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"To Be, or Not to Be..." an Apartment Renter? | September 2012

In August, as measured by the MSCI US REIT Index (RMS), REITs delivered a total return of -0.1%, bringing the year-to-date total return to +17.0%. This compares to the S&P 500 at +2.3% for the month, and +13.5% for the year-to-date period. Perhaps Shakespeare wasn't exactly referring to the apartment market when he penned (or shall we say quilled) the words, "to be, or not to be," as Hamlet's most famous soliloquy. But, as the rest of Shakespeare's line follows, "…that is the question," does truly fit the latter part of our title for the September REIT Outlook. Are consumers considering home purchases instead of renting apartment units more than they have historically? The apartment segment of the REIT industry has lagged all other REIT sectors year-to-date. This month we investigate the apartment sector fundamentals to decide if Mr. Market has left room in these stocks for investors to make money.

Are Apartment REITs Overvalued?

Apartment REIT valuations have been in question as of late. They have consistently traded at a premium to other REIT sectors on an implied cap rate basis. As of August 31, 2012, apartment REITs traded at an average implied cap rate of 5.3%, which makes them appear overvalued when compared to the REIT sector average of 5.7%. Tenants across all geographic markets have experienced rent bumps in the past few years, and construction has started to creep up as risk capital is chasing returns.

While net operating income (NOI) and adjusted funds from operations (AFFO) growth may decelerate due to slowing rent increases, higher expenses, a modest increase in supply, and unimpressive job growth prospects, we anticipate fundamentals will allow continued above average growth for this sector. AFFO is a REIT industry term used to measure cash flow adjusted for capitalized expenditures and straight-lined rents. As shown in Figure 1, apartment REITs are trading near the REIT average AFFO multiple for 2013 and below the REIT average for 2014. However, AFFO growth per share for apartments is estimated at 11.0% in 2013 and 9.6% in 2014. This compares to all REITs (excluding the lodging sector) of 8.2% and 7.7%, respectively, for the same two years. Lower interest expense due to refinancing positively affects AFFO growth and should help mute the effects from any deceleration in rent growth.

Historically, apartment REITs have traded at a higher premium to NAV than the REIT average. As of August 31, 2012, apartment REITs traded at an estimated average 0.9% premium to their net asset value (NAV), compared to all other REIT sectors at an estimated 19.2% premium, according to Green Street Advisors. Therefore, at current prices, apartment REITs appear to actually be undervalued compared to NAV premiums in other sectors.

FIGURE 1: REIT SECTOR MARKET CAP WEIGHTED PRICE/AFFO MULTIPLES

	2013 PRICE/AFFO	2014 PRICE/AFFO
Apartment	21.0	19.1
Health Care	17.7	16.6
Industrial	19.5	18.2
Mall	20.9	19.1
Office	20.3	19.5
Self Storage	19.2	18.1
Shopping Center	23.0	21.3
Student Housing	20.9	19.1
Data Center	23.0	20.0
Average	**21.3**	**19.7**

Source: Green Street Advisors as of August 24, 2012

Supply

The National Association of Real Estate Investment Trusts (NAREIT) published a report on March 1st, 2012 that determined there is a 2.5 million unit supply-demand shortfall in the apartment market in the U.S. This statistic is great for landlords and it is one of the reasons why apartment starts and permits are increasing. After new apartment supply dropped down to about 75,000 units/year during the crisis (not even enough to offset the 125,000 units becoming obsolete per year), new construction has been steadily increasing to capitalize on the supply shortfall, as shown in Figure 2. Green Street Advisors suggests apartment development will "return to levels consistent with the last two decades by 2013/2014." The latest housing report published in July revealed starts were up 10% month-over-month (MoM) to an annualized rate of 229,000 units and permits increased 10% MoM to an annualized rate of 274,000 units. On a year-over-year basis, multifamily starts have increased 30% and permits have increased a staggering 47%. However, apartment research firm Axiometrics states that new apartment construction will only add 0.7% to overall inventory in 2012 and 0.9% in 2013. Those numbers are still below the longterm historical average, according to Axiometrics' Director of Research Jay Denton. He notes that, from 1997 to 2009, new apartment construction grew by an average of 1.5% per year. During 2010 and 2011 the inventory growth average was 0.5%. Upcoming supply brought to market could be thought of as filling the gap that was created during the financial crisis.

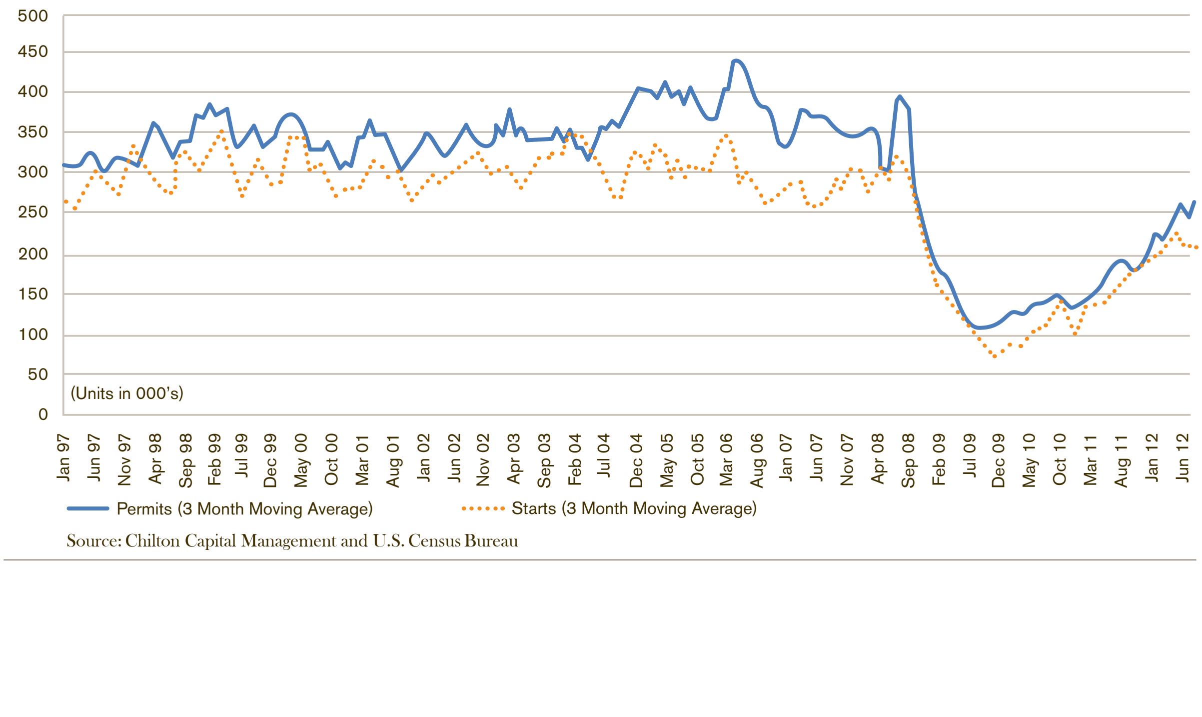
Additionally, the nature of the construction cycle gives us clarity as to when the new supply coming online will be a threat. While the starts and permits percentages have increased, it is important to note that not all permits will actually result in starts. The average length of time it takes to complete an apartment building is 18 to 24 months, so it will be awhile before new units actually impact occupancy levels. The apartment market goes through cycles just like any other business, but we expect a fair amount of runway is left before oncoming supply begins to threaten the return potential of the sector.

Demand

Low supply, single-family home foreclosures, and stringent mortgage requirements have driven high occupancy which has given landlords pricing power. The occupancy rate, which has averaged right above 95% over the past 4 years, has aided landlords in pushing rents. Though it has been to varying degrees depending on geographic region and asset quality, the nationwide averages for apartment rent have been increasing. The average apartment REIT increased same store revenue by 4.3% in 2011, which resulted in NOI growth of 6.5%. The trend has continued in 2012 with average revenue growth of 5.7% in the second quarter, resulting in NOI growth of 7.4%. Though some renters may push back at such rent increases, there has been more than adequate demand from new renters to step in and pay the higher rents.

Going forward, Green Street Advisors forecasts 3.8 million new rental households will be created over the next five years, and 1.1 million of the new rental households are predicted to seek professionally managed apartments. The target age demographic for apartment landlords is the 20-34 age group and, currently, 60% of new jobs are going

FIGURE 2: MULTIFAMILY PERMITS AND STARTS FOR BUILDINGS WITH 5+ UNITS (FOR RENT AND FOR SALE)



Source: Chilton Capital Management and U.S. Census Bureau to people 34 years of age or younger. The growing trend for young people to delay marriage is leading people to stay in urban areas instead of moving to suburban locations in favor of family life. In many cases, the single-family rental product does not compete with multifamily units because more affordable single-family homes tend to be in suburban areas, which are located away from the urban core where the target demographic wants to be.

Often times, it is challenging for debt-burdened recent college graduates to find money for a down payment on a single-family home. The Federal Reserve Bank of New York reported total student loan debt of $904 billion for the first quarter of 2012, representing a $30 billion increase over the prior quarter. Since total household debt peaked in 2008, student loan debt has tacked on $293 billion while all other forms of debt have declined by a total of $1.5 trillion. We believe higher student debt is, and will continue to be, a reason people stay in apartments longer. We have seen on our property tours nationwide that more suburbanites of all ages are interested in moving closer to the city. While hard to quantify, it could be the economic benefits of downsizing or the social premium of urbanization.

Still a Long Runway?
Jeffrey Friedman, CEO of Associated Estates (NYSE: AEC), noted, "We believe the down cycle ended in 2010, and 2011 was the first year of the up cycle. We think this time the cycle will be longer…. We do expect the strong fundamentals to continue beyond 2014." Camden CEO Rick Campo echoed this on the second quarter earnings call by saying, "I don't think we're in the late stages of the game. I think we're in the sort of middle part of the game ...." We agree with these CEOs and also think there is still room left on the runway.

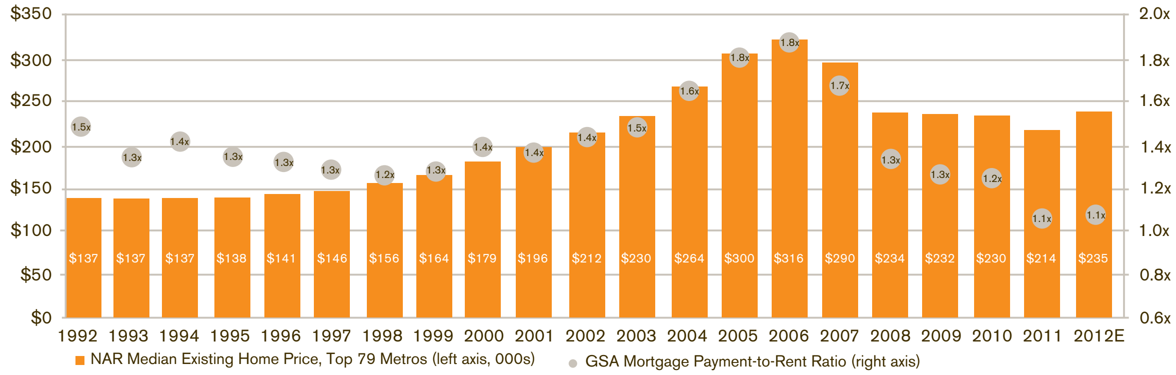
According to the U.S. Census Bureau, the 65.4% home ownership rate recorded in the first quarter of 2012 is the lowest level the US has seen since 1997. The rate modestly rebounded by 10 basis points to 65.5% in the second quarter of this year and compares to the historical average of 65%. The data from apartment CEOs indicates that people are increasingly leaving to buy a home, but it doesn't necessarily mean that the homeownership rate will stop decreasing. CPT stated on their most recent earnings call that the move-outs to purchase a home increased slightly to 12.6% during the quarter, up from 11.5% in the second quarter of 2011. CPT's current rates may sound like they are elevated, but they are actually low compared to their historical average of 18-19% and a peak of 24%.

Apartment rental rates and tenant household incomes are highly correlated over time. Over the past two years, rents have increased faster than real wages on a national level. This is not sustainable over the long run. Eventually, renters will leave in search of cheaper housing to avoid the increasing burden on their disposable income. However, Camden's residents reported average income for the most recent quarter of $71,000 vs. $63,000 for the same period last year. The increase in income lowered the rent/income ratio to 17.7% from 18.4% for the same period in 2011, and compares to CPT's historical average of 22%. The unemployment rate of college-educated people older than 25 is 4.1%, as of July 2012, down from 4.7% in July 2011. On a related note, the percentage of Camden's residents who moved out for financial reasons or job loss declined to 4.8% during the quarter, which compares to the 9.3% residents reported a year ago. Despite lack of growth in national wages, the profile of the average renter in high quality apartments has changed as a result of the structural shift towards renting longer.

The mortgage payment to rent ratio has historically been a useful tool for predicting the behavior of households in the decision to rent or to buy. After peaking at 1.8x in 2006, the ratio has decreased back down to the level where an observer would think that more and more people would choose to buy. Figure 3 points out the multiple for 2011 was 1.1x and the same is expected for 2012, representing the lowest reading on the graph which dates back to 1992. A multiple of 1 indicates the amount paid for rent and the amount paid for a mortgage is equal at the same property. Though the multiple is at a 20 year low, it was at the same level in 2011, during which time landlords experienced high demand and were able to increase rents. We believe the structural issues in the rent versus buy decision will continue to favor apartments for the near term.

Upon Closer Review…
Apartment REIT stock price performance in

FIGURE 3: MORTGAGE PAYMENT-TO-RENT RATIO



Source: Green Street Advisors

2010 (SNL Residential REIT Index +46.9% vs RMS +28.5%) and 2011 (SNL Residential REIT Index +14.6% vs. RMS +8.7%) provide a clear positive answer to the question, "to be, or not to be…an apartment renter?". However, the 2012 sector performance (SNL Residential REIT Index +9.0% vs. RMS +17.0%) reflects concerns that fundamentals will not support higher valuations. Some take issue with the level of new supply, but it is important to note supply is coming off of a low base and, due to the planning and building process, it will take several years for deliveries to get back to historical averages. Same store NOI growth may slow due to increased expenses, but we anticipate the growth rates should remain positive. Additionally, due to the length of the construction cycle, we have a clear outlook on below average supply and high demand stemming from the structural shift of people renting longer. Last, with above average AFFO growth rates, at a minimum, the apartment sector should support NAV premiums in-line with the REIT average. Apartment REITs are trading at a discount to other REIT sectors on an NAV basis at a time of very robust fundamentals. We will watch closely for the point at which the fundamentals shift back in favor of the single-family housing product, but we feel confident the multifamily growth story isn't over. Accordingly, we remain overweight the sector in our REIT composite.

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RMS: 1272 (8.31.2012) 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