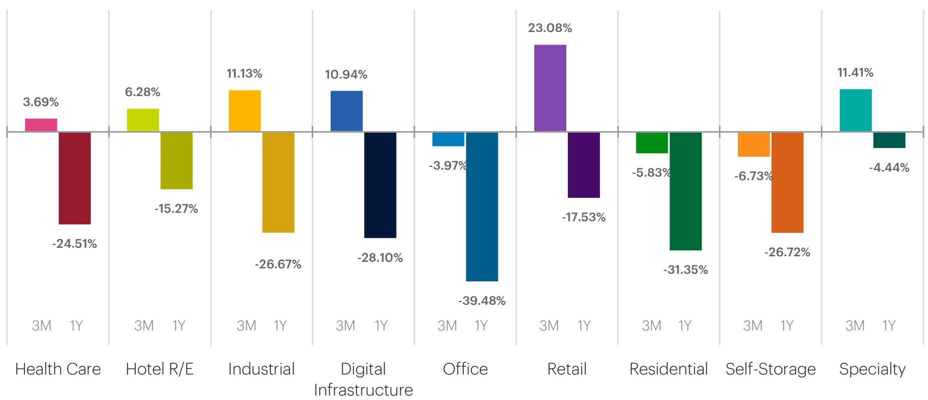
Macro and Performance Review - QTD

In the December quarter of 2022, the FTSE NAREIT Equity Index gained 5.24%.[1] The rebound in the REIT markets has, in our opinion, been driven by positioning for a slower hiking pace beyond upcoming central bank meetings across the world in response to evidence that the global economy is slowing down. For example, consensus world GDP economic forecasts for 2023, as measured by Bloomberg, has fallen from 2.5% in late September to 2.1% at the end of December 2022.[2]

1 All performance is quoted in US Dollars.
2 Bloomberg Finance L.P.

We believe that a continued slowdown in spending is likely

FTSE NAREIT EQUITY REITS PERFORMANCE AS OF 12/31/22



Despite performing better than expected in the last quarter of 2022,[3] Heitman believes the US economy will face a difficult 2023. Early estimates for Q4 2022 GDP from the Federal Reserve Bank of Atlanta's GDP Now model[4] and Oxford Economics[5] range from 3.5%-4.0% annualized. This represents an improvement from previous quarters as revised Q3 2022 GDP grew by 3.2% annually, and GDP growth was negative during the first two quarters of 2022.[6] Inflation also improved through the end of 2022. Headline PCE (Personal Consumption Expenditures, the Fed's preferred measure of inflation) in November was down 60 basis points ("bps") from the previous month to 5.5% year-over-year.[7] Core PCE, which excludes food and energy, also decreased in November, down 30 bps from the previous month to 4.7%.[8] While Heitman feels that these indicators are moving in the correct direction, the Fed has signaled that they would like to see inflation come down closer to their 2.0% target before they pull back on monetary policy intervention.[9] Heitman believes that the Fed's ability to rein in inflation will largely determine if the US will fall into a recession this year.

Following four consecutive 75 bps rate hikes,[10] the Fed raised the Federal Funds rate by another 50 bps at the December 2022 FOMC meeting.[11] Aggressive rate hikes last year resulted in the fastest run-up of mortgage rates since the 1980s.[12] The slight lessening of rate hikes at the

3 Oxford Economics (January 5, 2023). US: Positive GDP news keeps rolling in
4 Federal Research Bank of Atlanta (January 3, 2022). GDP Now: https://www.atlantafed.org/cqer/research/gdpnow#:~:text=Latest%20estimate%3A%203.9%20percent%20%E2%80%94%20January,3.7%20percent%20on%20December%2023
5 Oxford Economics (January 5, 2023). US: Positive GDP news keeps rolling in
6 U.S. Bureau of Economic Analysis (December 22,2022) Gross Domestic Product (Third Estimate), GDP by Industry, and Corporate Profits (Revised), Third Quarter 2022
7 U.S. Bureau of Economic Analysis (November 2022). Personal Income and Outlays, November 2022
8 Id.
9 Oxford Economics (December 16, 2022). US: Don't fight the Fed
10 Moody's Analytics (November 10, 2022). Road to Recession: Cautiously Optimistic
11 Oxford Economics (December 16, 2022). US: Don't fight the Fed
12 Oxford Economics (November 2, 2022). US: Mortgage applications slip as rate rise takes a breather

last meeting of the year gave some relief to 30-year fixed mortgage rates, as the average rate closed out the year at 6.6%.[13] While this is an improvement from recent high rates recorded earlier in the year, John Burns Real Estate Consulting does not believe it changes the near-term outlook for the housing market.[14] Heitman agrees that the run-up in rates has already impacted housing demand, as we have observed mortgage applications slowing and prices receding from the record-high levels recorded in July 2022.[15] Existing home sales declined through the end of the year with Moody's estimating that home sales during the last three months of 2022 averaged $3.95 million,[16] the slowest pace of sales since the start of the pandemic.[17]

We believe that housing affordability remains a significant challenge nationally. However, the S&P/Case-Schiller U.S. National Home Price Index has fallen in recent months. The most recent reading from the October 2022 index was down 0.5% from the previous month.[18] That said, the October index is 9.2% above where it was a year ago.[19] The limited supply of homes for sale will likely prevent a steep decline in home prices. However, Oxford Economics believes annual home price growth will turn negative in 2023, bottoming out at -5.0% year-over-year in Q2.[20] As we view it, the health of the housing market heavily depends on how high mortgage rates can climb and for how long. Based on our research, we do not foresee a significant decline in mortgage rates until the Fed is finished with its own rate hikes.[21] As a result, we believe that the previously hot housing market will continue to slow, which should benefit rented residential properties broadly. However, we concede that a recession may temporarily dampen household formation.

Other factors of the economy, such as the labor market, consumer spending, and manufacturing, have started to weaken but remain on solid ground despite the restrictive monetary policy. The labor market has been a bright spot for the economy, and its resiliency is primarily what has kept the US out of a recession thus far.[22] At September's FOMC meeting, Chairman Powell stated that he was committed to raising rates to a "meaningfully restrictive stance" to cool the labor market and bring supply and demand in balance.[23] Heitman believes that the Fed's aggressive moves to date were somewhat justified by another stronger-than-anticipated jobs report in November 2022[24] and initial jobless claims in December falling to a three-month low.[25] Ahead of the December jobs report, Moody's Analytics expects nonfarm payrolls will have grown by 215,000 net jobs during the last month of the year,[26] well above the Fed's target pace of 100,000 per month as they attempt to rein in inflation.[27] Additionally, the November Job Openings and Labor Turnover Survey ("JOLTS") report showed no signs of a cooling labor market as most metrics remained unchanged from October, outperforming the consensus expectations for a second month.[28]

Like the labor market, we believe that consumer spending has thus far been a tailwind for economic growth. Nominal retail and food spending in November 2022 fell by 0.6% from the previous month, seasonally adjusted.[29] Although this shows a slowdown in momentum, November spending was still up 6.5% from a year ago.[30] We believe that a continued slowdown in spending is likely, as the impact of higher borrowing costs and elevated prices ripple through the economy, which we believe will be compounded if the labor market softens.

13 John Burns Real Estate Consulting (December 19, 2022). Burns US Housing Analysis and Forecast (pg. 10)
14 Id.
15 Id.
16 National Association of Realtors (NAR) (December 2022). Existing Home Sales: Single-Family,(Million, SAAR) for United States, December 2022
17 Id.
18 St. Louis Fed, Federal Reserve Economic Data (October 2022). S&P/Case-Shiller U.S. National Home Price Index, Index Jan 2000=100, Monthly, Not Seasonally Adjusted
19 Id.
20 Id.
21 Moody's Analytics (November 22, 2022). US Chartbook: Waiting with Bated Breath (pg. 6)
22 U.S. Bureau of Labor Statistics (November 2022). Employment Situation Summary.
23 Oxford Economics (September 16, 2022). US: We forecast a mild recession in 2023; will the FOMC?
24 Oxford Economics (December 2, 2022). US: Employment and wage growth give the Fed a headache
25 Oxford Economics (January 5, 2023). US: Initial jobless claims fall to a three-month low
26 Moody's Analytics (January 5, 2023). Final Thoughts Ahead of December U.S. Employment
27 Oxford Economics (December 2, 2022). US: Employment and wage growth give the Fed a headache
28 Oxford Economics (January 4, 2023). US: Job openings show little signs of budging in November
29 U.S. Census Bureau (December 15, 2022) Advance Monthly Sales for Retail and Food Services, November 2022 Monthly Retail Trade - Sales Report (census.gov)
30 Id.

The ISM Manufacturing index contracted for the second consecutive month in December 2022, falling 0.6 points to 48.4.[31] While we do not believe that the December reading was particularly alarming, it does offer evidence that most growth in the sector is in the rearview mirror, as a reading below 50 indicates contraction.[32] The report's details signaled that factories endured a mild contraction at the end of 2022 as production retreated. As new orders, backlogs, and exports are falling and customer inventory conditions are more balanced than they were a year ago, the report suggests that more losses are in store for 2023.

While the US economy closed out 2022 with likely positive GDP growth, cooling inflation, and a solid labor market, Heitman believes several serious threats could quickly push the economy into a recession in 2023. The most significant of these threats will be if the Fed makes an error in setting monetary policy. The next FOMC meeting will occur at the end of January 2023, and minutes from the December 2022 meeting indicate that the Committee will continue to raise rates until it is confident that inflation is returning to its 2.0% target.[33] The Wall Street Journal's most recent survey of economists found that they believe the probability of a recession in 2023 is nearly two-thirds.[34] This belief is supported by Oxford Economics, whose baseline forecast includes a mild recession in the US this year.[35] Moody's Analytics remains optimistic with its base case expectation being a "slowcession," where growth comes to a near standstill but never slips into negative territory.[36] The firm does however acknowledge that the probability of a recession grows with each subsequent rate hike.[37]

Within the REIT sector, $7.01 billion of equity was issued in the December 2022 quarter,[38] dominated by issuances of $1.5 billion by Equinix Inc and $1.0 billion by Gaming and Leisure Properties. Industrial REIT, Eastgroup Properties, raised $750 million, $644 million was raised by Rexford Industrial Realty Inc., and $586 million by VICI Properties Inc.

In corporate activity, Veris Residential Inc., formerly known as Mack-Cali Realty Corp., jumped after Kushner Cos. initially made a takeover offer for the New Jersey-based owner of apartment buildings at $16.00 per share with a further $18.50 bid (rejected by management) in December 2022.[39] The stock gained 40.11% for the quarter.

In November 2022, INDUS Realty Trust Inc., an industrial-focused REIT in the US, received a bid by GIC and Centerbridge for $65.00 per share,[40] a 13.5% premium to its previous closing price, pricing the company at a 5.6% implied cap rate based on media analysis.

In property transactions, Unibail-Rodamco-Westfield announced on December 27, 2022 a $325 million disposal of The Village, an open-air shopping mall in Los Angeles.[41] The property was sold at an NOI yield of 5.6%, representing a 10.6% discount to the last reported value.

There was a wide dispersion of REIT sector performance in the quarter, with benchmark returns ranging from a low of -6.73% for storage, -5.83% for residential and -3.97% for office, to 23.08% for retail, 11.13% for industrial, and 11.41% for specialty sectors.

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31 Oxford Economics (January 4, 2023). US: Manufacturing slumps
32 Id.
33 Oxford Economics (December 16, 2022). US: Don't fight the Fed
34 Wall Street Journal (December 4, 2022). Economists Think They Can See Recession Coming – for a Change
35 Oxford Economics (December 16, 2022). US: 2023 Key Themes – Will the landing be hard or soft?
36 Moody's Analytics (January 2023). Slowcession
37 Moody's Analytics (November 21, 2022). This Week in The Economy
38 Bloomberg Finance L.P.
39 https://www.reuters.com/article/veris-kushner-ma-idUSL1N33200W
40 https://www.mingtiandi.com/real-estate/outbound-investment/gic-centerbridge-seek-buyout-of-us-industrial-reit-in-660m-deal/
41 https://www.globest.com/2022/12/28/urw-sells-san-fernando-valley-shopping-center-for-325m/#:~:text=Unibail%2DRodamco%2DWestfield%20(URW,transaction%20valued%20at%20%24325M.

Outlook

In Heitman's view, the outlook for real estate and REITs is mixed with direct real estate transactions, pointing to a downward trajectory. In our opinion, much of this has already been priced into the listed real estate markets.

For the US REIT sector, in our opinion, recent news flow indicates occupancy and rent declines may exceed normal seasonality in the residential sector. Additionally, high labor costs in the healthcare sector have delayed the recovery in income from the depths of COVID-19. Still, we believe the intermediate and long-term outlook remains favorable. We expect fundamentals to remain healthy in the logistics sector with strong mark-to-markets as leases roll. Real-time market rent growth appears to be slowing, but remains elevated relative to history as e-commerce demand slows and tenants are cautious of recession. We see office conditions continuing to deteriorate as companies reduce their space needs. According to company disclosures, these reductions are most evident when their existing leases mature, but there is also growing sublet space. As noted previously, retail tenants continue to open new stores as they adjust to customer spending channels. There have been some recent weaknesses at specific retailers that, in our opinion, are likely more indicative of particular business model failures than the sector's health. We expect store openings to decline in 2023, but remain positive. Self-storage market rent growth appears to have peaked in our analysis and turned negative for some REITs. Still, the existing customer rent increases will keep revenue growth above historical averages in the coming quarters.

> We remain focused on the opportunities presented in these volatile markets by focusing on stocks with identifiable catalysts and strong secular trends

On the valuation front, according to ISI estimates, US REITs are trading inexpensively at a forward AFFO multiple of just 17.9x vs. 27.0x at YE 2021. Similarly, UBS estimates are pricing the market at a discount to NAV of 22%, a 4.1% dividend yield and an implied capitalisation rate of 5.3% as of 30 December 2022.

Heitman remains focused on the opportunities presented in these volatile markets by focusing on stocks with identifiable catalysts and strong secular trends. Additionally, we have increased our focus on higher-quality assets and strong balance sheets while taking risks where lower-quality opportunities arise.

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— Performance of the Wilshire US Real Estate Securities index classified using Heitman Proprietary property types.

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