CenterSquare
REAL ASSET INVESTMENT LEADERSHIP

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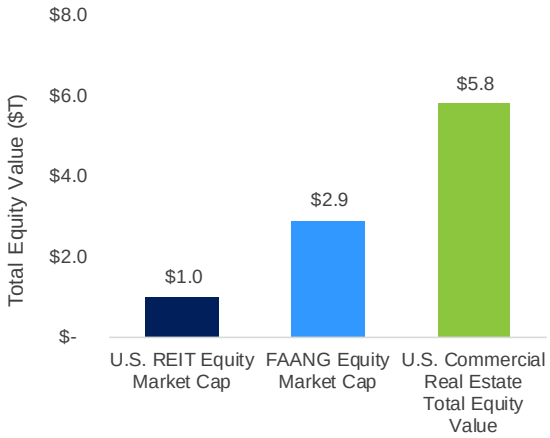
The REIT vs FAANG Valuation Showdown

Scott Crowe, *Chief Investment Strategist*

Uma Pattarkine, *Investment Strategy Analyst*

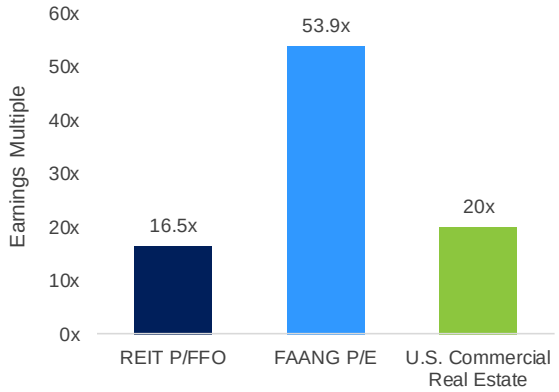
Are the market's five most popular and best-performing tech stocks worth 50% of the value of the U.S. commercial real estate market? That is the investment challenge posed by today's equity market, with the market capitalization of FAANG stocks (Facebook, Apple, Amazon, Netflix, and Alphabet's Google) currently equal to 3 times the market capitalization of the U.S. REIT market (which represents 17% of the U.S. commercial real estate market[1]).

REITs, FAANG, and Commercial Real Estate Equity Value



Source: U.S. REIT Market Equity Market Cap and U.S. Commercial Real Estate Total Value (adjusted for leverage) as reported by the EPRA Global Real Estate Total Markets Table, March 2018. FAANG Equity Market Cap is as per Bloomberg, March 2018.

Forward Earnings Multiples

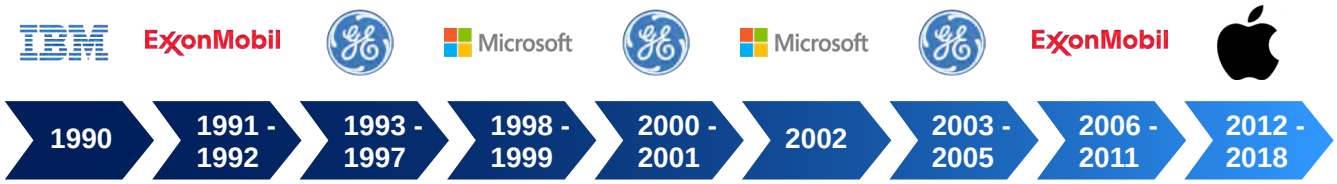


Source: Citi, Bloomberg, as of 3/29/2018. U.S. Commercial Real Estate Multiple is calculated as the inverse of the cap rate determined for CenterSquare's proprietary REIT ODCE proxy, which uses gateway/infill REITs in core sectors and weights them according to the ODCE index.

[1] *Source: EPRA, Bloomberg, as of March 2018*

While economic cycles change, commercial real estate is enduring. Hard assets exist no matter what economic driver dominates at a point in time. Corporations, employees and consumers all need to occupy a real estate asset - be it an office building, a logistics facility or an apartment – to drive the economy. By contrast, the largest company in the S&P 500 has changed with regularity over time, as shown below. A decade ago, the largest equity was Exxon Mobil, and the decade before that, Microsoft. Today it is Apple.

Largest U.S. Company in S&P 500 Over Time



Source: Bloomberg

While the average age of New York City office is 60 years, it has remained functional with moderate amounts of capital expenditure. In comparison, in 1958 the idea of a mobile phone seemed pure science fiction. The valuation discrepancy between REITs and FAANG stocks today may be the result of sentiment, but while the fast pace of technological change generates investor enthusiasm, many of today's largest and most successful tech companies may not be direct beneficiaries of this change. Instead, based on history, these companies are likely to experience an erosion of their premier position. What will be the largest equity in decades to come and what companies will be dominating the new and exciting technologies that will be shaping our lives? Uncertain. Will they, their employees, and their customers need a physical location? Probably.

The relative valuation argument for REITs also holds true for the broader equity market. REITs have only been this deeply discounted relative to equities on a full cycle twice over last 20 years; the Tech Boom 1.0 (1998-2000) and the Global Financial Crisis (2008-2009). During these cycles, not only have REITs delivered positive returns, but they have also outperformed equities. The catalyst for a repeat of REIT outperformance could be that at some point, the Fed hiking cycle will become more of a challenge to equity valuations than it is to real estate.

In fact, the consensus concern that REITs are an unfavorable investment as interest rates rise is challenged by historical data - REITs have actually delivered positive returns during rising interest rate cycles. Interest rates rise because economic growth improves, which

1950s vs 2018

New York Skyline

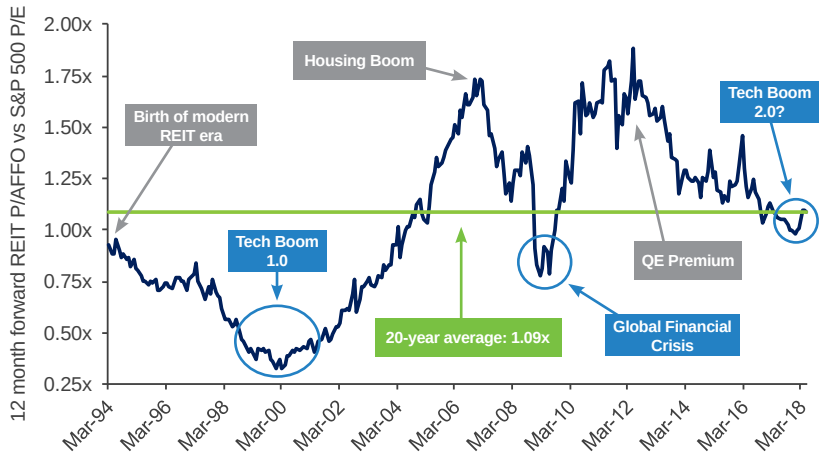

Image Credit: UN Photo

Technology

increases real estate NOI, and this more than offsets valuation pressure from higher rates. In addition, as growth improves, about half of the increase in interest rates is offset by declining bank credit spreads as lenders become more optimistic. In fact, even with the increase we have seen in 10-year bond yields recently, REITs continue to trade at dividend yield spreads to government bond yields in line with the long term average and above-average spreads to corporate bond yields. It appears the real estate market is well positioned for higher interest rates, as this topic has already attracted investor attention for many years. Consequently, investors did not price in low interest rates as a permanent fixture for either the REIT or private real estate markets.

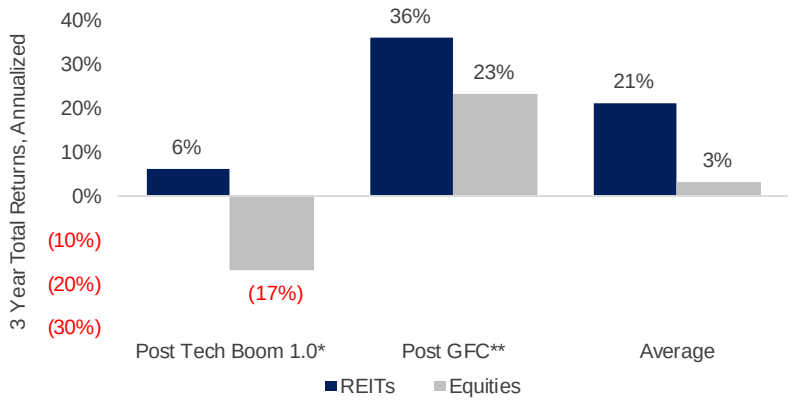
In conclusion, we believe that the valuation case for REITs makes the sector a compelling hedge against elevated tech valuations. REITs have a proven track record of outperformance when relative valuations to equities are stretched. Relative to fixed income, REITs are offering investors access to strong yield spreads versus government and corporate bonds. So, the challenge for investors is this – would you rather own five technology stocks that risk shifting sentiment around the latest trends, or 50% of U.S. commercial real estate assets that stand steadfast over time?

Historical Relative Valuations (REITs & Equities)



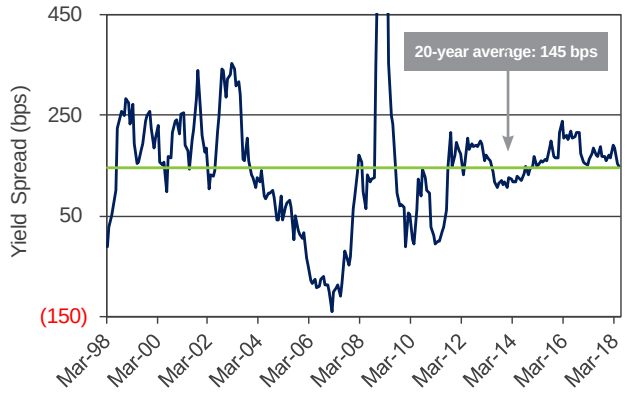
Equities based on S&P 500, REITs based on the FTSE Nareit Equity REITs Index.
Source: Bloomberg, as of 3/29/2018. Average covers 20 years ending May 31, 2018.

Performance Following Prior Cycle REIT Relative Valuation Lows

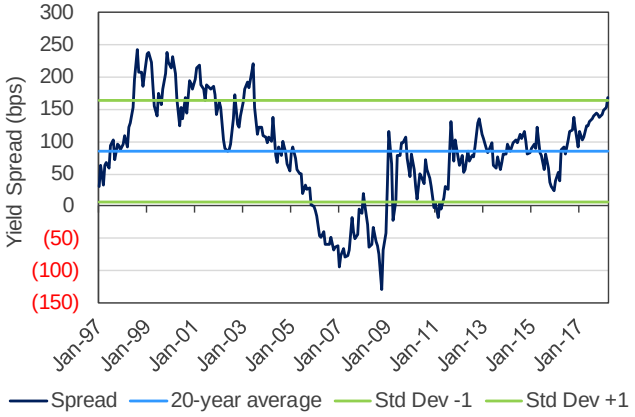


**Post Tech Boom defined as the period from 3/31/2000 – 3/31/2003*
***Post GFC (Global Financial Crisis) defined as the period from 2/28/2009 – 2/28/2012*
Equities based on S&P 500, REITs based on the FTSE Nareit Equity REITs Index.
Source: Bloomberg, as of 3/29/2018

REIT Dividend Yield minus 10-Year U.S. Treasury Yield



Implied Cap Rate Spread (REITs vs Baa Bonds)



Sources: Bloomberg, NAREIT, CenterSquare Investment Management. The REIT market is represented by the FTSE Nareit Equity REITs Index in the charts above. Baa Bond Yields are based on data from Green Street Advisors, as of March 2018

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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.

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.

NCREIF Fund Index – Open End Diversified Core Equity ("ODCE")
The ODCE is a capitalization-weighted, gross of fee, time-weighted return index with an inception date of December 31, 1977. The term Diversified Core Equity style typically reflects lower risk investment strategies utilizing low leverage and generally represented by equity ownership positions in stable U.S. operating properties diversified across regions and property types. The NFI-ODCE, like the NCREIF Property Index (NPI) and other stock and bond indices, is a capitalization-weighted index based on each fund's net invested capital, which is defined as beginning market value net assets (BMV), adjusted for weighted cash flows (WCF) during the period.

The REIT ODCE Proxy is a universe of REIT stocks built to resemble the NCREIF Fund Index – Open End Diversified Core Equity (ODCE). The ODCE, short for NCREIF Fund Index - Open End Diversified Core Equity, is the first of the NCREIF Fund Database products and is an index of investment returns reporting on both a historical and current basis the results of 36 open-end commingled funds pursuing a core investment strategy, some of which have performance histories dating back to the 1970s. The REIT ODCE Proxy is proprietary to CenterSquare and uses gateway/infill names in apartments, retail, industrial and office, and then weights them according to the ODCE index to create a proxy.

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, actual portfolios are actively managed. Furthermore, actual portfolios may 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 actual portfolios will be comprised of the securities in 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.

About the Authors

Scott Crowe, *Chief Investment Strategist*

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.

Uma Pattarkine, *Investment Strategy Analyst*

Ms. Pattarkine is an Investment Strategy Analyst for CenterSquare Investment Management. She joined the team in 2017 and focuses primarily on top down analysis, research and product development, and is an active member of the public side research effort. Prior to joining CenterSquare, Ms. Pattarkine spent three years in corporate finance and strategic planning at ExxonMobil in Houston. Ms. Pattarkine graduated from The Pennsylvania State University with Interdisciplinary Honors and High Distinction and holds a BS in Finance with a minor in International Business, BS in Accounting, and Master of Accountancy.

About CenterSquare

Founded in 1987, CenterSquare Investment Management is an independent, management-owned real asset manager focused on listed and private equity real estate and listed infrastructure investments. As an investor and manager, our success is firmly rooted in aligning our firm's interests with those of our clients, partners and employees, as well as our commitment to alpha-generating research.

CenterSquare Investment Management is headquartered in suburban Philadelphia, with offices in Los Angeles, Denver, London and Singapore. CenterSquare is proud to manage investments on behalf of some of the world's most well-known institutional and private investors.

Philadelphia, Pennsylvania

For More Information, Please Contact:

CenterSquare Investment Management
630 West Germantown Pike
Suite 300
Plymouth Meeting, PA 19462
(610) 834-9500
ContactUs@centersquare.com

www.centersquare.com

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