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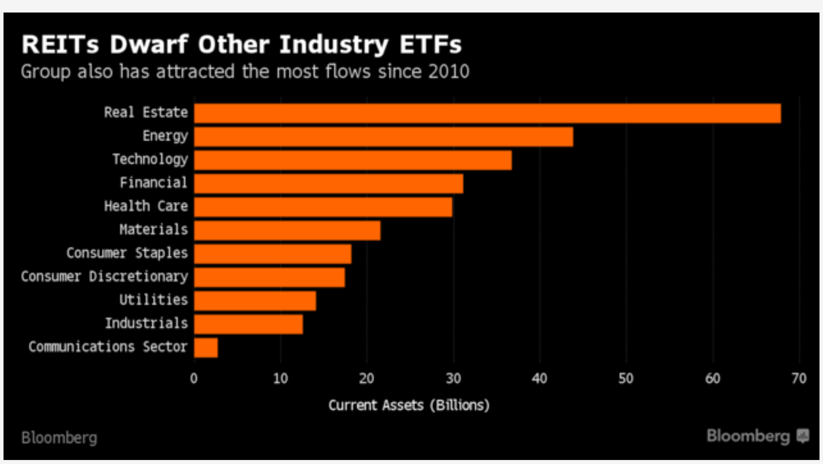
Effects of the New GICS Sector for the Real Estate Industry

Introduction and Overview

After years of impressive returns and significant growth in the industry, real estate companies will no longer be buried within the financial sector as they have been moved to their own, new headline sector. S&P Dow Jones Indices, a leading provider of financial market indices, and MSCI Inc., a leading provider of investment decision support tools, have created a new real estate sector under the Global Industry Classification Standard (GICS®) structure. GICS serves as the primary classification system for equities worldwide and provides a structure for investors, analysts and economists to consistently identify and analyze investment performance and economic activity, as well as to develop investment policies, products and research. The new real estate sector was officially implemented on September 1, 2016 and represents the first new GICS sector since the framework's inception in 1999. In total, the new GICS structure consists of 11 sectors, 24 industry groups, 68 industries and 157 sub-industries. The new real estate sector will include two industries, equity real estate investment trusts (REITs) and real estate management and development companies. The sector will exclude mortgage REITs, which will remain in the financial sector under its own newly created sub-industry. In total, the new sector will make up approximately 3% of the market capitalization of the S&P 500, and real estate companies currently account for approximately 3.5% of the global equities market.

Historical Sector Growth and REIT Performance

The creation of the new sector is a firm recognition of the significant growth and attractive historical returns offered by the real estate industry. More specifically, according to data from Morningstar Inc., over $62 billion flowed into U.S. real estate funds from 2001 through the end of 2015. Additionally, according to Bloomberg, REITs have dwarfed other industry ETFs in terms of capital flows since 2010:



Source: Bloomberg

The number of public REITs has also risen over the last decade and a half with approximately 240 REITs currently listed on the New York Stock Exchange and the NASDAQ. In terms of performance, REITs have been a top performing asset class for more than two decades and, according to Green Street Advisors, average annual total returns for U.S. REITs over the past 25 years are 12% compared to 9% for the S&P 500. Furthermore, over the last five years, REITs have outperformed the S&P 500 and the Dow Jones Industrial Average as illustrated in the following chart:

Effects of the New GICS Sector for the Real Estate Industry (continued)

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Total Returns (as of September 2, 2016)

	REITs	S&P 500	DJIA
LTM:	30.5%	14.4%	16.2%
2 Year:	24.8%	13.6%	14.0%
3 Year:	54.4%	42.2%	34.5%
4 Year:	65.8%	68.8%	56.2%
5 Year:	120.0%	106.8%	87.0%

Source: KeyBanc Capital Markets

Expected Impact

Many consider this change the biggest development in the real estate industry in years as it will have an immense impact on how investors view and analyze real estate as an asset class. Some of the major impacts expected to occur due to the creation of the new sector are discussed in detail below.

Increased Validation for the Real Estate Sector

As discussed prior, REITs have consistently delivered superior performance relative to the overall market and the increased attention to the sector has been evidenced by the growing amount of capital entering the industry. Moreover, the creation of the new sector reaffirms that investors are recognizing the real estate sector's impressive historical performance and also viewing the sector as a distinguished and primary asset class within modern investment management. Going forward, having its own asset class will provide comfortability to investors that REITs should be a fundamental piece of a well-diversified investment portfolio.

Increased Visibility and Investment

A separate GICS real estate sector should provide REITs with more attention from institutional investors, individual investors, financial advisors, and research analysts, which will provide a more diversified group of ownership and research coverage to the sector. The creation of the new sector will change the perspective for investors who once considered REITs a niche sub industry buried within the financials umbrella, and will now present REITs as a primary asset class recognized globally by retail and institutional investors alike.

Furthermore, the change is expected to significantly impact investors with broader, diversified portfolios as real estate allocations will be brought into prominent focus, leading generalist investors who once had no investment or minimal investment in the sector to likely reconsider that decision. According to Grosvenor, REITs account for 4.4% of all U.S. equities but only make up 2.3% of generalist fund managers' portfolios, indicating real estate is underinvested by nearly 50% in general investment funds. The separation of real estate into its own sector will likely draw attention to this underinvestment in REITs, especially given the sector's impressive historical returns, which should lead to increased allocation levels for the sector in general investment portfolios. Moreover, many portfolio managers with underweight allocations to REITs relative to indices will likely take initiative to increase their exposure to the sector to better align their portfolios with the new composition of investment indices. All in all, these changes should drive increased liquidity and capital flow for the sector.

Increased Understanding of REITs

Although understanding of REITs' operations and investment characteristics has significantly increased over the last decade, even before the establishment of the new GICS sector, the creation of the new sector will likely breed better understanding of industry specific nuances and terms associated with REITs. Additionally, common misconceptions about REITs, such as the notion that REITs act as a proxy for the housing market, will likely be dispelled with increased coverage and reporting on the sector. As investors of various backgrounds become more familiar with REITs, investment decisions will be based more fully on the fundamentals and economics of the industry. Also, as its own sector, real estate securities will no longer be impacted by current sentiment and outlook for the financial sector as a whole. As an example, over the last several years, the interest rate environment weighed heavily on the financial sector as a whole, and REITs were likely negatively impacted as a result of their prior classification under the financial sector. The creation of their own sector will prevent this type of impact from occurring moving forward. Similarly, a better understanding of REITs could lead to closer attention to the differentiation between property sectors, allowing active and insightful managers to select real estate securities more effectively.

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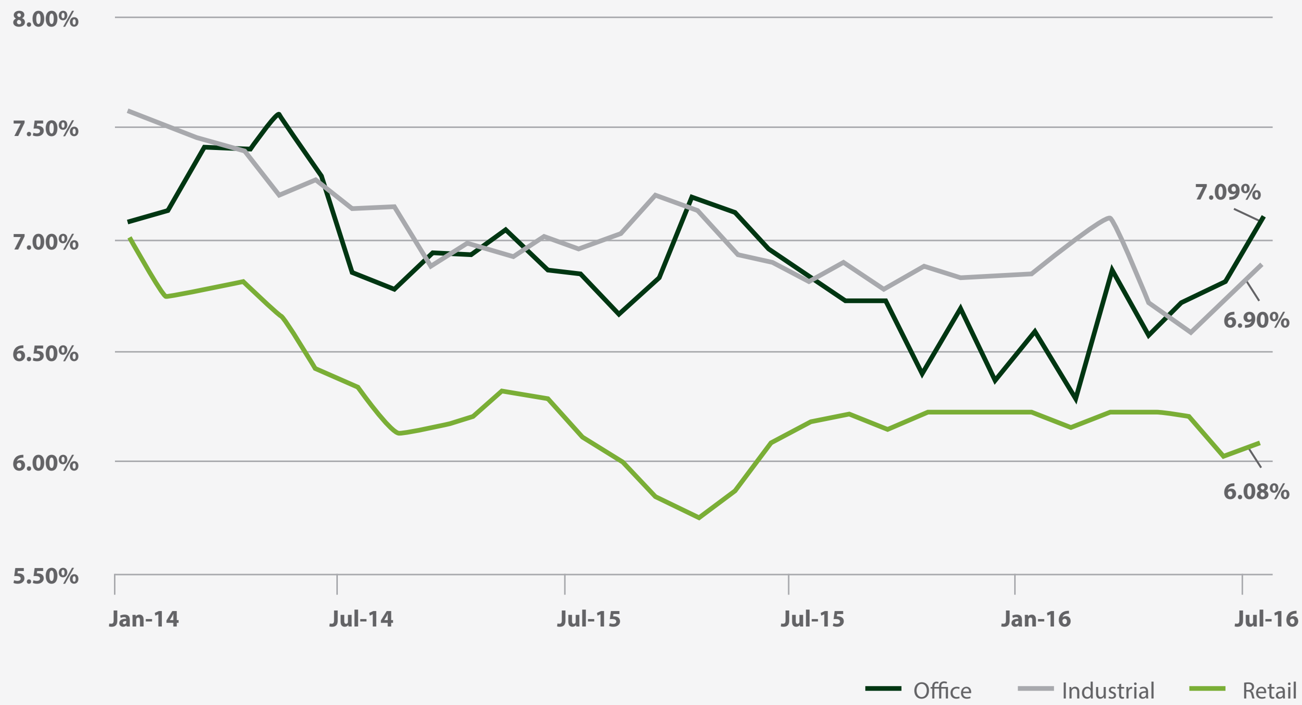
Summary

Going forward, the implementation of the new GICS real estate sector should provide increased validity and recognition to the real estate sector and drive increased capital flows into the space. Investors who were typically underinvested in real estate will likely reconsider their allocation policies, which should significantly increase the level of investment in REITs over the next several years.

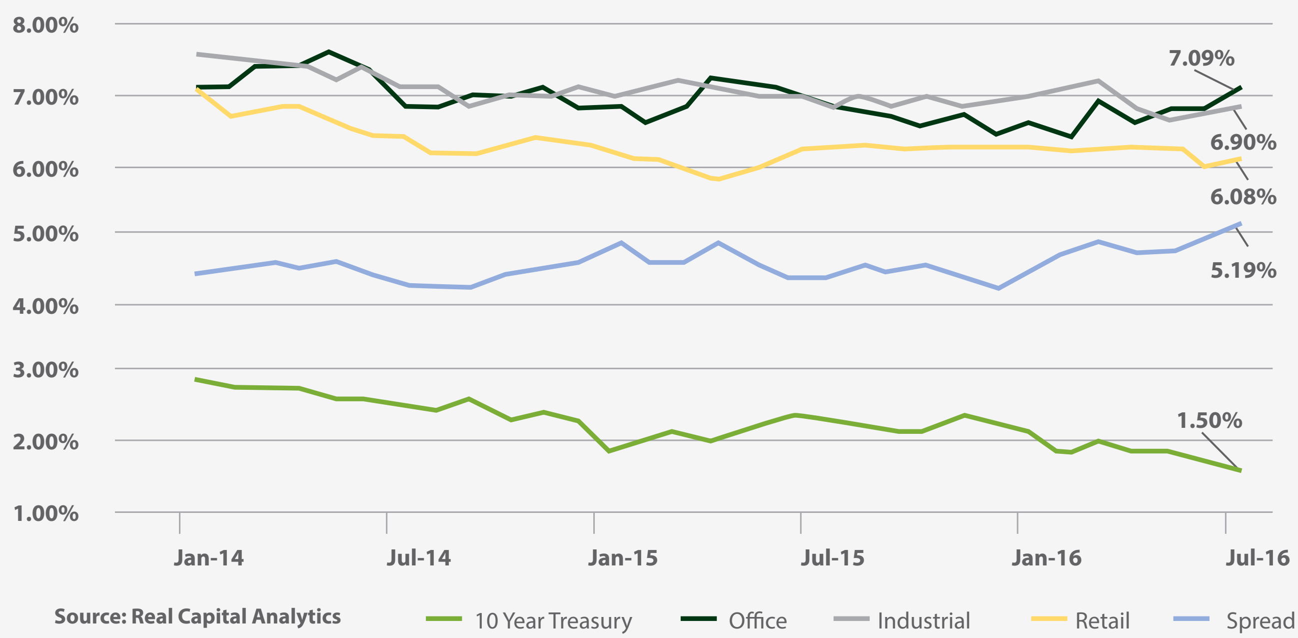
Additionally, REITs will be monitored more closely and effectively than under the previous classification system and the distinction and visibility provided by the new sector may also create new investment products, such as active and passive mutual funds and exchange-traded funds exclusively focused on real estate. In total, the changes will not all occur immediately, but the increased visibility, understanding, and coverage of REITs over time due to the new classification system will immensely benefit both the global investment community and the real estate sector as a whole.

Net Lease Market Update

Single-Tenant Sector Cap Rates



Single-Tenant Cap Rates vs. 10-Year Treasury Yield



Source: Real Capital Analytics

For more information regarding this newsletter or other related net lease matters, please contact Wes Walker or Jason Ridgway at:
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