December 21, 2018

REIT Preferred Securities Present Significant Opportunity

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Amidst one of the worst years for REIT preferred securities in more than a decade, we believe the asset class offers significant opportunity and value across the entire spectrum of the sector.

The widespread sell-off in REIT preferred securities has created what we view as a rare opportunity for investors. We see significant value in this sector due to a combination of two factors: favorable macro backdrop and attractive pricing. From a macro perspective, REIT preferred securities usually thrive when economic growth rates are positive, interest rate expectations are modest, REIT fundamentals are stable, and investors are seeking attractive income alternatives for their portfolios. It appears to us that all of the above are aligned in 2019.

From a pricing perspective, REIT preferreds now appear to present attractive value all along the spectrum. At present, we calculate that REIT preferreds yield an average 7.6%*, which is a full ~480 basis points above the prevailing 10-year US Treasury rate and approximately 100 basis points above the historical average. We also calculate that 91% of REIT preferreds now trade at or below par value with an average 11%* discount to par value—a price point that has, in recent history, presented an opportunistic entry level. Given these discounted levels, REIT preferreds price in risks beyond prevailing market conditions, in our view.

One must also not forget that market price swings are often *not* correlated with underlying collateral value. In fact, credit-worthiness across the REIT preferred industry (which has historically been quite high) remains strong given continued earnings growth and continued industry-wide balance sheet delevering. Consequently, the recent downdraft in REIT preferred securities seems to carry little relation to the stable underlying collateral values of the REIT preferreds.

Market pricing across the entire spectrum of REIT preferred securities has thus disengaged from underlying value of those securities, thereby creating significant value in the market, and in our view one of the most attractive entry points in years.

Three Reasons to Own REIT Preferreds Now

1. Macro trends for 2019 appear to set up well for REIT preferreds. *Positive GDP growth, more modest interest rate expectations and positive REIT fundamentals all combine to potentially drive strong performance from REIT preferred securities.*

2. Attractive price-value at current levels. *We believe investor redemptions and tax loss selling across the entire REIT preferred universe has caused market pricing to disengage from underlying value, thereby creating a significant opportunity and attractive entry point.*

3. High, tax-advantaged income*. With the 2018 Tax Cuts and Jobs Act now in place, REIT preferreds offer yields that compare favorably to yields offered in many other income-oriented asset classes.*

** All pricing data as of 12/21/18. Source: Bloomberg.*

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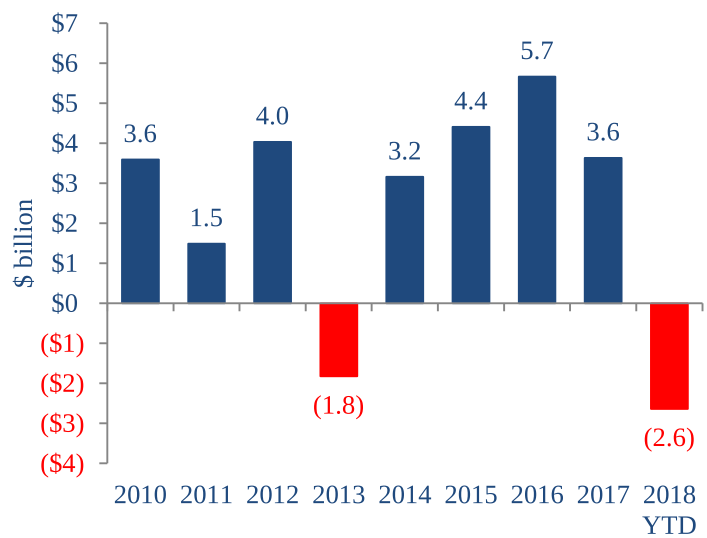
What Has Happened in 2018?

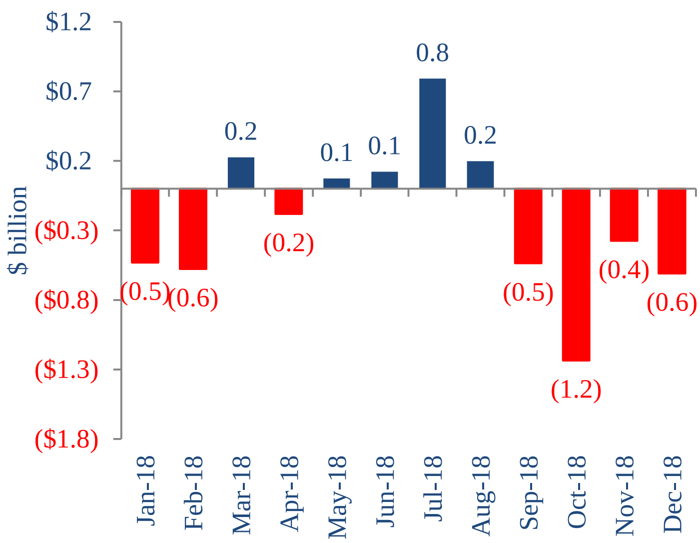
The preferred marketplace in 2018 has been buffeted by successive fears of rising interest rates, worries about a slowing global economy, concerns about excessive Fed monetary tightening, and violent year-end tax loss selling. As a consequence, preferred securities overall and more specifically REIT preferred securities have experienced one of their worst years in over a decade, with capital values down 10%-20% across the entire spectrum. Specifically, the broad $25 par-value listed preferred securities market (as defined by the ICE BofAML Fixed Rate Preferred Securities Index) is down -5.0% including dividends while the REIT preferred securities market (as defined by the ICE BofAML REIT Preferred Securities Index) is down -8.8% including dividends.

The myriad of investor concerns have, in our view, prompted significant outflows from the preferred sector, with the largest preferred ETFs experiencing substantial and sustained outflows in 2018 through December 20th. In total, we calculate the largest six preferred ETFs have experienced approximately $2.6 billion of net outflows in 2018, $2.2 billion of which has occurred in the 4th quarter to date (see charts below). In fact, preferred securities ETFs have seen the heaviest volume of outflows since the Great Financial Crisis a decade ago. Momentum-driven investors and most recently investors seeking to lock in year-end tax losses have exerted severe negative pressure on REIT preferred securities. In turn, fund managers have become forced sellers just at a time when liquidity has begun to dry up toward year end.

Preferred ETFs Have Experienced the Most Net Outflows in Recent History…



…with $2.7B of Net Outflows in the Past 4 Consecutive Months



Preferred ETFs include: iShares US Preferred Stock ETF, PowerShares Preferred Portfolio ETF, PowerShares Financial Preferred Portfolio ETF, First Trust Preferred Securities & Income ETF, SPDR Wells Fargo Preferred Stock ETF, and Market Vectors Preferred Securities ex Financials ETF. As of 12/20/18. Source: Bloomberg.

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2019 Should Offer a Favorable Market Environment for REIT Preferred Securities

Slowing US economic growth, a more dovish stance by the Federal Reserve, more modest expectations for rising interest rates, and more volatile equity markets offer what we believe to be a positive backdrop for REIT preferred securities in 2019. Generally, real estate as an asset class, and REIT preferred securities in particular, perform well in an environment where GDP growth is positive and debt service costs are reasonable. It appears we are moving into just that sort of environment, with expected GDP growth for 2019 (albeit at lower levels than in 2018) and more modest expectations for changes in interest rates.

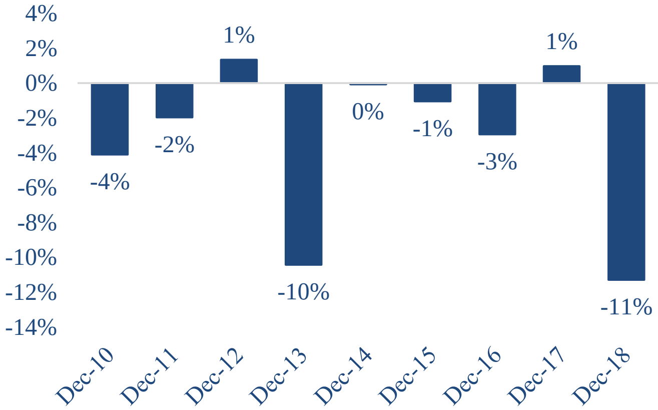
On the macro front, as of late December, the Federal Reserve and *Wall Street Journal's* poll of economists both call for GDP growth in 2019 of 2.3%. Further, *Wall Street Journal's* poll of economists calls for US 10-year Treasury yields to end 2019 at ~3.4%. In the debt markets, the US Treasury yield has flattened markedly, as long-end Treasury yields have declined from their former highs, and inflation breakeven levels have recently fallen from 2.2% to ~1.8%. Finally, the Fed's expectation for rate hikes has fallen from three hikes to two; some expectations show the Fed with no more rate hikes next year. *This creates a macro backdrop that could set up well for REIT preferred securities – especially at current pricing levels as described in the next section.*

Current Pricing of REIT Preferred Securities Offers Interesting Entry Point

We view current valuation of REIT preferreds as extremely attractive, based on the following LDR calculations:

- The REIT preferred market now trades at its lowest percentage of par value since 2009, with a price value equal to an average $22.20, or approximately 89% of par value;
- 91% of the REIT preferred universe now trades at or below par value;
- REIT preferred securities now carry an average 7.6% dividend yield, or ~480 basis points over 10-year US Treasuries, approximately 100 basis points wider than the historical average.

REIT Preferreds Trade at Biggest Discount in Recent History



91% of REIT Preferreds Now Trade At or Below Par Value

	Dec 2018	Dec 2017	Dec 2016	Dec 2015	Dec 2014	Dec 2013
Trading < par	86%	17%	56%	39%	35%	77%
Trading at par	5%	24%	17%	10%	10%	8%
Trading > par	9%	59%	27%	51%	55%	15%

Data based on proprietary database of REIT preferreds. As of 12/21/18. Source: Bloomberg.

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Clearly, the critical question is: Does an unleveraged 7.6% dividend yield and an 11% discount to par value create an attractive entry point and "price in" upcoming interest rate and economic risks?

We believe so. In our view, when the smoke clears, this entry point could prove to be one of the most attractive levels seen in years. Looking at historical performance, we examined each time period since 2010 (after recovering from the financial crisis) when 70% or more of REIT preferred securities have traded at or below par value. As the table to the right shows, the asset class has produced consistently positive returns in the subsequent six-month and 12 month periods after trading down to these levels.

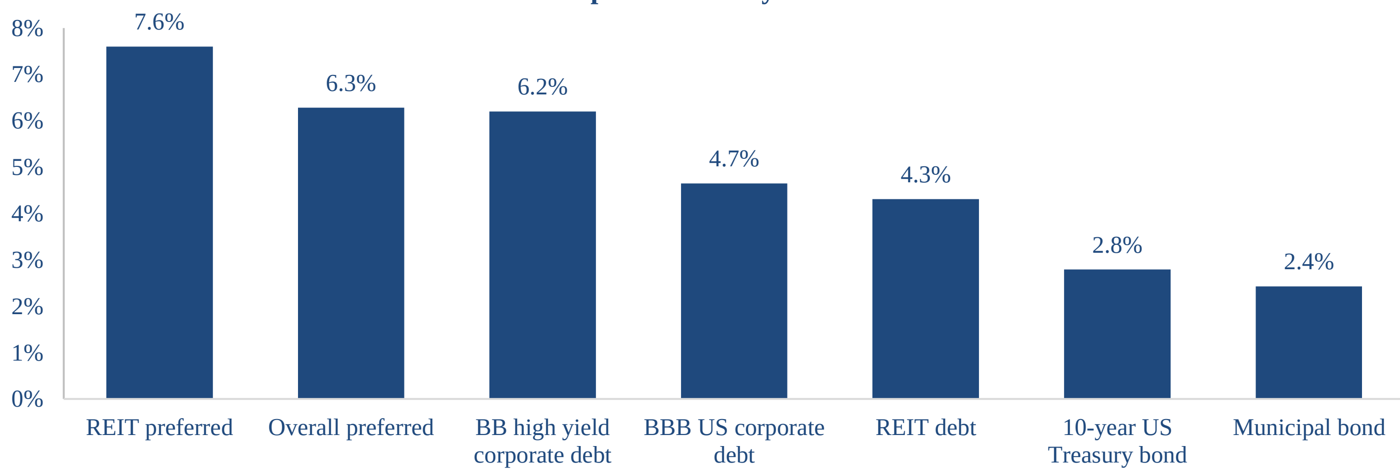
Date When 70% of REIT Preferreds Hit Par or Discount	% of Preferreds Trading At or Below Par	Next 6 Months REIT Preferred Return	Next 12 Months REIT Preferred Return
July 2011	77%	5.0%	11.9%
August 2013	84%	5.4%	15.6%
December 2016	73%	8.8%	11.5%
January 2018	78%	3.9%	NA
Average		**5.8%**	**13.0%**

Percent of preferreds trading at or below par based on proprietary database of REIT preferreds. REIT preferreds returns based on Wells Fargo Hybrid & Preferred Securities REIT Index. Source: Bloomberg, LDR Capital Management.

Furthermore, as historical context, during the 2001 recession, REIT preferred spreads, as measured by the Wells Fargo Hybrid and Preferred Securities REIT Index, averaged 400 basis points above the then-current 10-year Treasury yield. We do not include the financial crisis of 2007-2009, given the severity of that recession and the consensus that the US financial system appears much better capitalized now than in 2007. This compares to current spread of 460 basis points to this specific index. Based on historical data (albeit limited, as there has been only 2 recessions in the past 20 years), current spreads appear wide relative to a prior economic downturn.

From a relative value standpoint, the 7.6% yield that REIT preferreds now offer compares favorably to the yields offered in other income-oriented asset classes. All in all, all pricing metrics suggests to us that this level of discounted pricing presents an attractive entry point.

REIT Preferreds Yields Compare Favorably to Other Fixed Income Asset Classes



REIT preferreds based on LDR Capital Management's proprietary database of the asset class. Overall preferreds based on the ICE BAML Fixed Rate Preferred Securities Index. BB high yield corporate debt and BBB US corporate debt based on corresponding ICE BAML indices. REIT debt yield from Wells Fargo (as of 12/14/18). Municipal bond based on dividend yield of iShares National Muni Bond ETF. As of 12/20/18. Source: Bloomberg, LDR Capital Management.

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Overall REIT Fundamental Trends Remain Positive

In our view, the fundamental picture for REIT preferred securities remains positive. Looking into 2019, Wall Street analyst expectations call for same property income growth, stable to improving balance sheet leverage, smaller development pipelines, and rental supply/demand trends in decent shape across most markets (with challenges associated with the retail sector somewhat isolated).

JPMorgan research specifically forecasts positive REIT industry earnings per share growth in 2019, driven by same-property net income growth of 2.4% and enhanced by reasonable financial leverage. This growth may be partially offset by a new accounting rule requiring the expensing of internal leasing costs and the dilutive impact of ongoing asset sales and deleveraging. Combining these factors, JPMorgan forecasts REIT earnings growth to be 3.2% in 2019.

From a credit perspective, JPMorgan research notes that median interest and fixed charge coverage levels, at ~4.5x, are the highest in over a decade. At the same time, median debt/EBITDA ratios have been consistently declining since 2007 and stand at the lowest levels in over 10 years at ~5.9x. Assuming industry growth in earnings in 2019, we think REIT balance sheets could continue to improve next year, providing fundamental support for REIT preferred coverage ratios.

We also note that REIT preferred securities have exhibited a strong credit history, with minimal defaults (in either lost capital value or dividends) in the industry’s 25-year history. All in all, positive earnings growth combined with continued deleveraging of REIT balance sheet presents a potentially favorable fundamental environment for REIT preferred securities in 2019.

Improved Tax Efficiency To REIT Preferreds

As part of the 2018 Tax Cuts and Jobs Act, investors are now able to exclude 20% of REIT preferred dividends from taxation. Based on our calculations, top tax bracket citizens of the United States can benefit from 1,000 basis points reduction in taxation to REIT preferred shares (from a 39.6% top tax rate to a current 29.6% top tax rate).

As such, we believe REIT preferred securities compare well on an after-tax basis versus other fixed income alternatives.

Illustration of Dividend Income Tax Savings under TCJA

	Old Tax Rates	TCJA Tax Rate
Hypothetical Dividend Income	$100	**$100**
Less: 20% Pass-Through Income Deduction	--	**($20)**
Taxable Dividend Income	$100	**$80**
Highest Marginal Income Tax Rate	39.6%	**37.0%**
Dividend Income Tax	$39.60	**$29.60**
Dividend Income Tax Rate	39.6%	**29.6%**

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Conclusion

A confluence of several events has caused a sell-off in the entire spectrum of REIT preferred securities not seen in many years. Clearly, recent market volatility shows that investing in the area is not without risk of price swings at times. However, one should note that market price swings are often *not* correlated with underlying swings in collateral value. In fact, we feel that credit metrics across the REIT preferred industry remain stable, industry earnings are growing, and balance sheets are delevering. We therefore believe that market pricing across the entire spectrum of REIT preferred securities has disengaged from underlying value of those securities, thus creating value in the market.

Looking into 2019, we think the macro environment offers a favorable backdrop for REIT preferred securities, with GDP growth expected to be positive and an interest rate climate expected to be more dovish. Further, we calculate a full 91% of REIT preferred securities now trade at or below par value with an average discount of 11% – pricing metrics that have proven to be an attractive entry point in recent history. Finally, current dividend spreads for the asset class are now well above historical averages, and in excess of the levels seen during the 2001 recession.

Overall, we believe an opportunity exists in the REIT preferred securities asset class, priced at a significant discount to par value with potentially favorable upcoming market drivers.

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Index Definitions

ICE BAML REIT Preferred Securities Index is a market-cap weighted index that tracks the performance of investment-grade rated, fixed rate REIT preferred securities. ICE BAML Fixed-Rate Preferred Securities Index is a market-cap weighted index that tracks the performance of investment-grade rated, fixed rate preferred securities from all sectors. The Wells Fargo Hybrid and Preferred Securities REIT Index is an index composed primarily of U.S. REIT preferreds designed to track the performance of preferred securities issued in the U.S. market by REITs; it is not limited to only investment-grade rated securities. ICE BAML BB US High Yield Index is a market-cap weighted index that tracks the performance of USD-denominated BB-rated corporate debt publicly issued in the U.S. domestic market with at least 1-year remaining term. ICE BAML BBB U.S. Corporate Index is a market-cap weighted index that tracks the performance of USD-denominated investment grade corporate debt publicly issued in the U.S. domestic market with at least 1-year remaining term to maturity. The S&P 500 Total Return Index tracks the performance, including dividends, of 500 large U.S. publicly traded equities. It is generally considered to be representative of U.S. stock market activity. The FTSE NAREIT All Equity REITs Total Return Index is a free float adjusted market-cap weighted index that includes all tax qualified REITs listed in the U.S. All pricing and returns data for indices (including the 10-year U.S. Treasury yield) are based on Bloomberg.

LDR Calculations

LDR's calculations regarding REIT preferreds described herein are derived from its proprietary database of REIT preferreds. LDR seeks to track performance and various valuation metrics for all REIT publicly-traded preferreds issued in the U.S. that are currently outstanding. This database does not include $1000-par preferreds, as they are not exchange listed. Otherwise, LDR believes that its database captures the universe of publicly-traded REIT preferreds in the U.S. that are currently outstanding. However, the LDR proprietary database does not include historical data, so references to historical yields and returns are based on relevant indices as noted. Overall issuance data, where noted, includes U.S. and Canada-issued fixed-rate and convertible REIT preferreds. Yield data includes only U.S.-issued fixed-rate preferreds. All pricing and trading data for the database are derived from Bloomberg.