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Bending the San Diegan Time Space Continuum | December 2012

In a month with the 'most important election of our lifetime' and a 'one in a hundred years superstorm', REITs trailed the broader markets slightly. As measured by the MSCI US REIT Index (RMS), REITs had a total return of -0.4% for November, versus +0.6% for the S&P 500. Year to date (YTD), the RMS is up 13.5% while the S&P 500 is up 15.0%.

Archstone Saga Coming to an End
Before time-traveling back to the San Diego REITWorlds, it behooves us to mention the purchase of Archstone by AvalonBay Communities (NYSE: AVB) and Equity Residential (NYSE: EQR). In the biggest REIT news of the year, AVB and EQR combined to purchase Archstone Residential from Lehman Brothers Holdings Estate for $6.5 billion, valuing the assets at $16.0 billion.

The saga of Archstone goes back to the peak of the market in 2007 when Lehman Brothers took it private in a joint venture with Bank of America and Barclays for $22 billion. The downturn in commercial real estate following the purchase of Archstone was one of the reasons Lehman was forced to declare bankruptcy on September 8, 2008. Last year, EQR attempted to purchase a 26.5% stake in Archstone from the joint venture, which ultimately forced Lehman to buy out Bank of America and Barclays to block the sale, citing that the best way to unlock value would be to go public again. On November 19th, Archstone filed for a $3.5 billion IPO with the intention of going public by the end of the year.

On November 26th, EQR and AVB announced the complex acquisition in which AVB gets 40% of Archstone's assets and EQR gets 60%. The deal will be short term dilutive for both but should be long term accretive to earnings and Net Asset Value (NAV) due to higher asset quality and synergies in G&A costs. Additionally, apartment REIT investors can breathe a sigh of relief from avoiding having another public attractor of capital in the apartment space; Archstone's planned IPO has been a contributor to the apartment sector's YTD underperformance relative to other property types.

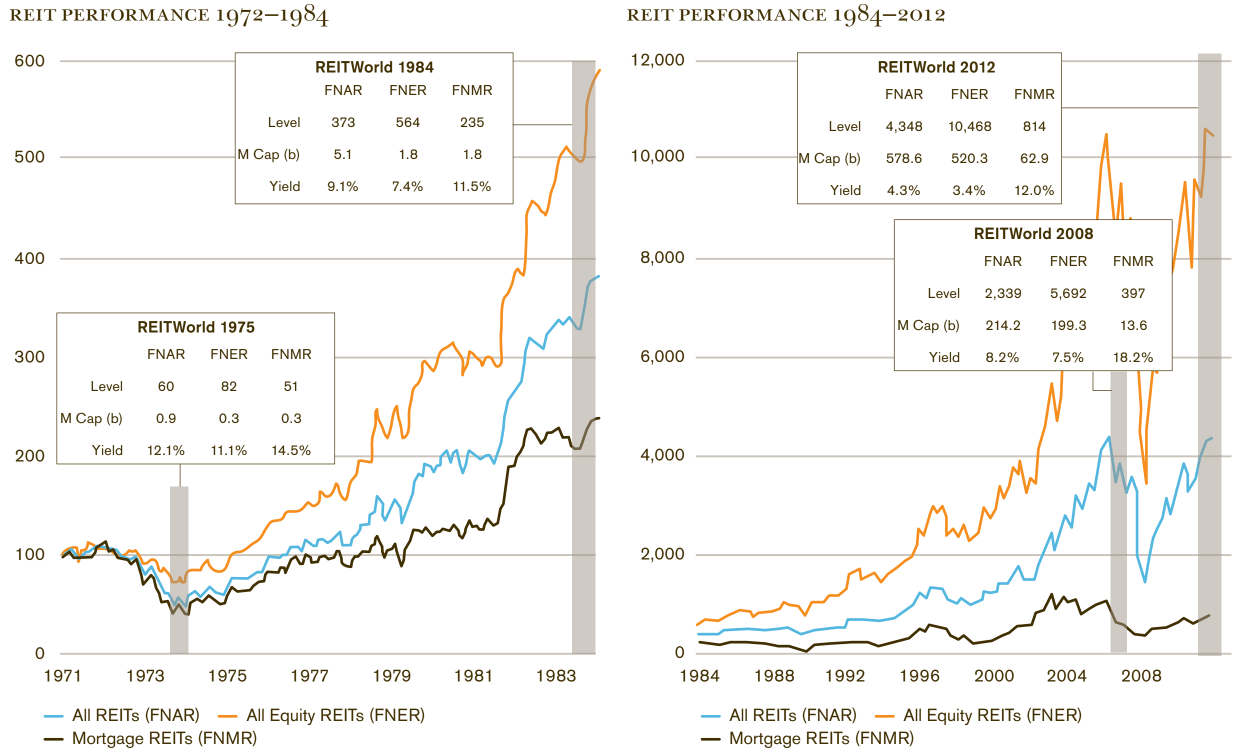
San Diego REITWorld through the Years
While Hurricane Sandy was flooding Manhattan and the surrounding areas, REIT management teams reported another strong quarter of earnings. However, expectations were running high and investors showed disappointment by bringing the RMS down 9.1% as of November 14 from the 2012 peak on September 14.

Subsequently, the Chilton REIT Team made a trip to San Diego, CA for the annual REITWorld conference where we had 19 one on one visits with management teams. San Diego also served as the host of REITWorld in 1975, 1984, and 2008. The annual conference serves as a perfect (read: grueling) forum to learn the long term strategic directions and macroeconomic views of a large number of REITs, which can later be incorporated into our analysis to see if they fit our long term theses. REITWorld 2012 was especially poignant given the history of the conference in San Diego and the timing soon after earnings. At time when investors are increasingly focused on whether or not a REIT is going to beat a quarterly earnings projection by a penny or two, it helps to take a step back to put where we are today into perspective.

San Diego Naval Base: REITs under Fire Early (1975)
NAREIT All Equity REITs Index (Bloomberg: FNER) Total Return 12/31/1971 – 10/31/1975: -15.7% (-4.5% annualized)

The real estate industry suffered a massive shakeout during 1974-1976, a period when most REITs were involved in lending (construction and development loans) instead of the ownership of income producing real estate. Back then, the common complaints by naïve investors were that equity REITs were too "boring" and did not exhibit the same growth characteristics as the mortgage REITs. According to the 'REIT

FIGURE 1: SAN DIEGO REITWORLD THROUGH THE YEARS



SOURCE: BLOOMBERG, NAREIT. NOTE: ALL DATA IS AS OF 10/31 FOR THE CORRESPONDING YEAR, EXCEPT MARKET CAP FOR 1975 AND 1984, WHICH ARE AS OF 12/31

Statistics' Publication by NAREIT, by Q3 1975, dividend-payers had shrunk to 48 out of 215 REITs and non-earning assets equated to almost 50% of industry assets that totaled $19.8 billion.

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What happened? Too many REITs came public during the halcyon days of the early 1970's. Few possessed the necessary management skills, and most were chasing a limited number of sound investments. The inevitable result was over-commitment to speculative projects. Since capital was widely available, leverage became excessive ($3.50 dollars of debt per $1.00 dollar of equity). Interest rates rose sharply and loans quickly went into non-earning status as a result of overbuilding, a sluggish economy, and lower availability of capital. The results were disastrous for the REIT industry, and made "REIT" a four-letter word. The NAREIT Stock Price Index, which encompassed all REITs traded on the NYSE, AMEX, and OTC markets, that started at 100 in January 1972 had fallen to 17 by December of 1974.

Coronado Island: REIT Proving Grounds (1975 – 1984)
Total Return 10/31/1975 – 10/31/1984: +585.9% (+23.8% Annualized)

As REITs went out of favor with institutions in part due to the poor performance from mortgage REITs, the supply of capital dried up. By December 1979, the market capitalization of REITs had dropped to $1.8 billion, which was lower than the $1.9 billion value of REIT equity in December 1972. However, high inflation at the end of the decade set the stage for several years of impressive returns for REITs, as rising construction costs prevented the threat of new supply. By the time Congress passed the Economic Recovery Act of 1981 giving tax shelter to real estate investors, the real estate bubble was already beginning to inflate. Though REITs did not offer the same tax write-offs enjoyed by private partnerships, they benefitted significantly from rising real estate values.

Sea World: A Whale of a Time for the Equity REIT Model (1984 – 2008)
FNER Total Return 10/31/1984 – 10/31/2008: +909.2% (+10.1% annualized)

The Tax Reform Act of 1986 changed everything by taking away the tax benefits bestowed on real estate investors through the Economic Recovery Act of 1981. Securitization of commercial real estate began in earnest in 1991 with the IPO of Kimco Realty (NYSE: KIM), which also signaled the beginning of the Modern REIT Era. What occurred after Kimco's IPO is nothing short of spectacular. The total market capitalization of the REITs increased from $8.8 billion in 1991 to $450 billion in February 2007, producing a +15.9% annualized return according to the FNER. By the peak of the REIT market in February 2007, enthusiasm for this liquid, dividend-paying vehicle to access commercial real estate was through the roof, and valuations reflected as much.

San Diego Zoo: Roaring Back to Life after Near Extinction (2008 – 2012)
FNER Total Return 10/31/2008 – 10/31/2012: +83.9% (+16.4% annualized)

In the two short months following Lehman Brothers' bankruptcy filing on September 15, 2008, REIT experienced losses to the tune of -49.7% as measured by the RMS (9/15/2008-11/14/2008), bringing the equity market capitalization of REITs down to $114 billion. To clarify, the decline in market capitalization was also a function of many REITs going private or being sold at peak valuations before the crash. With the capital markets closed for both debt and equity, REITs with maturing debt began to fight for their lives in refinancing negotiations. Milton Cooper of Kimco was telling all investors that REITs needed to "survive to thrive". With their equity trading close to a 40% discount to their Net Asset Values (NAV), an equity offering would be extremely dilutive to current shareholders, but REITs had no choice. The stage was being set for one of the most defining moments in REIT history which began a few months later in 2009 when an equity offering by Simon Property Group (NYSE: SPG) "broke the ice" and billions more to be raised by a number of REITs that continues to this day.

December 2008 had a nice rally of +17.6%, leading investors to be even more disappointed when January and February of 2009 had losses of -17.8% and -21.1%, respectively. By March 6, 2009, the RMS was down to 344 and the credit markets had been closed for 6 months. Coincidentally, the Citi REIT CEO Conference in West Palm Beach, FL was in session at the bottom of the market. General Growth Properties (NYSE: GGP), the second largest mall owner in the country, was the most notable victim of the credit crisis: GGP's stock price closed at $0.33 that day, down from $27.55 on September 12, 2008, the Friday before Lehman's filing. SPG was the largest REIT and used its clout to tap the capital markets first. On March 13, 2009, they elected to pay 90% of the dividend in stock to enhance financial flexibility. On March 20, SPG did a concurrent bond and equity offering, raising 17.25 million shares of equity at $31.50 and $500 million in 10 year unsecured notes at 10.75%. Despite selling equity at a huge discount to NAV and debt at a rate almost double that of their previous unsecured offering in May 2008 at 6.125%, the stock rose on the news. This signaled to other REITs that there was an appetite for REITs, but management would have to swallow a painful pill; though the capital was expensive, it was either dilute and survive, or potentially lose the company. It is doubtful that anyone could have predicted the extent to which the REITs would thrive in the ensuing period.

Four years after the 2008 REITWorld in San Diego, no REITs have gone out of business. As of November 19, 2012, GGP and SPG are trading at $18.95 and $150.00, respectively. The RMS stood at 1216 with a market capitalization of $456 billion, and an investor who bought the index on March 6, 2009 has received a total return of +249.5%. An investor who bought at the top of the market on February 7, 2007 is only 9.1% away from getting back to even as of November 19, 2012. REITs have been welcomed with open arms by the capital markets since the SPG offering, and have sold over $90 billion in equity to enable many balance sheets to attain fortress-like strength. When looking back four years, it's almost more appropriate to ask what *hasn't* changed, instead of what *has* changed.

"…an investor who bought the index on March 6, 2009 has received a total return of +249.5%"

Today, the US economy, albeit demonstrating modest growth, has been sufficient to produce enough demand to improve absorption rates in virtually all property types. The lack of new supply of commercial real estate is demonstrating that landlords should be enjoying slow but positive fundamentals for many years to come. Rent levels are too low in many property types to trigger a significant wave of new construction and, quite frankly, the transparency provided by equity REITs is making all real estate investors smarter and underwriting standards more sound, as well. REIT management teams are more disciplined, have upgraded the quality of assets owned, have reduced leverage, and have business models well suited for the times. But, despite how good things are today, it could be better if the US fiscal situation had a resolution and the economy were to achieve stronger growth rates.

Port of San Diego: All Aboard! (2012 – 2016)
FNER Total Return 10/31/2012-10/31/2016: ?

The most important job of a Chilton REIT analyst is to look forward, however. In addition to being in the midst of another 'most important election of our lifetime', 2016 could be a very important year from a balance sheet perspective. All 10 year debt issued in the record year of 2006 will be coming up for refinancing. With the Fed currently projecting low interest rates until 2015, 2016 could be the end of the 35 year (by that time) downward trend of interest rates. Our hope is that the 2016 REITWorld will be filled with a lot of patting on the back for the balance sheet work done since 2012. Last year, we issued a Christmas wish list for REITs to follow (See December 2011 Chilton REIT Outlook), which could be viewed as part of a four year plan of what to do. This year, we present the best ways for a REIT to get a lump of coal on its 2012-2016 performance in an effort to advise REITs on what not to do.

1) Use leverage over 35% of gross assets
2) Implement a development program that equates to over 10% of gross assets
3) Stray from the long term strategic plan toward being a focused REIT
4) Delay having a succession plan
5) Draw up executive pay plans that do not align with shareholder interests
6) Raise equity below NAV
7) Use short term and variable rate debt
8) Neglect the use of preferred equity for at least 10% of the capital stack
9) Increase the dividend payout ratio above 85% of Adjusted Funds from Operations (AFFO)
10) Increase debt/EBITDA ratios above 7x

If REITs avoid Santa's naughty list over the next four years, returns could be excellent for investors. We believe annual total returns in the 6-8% range would be produced by same store net operating income (NOI) growth of 3%, accretive refinancing, limited G&A needs, and some reasonable assumptions in multiple compression. Those REITs that are able avoid making the mistakes of REITs in the past will position their companies to outperform, while lumps of coal may be all that is left for REITs who choose to ignore them.

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RMS: 1234(11.30.2012) 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