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REITs and Rising Rates | July 2013

"Sell in May and Go Away" seems to be working for the REIT market, especially when compared against the S&P 500 since Bernanke's speech on May 21. Since that day, REITs, as measured by the MSCI US REIT Index (RMS), are down 11.2%, while the S&P 500 is down 3.6%. Because REITs are also looked at as a yield vehicle, it is useful to note that the Barclays Aggregate Bond Index is down 2.5%, and the Alerian MLP Index is down 2.1% over the same period. For the month of June, REITs were down 2.0% and the S&P 500 was down 1.3%. Year to date, the RMS is up 6.4% versus S&P 500 at +13.8%.

The annual REIT Week conference in early June came at an appropriate time, as we were able to hear responses from 25 REIT CEOs and CFOs on the recent decline in share prices. Overall, the sentiment was very positive, as fundamentals had not changed since the positive earnings reports in April. Though these management teams have a significant portion of their wealth invested in their individual REITs and many have compensation plans tied to share performance, they don't have the ability to pick and choose which REITs will outperform. Therefore, we have a greater responsibility to constantly question our macroeconomic theses and portfolio positioning on a broader basis.

Review: REIT Correlation with Rising Interest Rates

In several past REIT Outlooks (May 2011 and June 2012), we have examined REIT performance in periods of rising rates and found the results to be inconclusive. As shown in Figure 1, REITs sometimes are the best performers relative to equities, bonds, and MLPs, and sometimes are not. In the three most recent periods excluding our current unfinished period, REITs have had excellent performance, posting positive double digit returns. Because REITs are viewed as hybrids between equity and debt securities, they are often one of the first sectors to be hit when interest rate fears present themselves. However, history has shown that REIT prices recover after the shock in the first month and, on average, have outperformed the S&P 500 over the following 12 months.

Dividend Yield

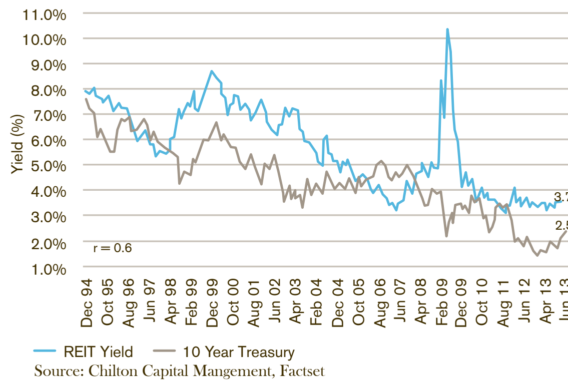
For those that view REITs as a yield investment and use the dividend yield spread over a particular interest rate (the 10 year US Treasury yield is popular) as their primary valuation tool, a rising interest rate would result in either a constant price and a compression in the spread, or a constant spread and a decline in price. We would argue that this is shortsighted research, and that there is a need to look at the effects of interest rates, if any, on fundamentals, and the potential for increases in the dividend.

FIGURE 1: ASSET CLASSES RANKED BY ANNUALIZED* TOTAL RETURNS IN PERIODS OF RISING RATES

Dec. 76 to Feb. 80	Jun 80 to Sep 81	Feb 83 to Jun 84	Aug 86 to Sep 87	Jul 89 to Apr 90	Sep 93 to Nov 94	Jan 96 to Mar 97	Sep 98 to Jan 00	May 03 to June 06	Dec 08 to Mar 10	Aug 10 to Mar 11	Jul 12 to Jun 13*
REITs 15.3%	REITs 2.2%	REITs 21.1%	Equities 28.7%	Bonds 1.3%	Equities 1.8%	REITs 26.4%	Equities 28.2%	REITs 25.5%	MLPs 67.4%	Equities 52.5%	MLPs 61.7%
Equities 1.8%	Equities 1.4%	Equities 7.3%	REITs 4.9%	Equities -2.7%	Bonds -3.0%	Equities 18.7%	Bonds -0.6%	MLPs 16.6%	REITs 29.3%	MLPs 42.6%	Equities 18.9%
Bonds -0.9%	Bonds -7.3%	Bonds 2.5%	Bonds -0.7%	REITs -10.1%	REITs -8.9%	MLPs 12.9%	MLPs -1.5%	Equities 11.3%	Equities 25.9%	REITs 32.5%	REITs 7.0%
						Bonds 2.0%	REITs -5.1%	Bonds 1.9%	Bonds 6.2%	Bonds -1.3%	Bonds -2.0%

SOURCE: BLOOMBERG. USES END OF MONTH DATA ONLY. REITS REPRESENTED BY NAREIT ALL EQUITY REITS INDEX; MLPS REPRESENTED BY ALERIAN MLP INDEX; EQUITIES REPRESENTED BY S&P 500 INDEX; BONDS REPRESENTED BY BARCLAYS US AGGREGATE BOND INDEX
*PERIOD OF JULY 2012 – JUNE 2013 NOT ANNUALIZED

FIGURE 2: REIT DIVIDEND YIELD AND US 10 YEAR TREASURY YIELD



Source: Chilton Capital Mangement, Factset

Historically, the spread between the REIT dividend yield and the 10 year Treasury yield has been about 100 basis points (bps). Figure 2 demonstrates the relationship between the two, which has been pretty loose. A correlation of 0.6 is not insignificant, but it is certainly not enough to stand alone in a valuation analysis. The most important difference between a public REIT and a bond is the ability for the REIT to increase the dividend. At some points in history, REITs were paying out more than their cash flow in dividends, which made dividend growth unpredictable, at best. At other points, cash flows were growing and payout ratios were low, indicating dividend increases were on the horizon. Analysis of the fundamentals can give analysts and investors higher predictability in the dividend, which may explain why the spread between the dividend yield and the 10 year Treasury yield has not been consistent.

Cap Rates

As NAV-focused investors, we strive to determine the proper cap rate to apply to net operating income (NOI). Though REITs have low leverage today, a 25 basis point swing in the cap rate can mean a change of 5% to 10% in NAV. The cap rate is determined by the price that buyers are willing to pay for an income-producing property. For example, a building with $6 million in annual NOI that trades for $100 million is valued at a 6% cap rate. The $100 million price may be based on several factors unique to that property resulting in an IRR that incorporates total NOI over a holding period and an exit cap rate. Rising interest rates have an immediate effect on the project decision-making, as the cost of debt drives up cost of capital. A prevailing theory is that higher cost of capital necessitates higher cap rates. However, the capital allocation decision is based on IRR, which also incorporates changes in rental income over the holding period and the residual cap rate used in a hypothetical sale.

What may help explain the varying results is that interest rates and cap rates cannot be observed in a vacuum. Recall the cap rates are calculated on year 1 NOI. If interest rates are rising due to a stronger economy and capital is widely available, NOI is likely increasing from higher rents and therefore projected IRRs are likely able to keep pace with higher cost of capital and cap rates may remain stagnant. Conversely, rising rates in an environment of poor economic growth with little demand for US equities or bonds would likely imply lower rents on properties and therefore necessitate higher initial cap rates to justify acceptable IRRs.

Fortunately, in today's market, we believe the former scenario is the most likely outcome due to strong fundamentals, namely very little new supply. Assuming no change in prices from today, organic REIT NOI growth over the next 3 years increases the implied cap rate from 5.9% on June 14 to 6.6% in 2016, according to Citi Research & Analysis. Similar to the investor that should be looking at what future dividends will be before selling a REIT because of a tighter yield spread, a REIT investor should also look at future NOI.

Interest Expense

An increase in interest rates usually implies higher borrowing costs, which would be a negative for earnings growth. Commercial real estate is a capital intensive business, and REITs are paying out over 70% of cash flow as dividends, so debt is an important part of the cost of capital equation. However, as it relates to earnings, the important number to observe is the difference between the coupon on maturing debt and the coupon at which the REIT could issue today to replace that debt. The weighted average interest rate

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FIGURE 3: 2013 – 2016 ANNUALIZED REIT TOTAL RETURN SENSITIVITY

		10 Year Treasury Yield					
		2.0%	**2.5%**	**3.0%**	**3.5%**	**4.0%**	**4.5%**
Dividend Growth	**9%**	15.1%	11.2%	7.9%	5.1%	2.8%	0.7%
	7%	13.1%	9.2%	6.1%	3.4%	1.0%	-1.0%
	5%	11.1%	7.3%	4.2%	1.6%	-0.7%	-2.7%

SOURCE: CHILTON CAPITAL. ESTIMATES BASED ON BEGINNING DIVIDEND YIELD OF 3.4% AND 100 BPS SPREAD BETWEEN 10 YEAR TREASURY YIELD AND DIVIDEND YIELD

of maturing debt in 2013, 2014, and 2015 is 4.9%, 5.3%, and 4.9%, respectively. Year to date, REITs have been major beneficiaries of declining interest rates. There have been 37 REIT senior debt offerings issued with an average coupon of 3.9% and an average maturity of 10.4 years. During this period, the spread on these debt issues over 10 year US Treasury yield averaged 207 bps. As a result, REIT refinancing has been and will continue to be accretive to 2014 earnings until the 10 year US Treasury yield rises to 3.1%, assuming no change in spread.

Cost of Capital

Every company should know its cost of capital before deciding to pursue a project. Currently, REIT balance sheets are made up of 61% equity, 3% preferred equity, and 36% debt. However, REIT private counterparts often use 60% debt and 40% equity (likely a conservative projection). Therefore, the private competitors would experience a disproportionate increase to their cost of capital if the cost of debt increases, all else being equal (we would argue that the cost of equity capital is much higher for private investors). On paper, public REITs would have an advantage in starting development projects or bidding on acquisitions in a rising interest rate environment.

Preparing for Rising Interest Rates

REITs have been beneficiaries of a 30 year bull market in interest rates that could be coming to an end in the not too distant future as the Federal Reserve begins to taper its stimulus program. Our job as investment manager is to be mindful of risks to the future outlook and prepare our REIT portfolios to be best positioned to outperform in a variety of conditions including an environment of rising interest rates. Many attributes can be identified that will help REITs outperform but we believe the most important of all is growth in FFO/AFFO and dividends. We have updated our proprietary models to 2016 to estimate dividend growth for each of the 30 REITs in our Chilton REIT composite. In this analysis, we maintained payout ratios at the current low levels of about 75% of AFFO. The end result is a weighted average dividend growth over the next 4 years of 6.9% per year. Assuming no changes in the portfolio by 2016, the blended yield on our REIT composite would increase from the current level of 3.4% to 4.2%.

In Figure 3, we have illustrated the sensitivity of the REIT Composite estimated annualized total return for a four year holding period would under various levels of interest rates on the 10 year Treasury bond, now at 2.5%. We assumed the spread between the REIT yield and the 10 year Treasury yield would remain at 100 basis points, in line with the average for the modern REIT era. The best case scenario is for estimated annualized returns of 15.1% for the next four years if dividend growth averages 9% per year and the 10 year Treasury yield is at 2%. Conversely, if the 10

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year Treasury yield rises to 4.5% and dividend growth languishes (relatively) at 5%, the annualized total return for our composite drops to -2.7%. In a recent report by Citi, they illustrated that the average forecast of 76 economists have the 10 year Treasury yield increasing to 2.5% by the end of 2013 and only 2.8% by the end of 2014. We believe investors deserve a total return in the 6-8% range using a long term holding period and, at a 10 year Treasury yield of 2.8%, this should occur. Given low historic payout ratios, REITs can also prudently increase dividends above our projections to help cushion a rise in rates.

However, investors need to be aware that the magnitude and pace of interest rate moves is very difficult to project with any certainty.

Property Type Preferences

We have positioned our portfolios away from REITs in the long lease sectors such as Office, Net Lease, and Health Care in favor of short lease sectors, namely Apartments, Storage, and Lodging. We are overweight all three relative to the benchmark. Pricing power is evident across all of these property types due to high occupancy rates, and we see fundamentals remaining strong for the foreseeable future. To the extent our estimates of dividend growth prove conservative, total return targets would improve. REITs can also continue to lower debt leverage ratios to lessen refinancing risk. The blended leverage ratio for our composite is 34%, which compares to 37% for all equity REITs. We wish more REITs would follow the example set by Public Storage that has both a low leverage ratio at 15%, and virtually all amounts outstanding consisting of fixed rate preferred stock with no maturity.

Measured Optimism

Stock prices do not always correlate with fundamentals; if they did, there would be no technical analysis, and active management via fundamental analysis would be the one and only option for investors. We acknowledge our optimism on the fundamentals of commercial real estate may not result in superior total returns relative to other asset classes. Ideally, interest rates will rise gradually as a result of better than expected job growth, thereby providing demand to drive up rental rates and occupancy. In this case, the rise in nominal rates would be due to higher inflation expectations and real interest rates would remain low. However, we cannot plan for the ideal scenario. Our estimated returns in Figure 3 may prove to be rosy if rates are rising without job growth, and the 100 basis point spread expands. Despite the risks inherent with investing in a yield-sensitive asset class at close to historic low interest rates, we believe the fundamentals are too good to ignore, which should provide some cushion as rates rise.

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RMS: 1361(6.30.2013) vs. 1280(12.31.2012) vs. 1087 (12.31.2011) vs. 1000 (12.31.2010) vs. 792 (12.29.2009) vs. 933 (9.30.2008) and 1330 (2.7.2007)

Please feel free to forward this publication to interested parties and make introductions where appropriate.

Previous editions of the Chilton REIT Outlook are available at www.chiltoncapital.com/publications.html

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