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Investing in REITs: How much has really changed in 20 years? | February 2012

Along with most other asset classes, REITs began 2012 with a positive month, producing a total return of +6.5%. This compares to a +4.5% total return for the S&P 500 over the same time period. Thanks to the recent run-up in stock prices, we now are looking at REITs as fairly valued when compared to historical average valuation benchmarks. Going forward, we believe that stock selection will continue to be of the utmost importance in helping investors reach their goals. In light of this view, the February Outlook will revisit the purpose of the REIT investment team, and focus on past and present industry trends, with an emphasis on the robust fundamentals now benefiting apartment owners.

Chilton REIT Team's Mission

The principal goal of the Chilton REIT Team is to produce total returns, net of all fees and expenses, that eclipse the MSCI US Equity REIT Index (symbol: RMS) over an extended time frame. This is how we justify our existence. We strongly believe that stock selection is the most important determinant toward producing outperformance, or alpha, within the REIT industry ('alpha' is a term used in investing circles to identify how one's portfolio performs relative to a benchmark).

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Our stock selection process has been honed over the past 12 years managing separate accounts, but also relies heavily on knowledge gained from 45 years of collective experience specializing in the research of REITs. Normal duties such as intense financial analysis, property tours, and meetings with management are a staple of most money management shops including Chilton. We differentiate our efforts from other fund managers because we believe our superior information and analytical capabilities give us the conviction to take larger individual positions in client portfolios. Typically, no more than 20-25 names are used. Additionally, we often are contrarian in the pursuit of alpha driven strategies by overweighting or underweighting the various sectors within real estate, while keeping an eye on prudent risk based limits.

Managing risk is an integral facet of portfolio management. The personal touch we offer our clients begins with customizing a portfolio that addresses individual risk tolerance and income requirements. We impose several disciplines to augment our fundamental stock selection. Namely, we limit individual positions to no more than 10% in all but special circumstances. However, we do not often reach that limit with any security. We have set a 30% maximum allocation to any property sector. For example, apartment REITs cannot exceed 30% of a portfolio. In addition, we adhere to a strict buy/sell decision process. Buys are only initiated when our proprietary financial models project an annual total return in the 6-8% range for a two year period. Sells are considered when the same model suggests a negative return of over 3%. When securities fall into this territory, we re-double our analysis to determine if it is caused by fundamental issues or trading anomalies. Given the high volatility in the market recently, being disciplined on sell decisions has helped us to avoid the market's tendency for unusual and quick downward moves similar to what occurred in August and September last year, only to rebound a few months later. The turnover rate for the Chilton REIT Composite was 16.2% in the fourth quarter last year and we expect it to remain low in 2012. Low turnover reduces expenses such as trading costs and taxes, and is also a measure of the stability of our stock selection process. For clients not taking regular distributions, we are able to perform "dynamic asset allocation" by reinvesting dividends into the sectors or companies that present the best total return prospects at the time of receipt, which allows us to tweak account allocations without triggering tax events or trading costs associated with a sell decision.

Property Sector Review: Apartments
Using the asset allocation process, we began to overweight the apartment sector in mid-2010. Apartments are enjoying the best fundamentals today of all property types nationwide due to strong demand coupled with limited new supply. Revenue growth in the 5-7% range among the apartment REITs should be common this year, which should produce growth in net operating income above those levels. Adding the benefits of lower debt cost, earnings (as measured by adjusted funds from operations, or AFFO) for the sector should grow 15% in 2012 and 11% in 2013. With dividend payout ratios under 70% for the group, the predictability of dividend growth is the highest we have witnessed in years. Apartment REITs in our coverage group are trading at a 7% premium to net asset value, reflecting that investors are seeing the same trends. Rich valuations should be expected given such halcyon conditions.

The U.S. housing stock includes about 132 million units with owner-occupied accounting for 75 million units and renter-occupied equating to 38 million units. Vacancy, units held off-market, and second homes account for the remainder. Within the renter-occupied component, our focus is on the multi-family category (5+ units) which equates to approximately 15 million units. The twelve multi-family REITs we follow own a total of 625,000 units or 4.1% of the total estimated inventory. The lack of consumer enthusiasm for home purchases is driving occupancy in each of the REITs we follow in the apartment sector. The falling home ownership rate is one of the major reasons demand is so strong for rental units, both single family and multi-family. At a current level of 66.3%, the homeownership rate has fallen dramatically from the peak of 69%. However, we believe the homeownership rate will continue to fall below the historical average of 66%. Also helping demand is the echo boom demographic component, which is comprised of people in the 25-34 age groups that usually rent first when setting up a household. In fact, with high balances on student and credit card debt, this age group is expected to remain in apartments much longer relative to the past.

Job growth is also necessary to trigger household formation which, in turn, translates into demand for housing of all types. Green Street Advisors estimates a base case of 5.5 million new households that will be formed by 2016 and, as a result, apartment demand should increase by 1.1 million units over this period based upon their estimates. These numbers could prove low or high depending upon the strength of the economy, employment, wage growth, and population growth.

In real estate, the supply side of the equation is measured by the level of new construction. As mentioned above, the low supply of real estate is accruing to the benefit of the apartment REITs. The banks have been extremely cautious in lending on land purchases and for construction. When they are willing to lend, they have enforced stricter terms, usually requiring equity to be at least 30-35% of the value. Both of these factors are acting as powerful governors on the commencement of new construction, but strong apartment fundamentals have brought new construction starts off of the historic lows. Even with the nice rebound in the past several quarters, completions were under 80,000 units in 2011. Losses from the existing stock of apartments average 115,000 units per year, or a little more than 1% annually due to obsolescence or conversion to other uses such as condominiums. Thus, the total supply of apartments has actually declined in the past year.

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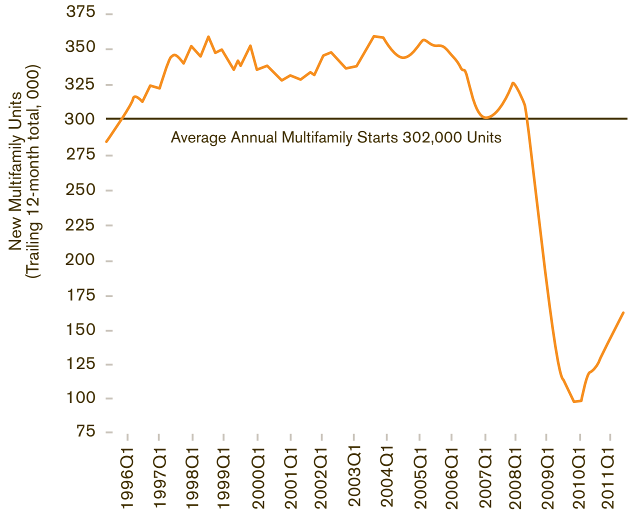
Multi-family construction starts should ramp back up, but we believe it will take several years before activity approaches the average of 302,000 units that has existed for the past 16 years. The base case for household formations articulated above coupled with the typical loss of units suggests that equilibrium between supply and demand should remain for several years, even as multi-family starts improve from the depressed levels today.

After peaking in 2012, the visibility of rental growth remains excellent but the growth rate is expected to decelerate. In a recent report by Green Street Advisors, Inc. dated January 13, 2011, the revenue per available square foot is expected to grow an average of 16.5% in the top 30 apartment markets in the United States between 2012 and 2016. The best markets are what we call "high barrier" cities

FIGURE 1: MULTI-FAMILY CONSTRUCTION STARTS BOTTOMED IN 2010



SOURCE: CENSUS BUREAU, STIFEL NICOLAS

where duplicating product is more difficult due primarily to the limited availability of permitted sites. California cities dominate the list led by San Francisco (24% growth rate), and followed closely by New York City (21.5% growth rate). To maximize exposure, we have populated our portfolios with the REITs that are concentrated in those geographic regions, which include AvalonBay Communities (NYSE: AVB), BRE Properties (NYSE: BRE), and UDR, Inc. (NYSE: UDR), all of which have at least 50% of their revenues derived from such cities.

The "Golden Rules" of REIT Investing

When the securitization of private real estate hit full stride in 1992 and beyond, investment banking and research was dictated by what we called "The REIT Golden Rules". This matrix formed the principal gateway that all companies had to pass to have a decent chance of success with public investors, both retail and institutional. Management was always viewed as the most important variable, followed by a focus on a specific property type or geography, high inside ownership, compensation aligned with performance, strong corporate governance including avoiding conflicts of interest, financial strength and flexibility, a low dividend payout ratio, and accounting standards that were considered conservative with a view of enhancing transparency. All these metrics are as important today as they were in 1992. The only major change we would add: Own properties in high barrier markets! Fortunately, the REITs have embraced this newest rule in a big way. Who would have guessed that public real estate companies including equity REITs in 2012 would make up four of the top five office landlords in New York City with about 70 million square feet of leasable area, for example? REIT-owned apartments in New York City have gone from zero to several thousand units and the number continues to grow. Since the start of the modern REIT era in 1991, the REITs have improved their portfolios significantly through capital recycling, which has positioned them among the largest owners of high quality commercial real estate in the country. We believe that the companies that are the best capital recyclers will outperform their competition, and we have confidence that our buy-rated REIT management teams will continue to be on the cusp of whatever the next trend may be.

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

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