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The REIT Elite: Comfort Food for Investors | August 2012

In July, REITs were a safe haven for investors looking to flee volatility and uncertainty in broader markets, causing the performance gap to widen between REITs and the S&P 500. As measured by the MSCI US REIT Index (RMS), REITs delivered a total return of +2.0% for the month, bringing the year to date total return to +17.1%. This compares favorably to the S&P 500 at +1.4% for the month, and +11.0% for the year to date period. REITs are in a unique position as the US markets have experienced high inflows from investors exiting the tumultuous European and Asian markets.

Given the flight to safety that we have seen, this month we are going to discuss a group of REITs that we have deemed the 'REIT Elite'. These are the blue chip, core quality holdings that an investor should buy for his or her grandparents, parents, and children. They are the 'sleep at night', confidence-inspiring companies with management teams and operational expertise that REIT investors can rely on for above average earnings growth over long time periods, despite changing economic conditions. Due to fluctuations in valuation metrics, we may not hold them in our composite at all times, but they certainly would be in the portfolio if we had to pick 11 stocks to hold for the next decade.

Qualifications of REIT Elite
Readers of this publication likely know that we classify each REIT into three different categories: Core, Value-Add, and Opportunistic. REITs in the 'Core' risk category have the highest quality portfolios, superior balance sheets, and established track records. 'Opportunistic' REITs typically have more leverage, but the potential for higher growth. 'Value-Add' fits somewhere in between the two. Of the 123 equity REITs as of June 30, 2012, we have classified 28 as Core. However, there are several Core REITs that are in a category of their own.

Using several metrics surrounding the capital structure, predictability of the dividend, management team, and operational excellence, we have deemed 11 of the Core REITs to be in a sub-category called the 'REIT Elite'. In no particular order, they are: AvalonBay Communities (NYSE: AVB), Federal Realty Trust (NYSE: FRT), Simon Property Group (NYSE: SPG), Ventas (NYSE: VTR), Eastgroup Properties (NYSE: EGP), Essex Realty Trust (NYSE: ESS), HCP (NYSE: HCP), Public Storage (NYSE: PSA), Boston Properties (NYSE: BXP), Taubman Centers (NYSE: TCO), and REIT newcomer American Tower Corp (NYSE: AMT). Each one of these companies consistently trades at above average multiples of Funds from Operations (FFO) and Adjusted Funds from Operations (AFFO), and commands a premium to NAV under most market conditions.

"Over the 10 year period ending July 19, 2012, the average REIT Elite produced a total return of +725% compared to the MSCI REIT Index total return of +214%."

Earning Their Stripes
As a group, these 11 REITs trade at a Price/2013 FFO multiple of 20.0x and a Price/2013 AFFO multiple of 23.1x as of July 19, 2012, which are well above the REIT averages of 16.1x and 20.1x, respectively. Additionally, they trade at an average of 21% above their consensus Net Asset Values (NAV). The market has ascribed a premium valuation to them due to confidence that the management teams will continue to make value-enhancing decisions on multiple fronts.

A skeptic may want to know why he or she would invest in the group versus less expensive peers. Five years ago, that skeptic would have been asking the same thing. Over the trailing 5 years ending July 19, 2012, the average total return of the REIT Elite was +87%, while the MSCI REIT Index produced a total return of

+15%. Over the 10 year period ending July 19, 2012, the average REIT Elite produced a total return of +725% compared to the MSCI REIT Index total return of +214%. Year to date as of July 19, the REIT Elite group has a total return of +16.8% versus the MSCI REIT Index at +16.4%.

To measure balance sheet flexibility, we look at a several metrics, which include the Debt/Total Market Capitalization, Debt/Gross Asset Value (GAV), and Net Debt/EBITDA ratios. As of March 31, 2012, the REIT Elite average debt/total market capitalization ratio was 28% with PSA leading the way with a 2% ratio. The average REIT has a debt/total market capitalization ratio of 38%. We should note that PSA funds itself with mostly preferred equity; however, the company had a debt plus preferred equity/total market capitalization ratio of 15% as of the same date, still well below the REIT average. The debt/GAV ratio average for the REIT Elite stood at 31%, which again is much more conservative than the average REIT at 40%. Lastly, the average net debt/EBITDA ratio for all of the REIT Elite members was 5.5x, versus a REIT average of 7.0x as of March 31, 2012. In summary, the REIT Elite maintain the most flexible balance sheets, which have enabled them to have access to capital on levels never seen in our 40 years covering the industry.

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Dividend Predictability

With an average dividend yield of 2.9% as of July 19, well below the REIT average of 3.4%, a skeptic may rather invest in a REIT with a higher dividend yield. However, the dividend yield has two components: security of the current dividend and expected dividend growth.

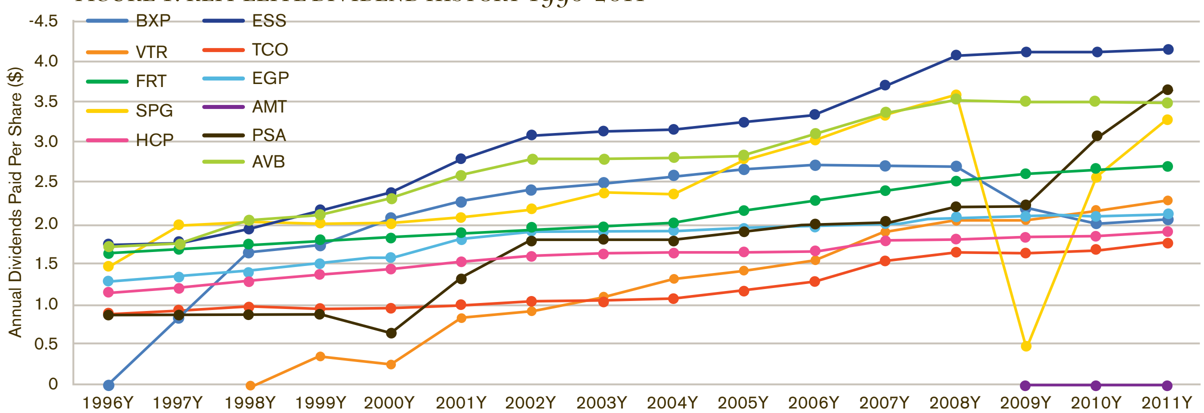
Figure 1 shows an overall consistent increase in cash dividends for each REIT, minus a few exceptions which can be explained. During the credit crisis of 2008-2009, the capital markets closed to most US companies, including REITs. Without the ability to access capital amidst declining rents, many REITs had to cut their dividends to enhance financial flexibility. Remarkably, 8 of the 11 REIT Elite members did not cut their dividends (AMT did not pay a dividend and was not classified as a REIT until January 1, 2012). In 2009, SPG cut its cash dividend, but more than made up for it by paying the balance of it in stock. By the end of the year, the total value of the stock and cash distributed to shareholders was $4.23, which is still the highest dividend distribution on an annual basis since the company's IPO. On July 24th, 2012, SPG announced the new annualized cash dividend rate of $4.20, which is considerably higher than the cash dividend in 2008. BXP had to cut the dividend by $0.18 per quarter in mid 2009 for financial flexibility. However, BXP has increased the dividend by $0.05 since then, and maintains an AFFO payout ratio of 56%, which gives investors security and confidence in dividend growth.

Despite the frequent dividend raises and lack of dividend cuts, the average payout ratio for the REIT Elite is 65% of AFFO today, far below the average for the REIT sector of 74%. This gives investors confidence that the dividends will be increasing over the near and long term. Analogous to a bond that increases in price and decreases in yield after a credit upgrade from a ratings agency, the REIT Elite have experienced price appreciation resulting in a lower dividend yield.

Management Team

In addition to the above concrete reasons

FIGURE 1: REIT ELITE DIVIDEND HISTORY 1996-2011



for the REIT Elite to trade at lofty valuations, there are several qualitative factors that should be considered. The REIT Elite possess the best management teams in the country and therefore warrant a premium. Experience, service with other management team members, and razor sharp focus on being the best at a particular niche characterize the CEO, CFO, and COO of each member of the REIT Elite. CEOs Ron Havner (PSA), David Simon (SPG), Mort Zuckerman (BXP), Bobby Taubman (TCO), Debbie Cafaro (VTR), Tim Naughton (AVB), Jay Flaherty (HCP), Don Wood (FRT), David Hoster (EGP), Michael Schall (ESS), and James Taiclet (AMT) have been intimately involved with each of their companies for a significant amount of time. They have developed a positive relationship externally with major tenants in order to best execute their business plans. In addition, they maintain a favorable rapport and transparency with the board of directors, fellow employees, sell-side analysts, and investors.

An outsider looking into the REIT landscape could easily make the assumption of thinking a REIT is merely a collection of buildings, instead of a company with employees and future value creation potential. We argue that a strong leadership team is as, if not more, important in the real estate business than in other sectors for several reasons. First, there is constant cash flow coming into the business, which requires prudent capital allocation decisions. Second, real estate is characterized by high leverage so a CFO must be disciplined to maintain relatively conservative targets. Third, the risk and return associated with development is alluring and should only be attempted if there is a favorable track record to assure shareholders there will be value added.

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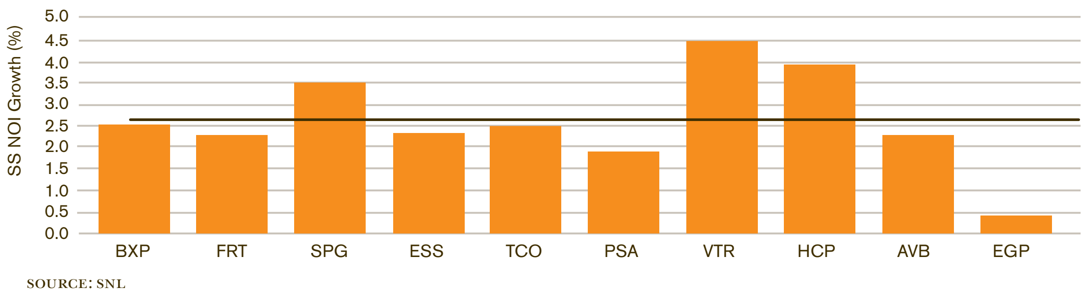
Operational Excellence

In addition to the superior capital allocation skills possessed by the best management teams, the most successful REITs are the best in their business at growing cash flow at the property level. This process begins with selecting the best cities and submarkets to own commercial real estate. Experience has positioned the REIT Elite members to have 'local sharpshooters' who are able to drive higher rents and occupancy at their properties relative to the submarket averages. We have found that the REITs that focus on having 'boots on the ground' are better able to anticipate move outs, backfill empty space, and maintain the right 'tenant mix' to drive higher rents and occupancy. As shown in Figure 2, each one of the REIT Elite has been able to produce positive same store net operating income (NOI) growth over the past 5 years. The period of 2007-2011 serves as an appropriate stress test for operations due to the depth of the cycle trough in 2008-2009. Note that AMT is not on the chart because it does not disclose same store statistics.

Flight to Quality

'Flight to Quality' is a term used to describe the movement of money from higher risk assets to lower risk assets. For example, the flight to quality helps to explain why the 10 year US Treasury yields hit new all time lows in July at rates below 1.4% on July 24-25. It's the reason that the German 10 year Bund yield traded at 1.3% the same day. For the same reason, the dividend-paying stocks with predictable earnings streams are receiving a disproportionate amount of investor flows. The US-centric, contractual rent revenue streams of REITs have become an attractive investment for those interested in income *and* growth. Figure 3 shows the flow of capital into REIT mutual funds and ETFs since the start of the Modern REIT Era in 1992. As of July 19, 2012, we have already

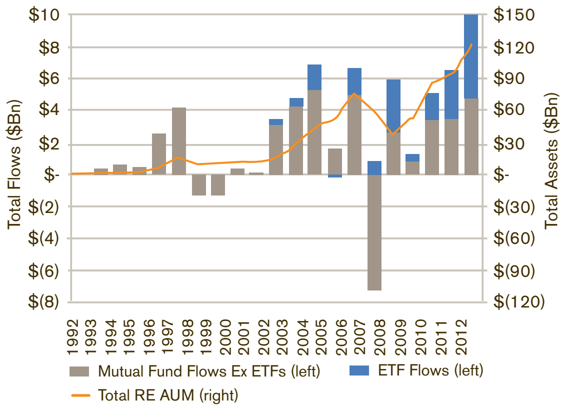
FIGURE 2: 2007 Q1 - 2012 Q2 AVERAGE YEAR OVER YEAR SAME STORE NOI CHANGE (%)



SOURCE: SNL

added $10 billion in REIT AUM from new flows into mutual funds and ETFs, plus another $20 billion through capital appreciation, bringing the total assets under management (AUM) of REITs in ETFs and mutual funds to a new record of $120 billion. Similarly, the REIT Elite have experienced a flight to quality as investors have sought the safety of the class A buildings in class A locations. The above average returns this year coupled with the expensive valuations indicate the perceived premium for the REIT Elite characteristics has increased. Though it has manifested differently in each stock, the A quality properties are experiencing higher

FIGURE 3: US REGISTERED ANNUAL REIT MUTUAL FUND, ETF FLOWS, & TOTAL AUM



SOURCE: CITI RESEARCH, AS OF 7/19/12

growth than the lower quality buildings. For example, the luxury consumer has been buying above 2007 levels, bringing more sales to luxury mall REITs Simon Property Group and Taubman Centers. High quality office buildings owned by Boston Properties are attracting tenants due to relatively affordable rents and its position with more capital to invest in tenant improvements and building maintenance. The 'renter nation' has been moving into apartments closer to urban core areas, filling up multifamily complexes owned by apartment REIT AvalonBay Communities.

Preferred REIT Update

On that note, investors have also been flying up the capital structure to buy REIT preferred equity. In 2012, REITs have issued almost $6.3 billion in preferred stock through July 19. To put that in perspective, REITs raised a total of $7.6 billion in the previous 4 years combined (2008-2011). Another reflection of the demand can be seen in the rates that are being achieved in these offerings. Readers of our previous outlooks may think we are being repetitive, but there was another record in REIT-land this month. Kimco (KIM) raised $225 million in perpetual preferred stock at a 5.5% coupon, an all-time record for REITs.

In our October 2011 REIT Outlook titled "New York, New York", we indicated that the average yield spread of preferred REITs over the 10 year treasury rate has been 480 basis points. As of July 26th, the average yield of preferred REITs according to the Wells Fargo Hybrid and Preferred Securities REIT Index (Bloomberg: WHSPR) stood at 7.0%. With the US Treasury note yielding 1.4% as of the same day, the spread stands at 560 basis points. So, despite the strong performance of preferred REITs year to date (WHSPR is up 8.4% through July 26) and their vulnerability to a rise in interest rates, we still believe the 80 basis point cushion above the historical average makes REIT preferred equity attractive today, albeit at lower yields than six months ago.

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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RMS: 1273 (7.31.2012) 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)