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REIT Elite and Preferred Equity Repeat | August 2013

After a rocky 30 days from mid-May to mid-June, REITs are still 10.5% from the high for the year. In July, the MSCI US REIT Index (RMS) was up 0.8%, which compares unfavorably with 5.1% for the S&P 500. Year to date, REITs are up 7.2%, while the S&P 500 has produced performance of +19.6%.

After focusing on REIT performance in times of rising interest rates, we decided to shift to two topics that have been the focus of previous publications: the REIT Elite and REIT Preferred Equity. From May 21 to July 31, the REIT Elite basket is down 10.7%, which compares to 10.5% for the RMS. REIT preferred equity, as measured by the Wells Fargo Hybrid and Preferred REIT Securities Index (Bloomberg: WHPSR), is down 5.4% over the same period, while the Barclays Aggregate Bond Index (Bloomberg: LBUSTRUU) is down 2.4%. Year to date, the REIT Elite has lagged the RMS with performance of +5.0%, while the WHPSR is down 0.2%, a favorable comparison to the -2.3% total return for LBUSTRUU.

FIGURE 1: PERFORMANCE OF REIT ELITE AND PREFERRED REITS

COMPANY	TICKER	5/21–7/31	2013 YTD	1 YR
American Tower Corporation	AMT	-16.1%	-5.3%	2.1%
AvalonBay Communities	AVB	-3.6%	2.9%	-3.2%
Boston Properties	BXP	-6.1%	4.1%	0.8%
Camden Property Trust	CPT	-5.7%	6.9%	4.5%
EastGroup Properties	EGP	-5.9%	19.6%	23.7%
Essex Property Trust	ESS	-4.7%	13.6%	7.3%
Federal Realty Trust	FRT	-9.6%	3.5%	0.7%
HCP, Inc.	HCP	-20.6%	1.0%	-1.0%
Public Storage	PSA	-4.3%	11.9%	9.9%
Simon Property Group	SPG	-11.2%	3.7%	3.2%
Tanger Factory Outlet Centers	SKT	-14.9%	0.8%	7.6%
Taubman Centers, Inc.	TCO	-17.2%	-4.4%	-1.7%
Ventas, Inc.	VTR	-20.0	6.8%	4.6%
MSCI US REIT Index	RMS	-10.5%	7.2%	7.8%
WF Hybrid & Pfd REIT Index	WHPSR	-5.4%	-0.2%	2.4%
Barclays Agg Bnd Index	LBUSTRUU	-2.4%	-2.3%	-1.9%
S&P 500 Index	SPX	1.4%	19.6%	25.0%

SOURCE: BLOOMBERG

REIT Elite, Revisited
Exactly one year ago, we released a list of high quality companies deemed the 'REIT Elite'. The purpose of establishing a list was twofold: first, to glorify companies that have set the standard for portfolio quality, balance sheet flexibility, dividend consistency, operational excellence, and management track records for capital allocation; second, to give investors investment ideas for which they can expect the least downside risk, reasonable upside participation, and a safe, growing dividend. Ideally, the investor who may be underweight to REITs in his or her portfolio due to a lack of knowledge or a negative prior experience would feel comfortable adding a REIT Elite member as a small step towards the 10-20% allocation to REITs that we recommend.

Grading the REIT Elite
Though each of the 13 members (including the two new additions) of the REIT Elite are meant for long term buy and hold strategies (>10 years), we thought the one year anniversary would be a good point to review performance and criteria. Figure 1 shows the performance of each member of the REIT Elite, plus two new candidates for inclusion. Compared to the RMS performance of +7.8% over the past year, only two members outperformed. Though the one year performance is disappointing, we would argue that stock performance over the past year has had an unwarranted focus on yield, and a lack of focus on fundamentals. Each member of the REIT Elite only strengthened its position versus competitors operationally and financially, but the market (almost) blindly rewarded companies with high dividend yields. As such, the health care and triple net sectors were both the highest yielding and best performing sectors over the past year. We believe that the market rewards quality and prudent balance sheets over the long term, and the REIT Elite will prove to be the least volatile way to maximize total returns on REITs for the risk-averse REIT investor.

Armor for Rising Rates
In the June 2013 Outlook, we focused on REITs and rising interest rates. We detailed attributes of stocks we believe will outperform in such a period, emphasizing dividend growth as a key defense against the typical generalization of REITs as a yield instrument. Given that the REIT Elite has a stellar track record of dividend growth, we would reiterate our long term positive outlook for these blue chip stocks. With a 65% average dividend/ AFFO payout ratio, the REIT Elite have ample room to increase their dividends over the next 4 years. According to the BAML base case scenario keeping the same AFFO payout ratios we have today, the Chilton REIT Elite should average annual dividend growth of 7.2% versus the index average of 7.0%.

New REIT Elite Members
Since our initial list, several REITs have made a strong case for inclusion into the REIT Elite. Namely, Tanger Outlets (NYSE: SKT) and Camden Property Trust (NYSE: CPT). Specifically, CPT decreased its average borrowing cost from 4.8% to 4.5% while increasing its weighted average maturity from 6.4 years to 6.8 years. CPT has posted sector-leading same store NOI growth while improving portfolio quality by using funds from dispositions to finance development. CEO Ric Campo founded the predecessor company with long time colleague Keith Oden in 1982, and the company has been featured annually as a 'Best 100 Companies to Work For' by Fortune Magazine since 2008, most recently ranked #10 in 2013. CPT attributes a large part of their 13% annualized total return since the IPO to the corporate culture that drives employees to believing that working for Camden is "more than just a job".

"The market will eventually recognize the intrinsic value of superior assets, management, and balance sheet over the long term, whereas earnings misses, sector rotations, and analyst downgrades will be diluted into obscurity."

Tanger has been the only pure play outlet center REIT since its IPO in 1993. CEO Steve Tanger has guided the company to 34 consecutive quarters of same store NOI growth and maintained steady growth in the portfolio of 1-2 outlet centers annually. SKT's adherence to a conservative balance sheet at close to a 25% net debt / total enterprise value and a flawless dividend track record are both qualities that are deserving of REIT Elite status. Now that almost every mall REIT owns or wants to own outlet centers in the portfolio, it seems that the sector is here to stay as a full cycle investment.

REITerating a BUY on the REIT Elite
Underperformance in quality stocks begets opportunity. In the May 2013 REIT Outlook, we stated:

> "When we wrote about the Chilton REIT Elite in August 2012, we owned six of the eleven members with a total allocation of 23.5%. In the first quarter, the valuation metrics relative to their lower quality peers narrowed to levels that made the REIT Elite extremely attractive from a total return perspective. By the end of the first quarter, we owned eight members with a total allocation of 26.7%."

In the four months since then, six of the REIT Elite outperformed the RMS. As a portfolio manager, we believe we can outperform the index through careful attention to any mispricing that occurs on a daily basis, and the REIT Elite can similarly be overpriced or underpriced. As a group, they appear to be underpriced relative to the index. There may be a valid reason that they are undervalued and they may continue to be priced that way for the short term. However, as stated before, the market will eventually recognize the intrinsic value of superior assets, management, and balance sheet over the long term, whereas earnings misses, sector rotations, and analyst downgrades will be diluted into obscurity.

How Does Preferred Equity Work?
Preferred equity is a valuable way for companies to access permanent financing without diluting shareholders. Similar to debt, companies have to make coupon payments on preferred equity; however, unlike debt, the principal amount never has to be repaid. Additionally, preferred equity holders have no claim on assets and therefore the company cannot default due to missed payments.

FIGURE 2: PERFORMANCE BY ASSET CLASS IN PERIODS OF RISING RATES

May 03 to Jun 06	Dec 08 to Mar 10	Aug 10 to Mar 11	Jul 12 to Jul 13
REITs 25.5%	MLPs 67.4%	Equities 52.5%	Equities 25.0%
MLPs 16.6%	Pref REITs 59.2%	MLPs 42.6%	MLPs 21.1%
Equities 11.3%	REITs 29.3%	REITs 32.5%	REITs 7.8%
Pref REITs 6.8%	Equities 25.9%	Pref REITs 15.7%	Pref REITs 2.4%
Bonds 1.9%	Bonds 6.2%	Bonds -1.3%	Bonds -1.9%

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, REIT PREFERRED EQUITY REPRESENTED BY WELLS FARGO HYBRID & PREFERRED REIT INDEX

The pricing of preferred equity is similar to bonds. They are issued at par (usually $25), and the price (theoretically) moves inversely to interest rates. Preferred equity is often issued with a five year call provision, which means the company has the right, but not the obligation, to buy back the stock at par at any time after five years. The call provision limits the upside potential of the security. When interest rates drop, companies can exercise the call provision in order to take advantage of lower rates. Calling the stock at par erases any price increase the investor could have recognized as a result of interest rate movements, which restricts how far above par a security may trade. During times of rising interest rates, companies may elect not to call the security at par as it may be trading below the par value and cheaper alternatives presumably would not exist for permanent capital.

The REIT Preferred Equity Index That We Prefer

The Wells Fargo Hybrid & Preferred Securities REIT Index, or WHPSR, is designed to track the performance of preferred securities issued in the US market by REITs. The index best represents Chilton's REIT preferred equity holdings due to its wide variety of index members including investment and non-investment graded securities. As of July 31, 2013, the Chilton portfolio currently yields 7.3% as compared to 7.1% for the WHPSR. The difference in yield can be explained by Chilton's 11% allocation to investment grade companies, while the WHPSR contains 45% investment grade companies.

REIT Preferred Equity

Since the WHPSR came into existence on December 31, 1999, we have identified four periods of rising interest rates, including the period we are currently experiencing (as illustrated in Figure 2). The data set shows preferred equity has performed better than bonds but worse than equity during times of rising interest rates. However, during the 2008-2010 time period, preferred equity was among the top performers due to the unusual conditions that prevailed during that time period. Presently, returns are positive for the current period of rising interest rates. However, from 5/21/2013 to 7/31/2013, the WHPSR is down 5.4%.

Is the 10 Year Treasury Yield the Best Measure for REIT Spreads?

Traditionally, the base rate or yield when measuring a spread has been the yield on the 10 year US Treasury Note because it represented the yield and/or return of a "risk-free" investment over a typical horizon for holding real estate (10 years). However, US Treasury Notes are susceptible to pricing anomalies caused by Fed purchases, which have recently accounted for over 75% of Treasury Notes sold at auction. Therefore, measuring risk using an artificial base rate would fall apart, as evidenced by the relatively low 0.50 correlation between the NAREIT Equity REIT Index yield and the 10 year US Treasury yield. In times like these, looking at the rates at which banks are actually lending to companies and how the bond market is pricing risk may be a better measure of risk.

When comparing the spreads between the yields on the BAML BBB (Investment Grade) Corporate Bond Index (Bloomberg: C0A4), the Wells Fargo Hybrid & Preferred Securities REIT Index(Bloomberg: WHPSR), and NAREIT Equity REIT Index (Bloomberg: FNER), stronger correlations are found for the period between January 2000 and May 2013: 0.86 for the WHPSR yield and 0.80 for the NAREIT Equity yield. Comparatively, the 10 Year Treasury yield correlations are 0.25 and 0.50, respectively. The analysis makes a strong argument for the BBB yield index as a better valuation tool for preferred and equity REIT yields than the 10 Year Treasury yield.

WHPSR Valuation Analysis

The WHPSR is yielding 7.1% as of July 30, 2013, with a spread of 320 bps over BAML's BBB Corporate Bond Yield index. Since

FIGURE 3: 2 YEAR ANNUALIZED REIT PREFERRED TOTAL RETURN SENSITIVITY

WHPSR vs. BBB Spread	Corporate Investment Grade Yield				
	3.0%	3.5%	4.0%	4.5%	5.0%
1.8%	27.2%	21.6%	16.8%	12.6%	8.8%
2.3%	21.6%	16.8%	12.6%	8.8%	5.5%
2.8%	16.8%	12.6%	8.8%	5.5%	2.5%
3.3%	12.6%	8.8%	5.5%	2.5%	-0.2%
3.8%	8.8%	5.5%	2.5%	-0.2%	-2.7%

SOURCE: CHILTON CAPITAL. ESTIMATES BASED ON CURRENT YIELD OF 7.1%

October 31, 2002, when daily yields began to be tracked for the WHPSR, the average spread above the BBB index has been 280 bps.

Using internal calculations based on BBB yields and WHPSR spreads, we were able to create a two-year annualized return sensitivity chart. Holding the spread between the BBB and WHPSR constant at 320 bps, the BBB yield could increase 120 bps to 5.1% before investors would begin to see negative returns. In Figure 3, note that a scenario consisting of the BBB yield rising to 4.0% and the spread between the BBB and WHPSR condensing to the historical norm of 280 bps generates a two year annualized return of approximately 8.8%. A situation in which BBB yields increase 110 bps while the spread increases 60 bps realizes a two year annualized return of -2.7%. In a more positive scenario, spreads could decrease as a result of higher credit ratings and lower risk profiles. Streamlining operations, delivering developments, lowering leverage ratios, and lowering the average coupon rate on debt which increases fixed coverage charge ratios are all examples of actions companies can take to achieve a higher rating. With a tightening of the spread 90 bps to 230 bps and a BBB yield of 4.0%, the two year annualized return would be 12.6%.

Historical Perspective

The last time BBB yields were near the 4% yield of today was from March 2012 to August 2012. The financial stress indicator from the St. Louis Fed was similar to that of today as well. The spread averaged 310 bps, as compared to the 320 bps spread today, suggesting that the sell-off could be overdone. However, there are other factors that could be causing the difference between today's spreads and the historical average, such as portfolio composition. Since 2002, the WHPSR has, on average, been comprised of 57% investment grade securities. At the end of 2012, the portfolio stood at 45% investment grade and is trending downward, signaling that the historical average would have been higher given today's composition.

The Common vs Preferred Decision

Since the WHPSR has been in existence, REIT preferred stocks have not produced negative returns during periods of rising interest rates. They have proven themselves as an excellent high yield investment, but the recent pullback does highlight the duration risk inherent with a perpetual maturity. Preferred equity issuers are getting stronger balance sheets and the dividends are in no danger of being cut. However, historical analysis and the current state of the economy lead us to believe that REIT common stock will outperform preferred stock in the foreseeable future.

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RMS: 1373 (7.31.2013) 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