees. Effective December 20, 2010 the ticker for the FTSE NAREIT U.S. Real Estate Index changed from FNERTR (total return) to FNRETR (total return). The old ticker (FNERTR) has been reassigned to newly established FTSE NAREIT All Equity REIT Index which is similar to the existing benchmark in all regards except that timber REITS will comprise approximately 7% of the new index and 0% in the FTSE NAREIT Equity Real Estate Index.

NCREIF Property Index
The NCREIF Property Index is a quarterly time series composite total rate of return measure of investment performance of a very large pool of individual commercial real estate properties acquired in the private market for investment purposes only. All properties in the NPI have been acquired, at least in part, on behalf of tax-exempt institutional investors - the great majority being pension funds. As such, all properties are held in a fiduciary environment

S&P 500
The S&P 500 is an index that is considered to be a gauge of the U.S. equities market. The index includes 500 leading companies spread across the major sectors of the U.S. economy. The index focuses on the larger cap segment of the U.S. market and represents approximately 75% of the market capitalization of U.S. securities. The index is the most notable of the many indices owned and maintained by Standard & Poor's, a division of McGraw-Hill Companies.

*These benchmarks are broad-based indices which are used for illustrative purposes only and have been selected as they are well known and are easily recognizable by investors. However, the investment activities and performance of an actual portfolio may be considerably more volatile than and have material differences from the performance of any of the referenced indices. Unlike these benchmarks, the portfolios portrayed herein are actively managed. Furthermore, the portfolios invest in substantially fewer securities than the number of securities comprising each of these benchmarks. There is no guarantee that any of the securities invested in by the portfolios comprise these benchmarks. Also, performance results for benchmarks may not reflect payment of investment management/incentive fees and other expenses. Because of these differences, benchmarks should not be relied upon as an accurate measure of comparison.*

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Mr. Scott Crowe is the Chief Investment Strategist at CenterSquare Investment Management and joined the firm in 2015. Scott is a member of CenterSquare's listed real estate, listed infrastructure and private real estate investment committees. In his capacity as Chief Investment Strategist, Scott works with each team's portfolio managers and investment professionals in the leadership of the investment process, with a particular focus on thought leadership by synthesizing our real asset views across the business. Scott is the portfolio manager of the Global Concentrated real estate securities strategy. Scott also works directly with CenterSquare's clients, providing education and guidance on the market and helping them execute their investment goals. Prior to joining CenterSquare, Scott was CIO of Liquid Alternatives at Resource Real Estate where he built and led a global investment and distribution platform. Prior thereto, Scott was the lead Global Portfolio Manager for Cohen & Steers, where he was responsible for $10B in assets under management and led the investment and research team of over 20 portfolio managers and analysts. Prior to this, Mr. Crowe held the position of Head of Global Real Estate for UBS Equities Research, where he built and managed the U.S. REIT division while leading a global team of more than 40 analysts. Scott began his career at Paladin Property Securities and holds an Honors Finance Degree from the University of Technology Sydney and a Bachelor of Commerce from the University of NSW / National University of Singapore.

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