Chilton
Capital
Management

1177 West Loop South, Suite 1310
Houston, Texas 77027

TELEPHONE: 713 650 1995
FACSIMILE: 713 650 1739
TOLL FREE: 800 919 1995

info@chiltoncapital.com
www.chiltoncapital.com

For further information,
direct inquiries to Christopher L. Knapp,
Chief Executive Officer
800 919 1995 or by email:
info@chiltoncapital.com

Is This Commercial Real Estate Cycle Different? | February 2013

As Washington DC once again kicked the can down the road in January, the broader markets continued their Christmas rally into 2013. The MSCI US REIT Index produced a total return of +3.7% for January, while the S&P 500 had a total return of +5.2%. After REITs outperformed the S&P 500 for the fourth year in a row and tested all-time highs in January, we are now hearing the following question:

Is it too late to invest in the space?

For reasons listed in our July 2011 Outlook titled "Role of REITs", we believe a 5-15% allocation to REITs is prudent given the low correlation with bonds and equities that has historically added return and lowered risk to a traditional stock and bond portfolio. Real estate is a long-term asset class that provides income AND growth to protect investors from inflation. That would be the short answer.

The long answer describes the conditions as we see them today, and how we use this information in client portfolios in an attempt to outperform our benchmark. Our location in the real estate cycle, supply and demand forces, and earnings models provide a much more robust indication of our long-term positive outlook on REITs.

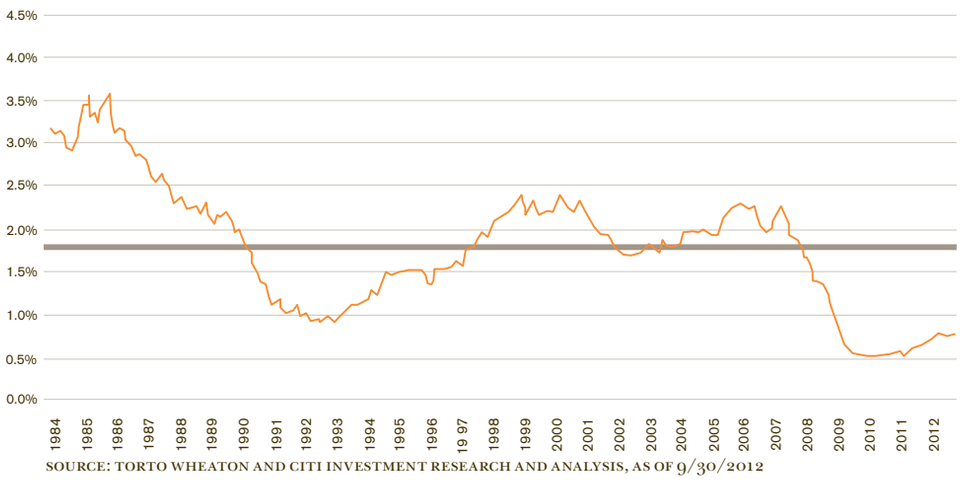
The Cycle Roller Coaster

Like many businesses, commercial real estate is cyclical. The October 2012 Chilton REIT Outlook depicted the four phases in the real estate cycle, singling out oversupply as the main culprit for declines in occupancies. In particular, real estate cycles in the 1970s and 1980s were characterized by boom and bust cycles caused by developers taking advantage of easy access to capital, which eventually resulted in a decline in values to the point where new construction was not economical. The oversupply would slowly become absorbed, access to capital would return, and construction would begin again. After the extended down cycle in the 1980s, commercial real estate cycles have averaged between 8 and 10 years.

The most notable cycle peaked in the mid-1980s and did not find the trough until the 1990-1991 recession. Fed policy for high interest rates in the late 1970s (over 20% bank prime lending rates!) artificially depressed construction during a time when demand for office space was increasing 4% annually. Overall office vacancy decreased to a low of 3.8% in 1981, until the passage of the Economic Recovery Tax Act (ERTA). ERTA allowed for accelerated depreciation of investments in commercial real estate, which provided investors with attractive after-tax returns almost regardless of the economics. Additionally, poor underwriting standards by lenders led to excessive leverage, which further magnified returns and increased demand for commercial real estate by more and more investors. A typical developer could achieve 100% financing on construction costs with no personal guaranty and, as a result, speculative projects were the norm.

The Tax Reform Act of 1986 put a stop to the senseless construction, but the bubble had already inflated for all of the wrong reasons (higher purchase price = bigger tax write-off!). Developers no longer could depend upon tax shelter-oriented partnerships to cover earnings from other sources and raise the sliver of equity lenders required for new projects. It is no wonder that higher risk was being assigned to real estate as an asset class. Real estate economics were "in the closet" because the industry was essentially private. Late in the decade, the gradual completion of the projects from the peak of the construction cycle brought supply far beyond demand, creating a bust of massive proportions that caused many bank and S&L failures. Energy states such as Texas felt the full brunt due to a precipitous drop in oil prices and the resulting loss of hundreds of thousands jobs in the oil patch. Finally, the US Government created the Resolution Trust Corporation (RTC) in 1989 to help clean up the worst mess in real estate since the Great Depression.

FIGURE 1: HISTORICAL CONSTRUCTION AS A PERCENT OF TOTAL OUTSTANDING COMMERCIAL REAL ESTATE



SOURCE: TORTO WHEATON AND CITI INVESTMENT RESEARCH AND ANALYSIS, AS OF 9/30/2012

Is This Cycle Different?

Ironically, these events set the stage for many secular and beneficial changes for commercial real estate. The tremendous collapse in value led to the need for an infusion in equity at a time when lenders instituted tighter underwriting standards and equity investors could only be found in the public market, and at a steep price. Wall Street mobilized to fortify the balance sheets of some of the best private real estate companies in America, forcing them to "lift up the kimono" and face the scrutiny of the public markets. Newfound transparency, conservative accounting techniques, and an emphasis on income-producing properties to meet annual dividend requirements came in the form of the public REIT structure. Importantly, public REITs put to use one of the key attributes of the aforementioned 1986 tax legislation: a provision that allowed REITs to be internally advised and managed for the first time. The ensuing tidal wave of securitization in what is now known as the 'Modern REIT Era' drove the market capitalization of equity REITs from $5.5 billion in 1990 to their current value over $500 billion.

What has changed in the 22 years of the Modern REIT Era? REITs are now typically fully integrated real estate companies, meaning that management can add value in a number of ways. They operate with considerably less leverage and provide transparency to investors of all types, public and private. Most importantly, investment in real estate is now typically tied to economics, not speculation or availability of capital. As seen in Figure 1, total construction as a percent of total commercial real estate has not been anywhere near the 3.5% levels reached in the mid-1980s. As a result of the reform in real estate investment during the early 1990s, the real estate cycles of the previous two decades have been much more benign in terms of new construction. Further tightening of lending standards following the 2008-2009 recession has depressed new construction to only 0.8% of total commercial real estate as of September 30, 2012. Given the muted projections for domestic economic growth for the foreseeable future, we expect construction to remain low for an extended period. Coupled with an obsolescence rate of 1%, the lack of new supply has us convinced that this real estate cycle will indeed be different in that it will be longer until the peak and less volatile to the downside. Commercial real estate should behave as a lower risk asset class for investors complete with return thresholds considerably below what was common just 10-15 years ago.

"Most importantly, investment in real estate is now typically tied to economics, not speculation or availability of capital."

Earnings Model for the REIT Industry

The belief that low supply and slow demand growth will produce an elongated cycle helps to form the basis for our long-term outlook for REITs. Accurately predicting the total returns of REITs can be a futile task, given the evidence that REITs have traded at premiums and discounts to NAV for long periods. However, an exercise in projecting total returns is extremely useful in determining whether current valuation premiums or discounts are present for the right reasons.

The two components of total return are price appreciation and dividend yield. The dividend yield component of total return should be easy enough to estimate, as it is the current

dividend plus an assumption of dividend growth (via earnings growth). Price appreciation projections require a little more faith, as an assumption of a future multiple on earnings or future premium (discount) to NAV must be made. An accurate model of future earnings is essential for both. Let's attempt to project a range for the expected 5 year total return of the entire REIT industry using both AFFO (Adjusted Funds From Operations) multiples and NAV premiums based on the assumptions in Figures 2 and 3.

FIGURE 2: ASSUMPTIONS

Implied Cap Rate (NOI/Assets)	6.0%
Private Market Cap Rate	6.4%
Private Market Economic Cap Rate	5.8%
Current AFFO Multiple (Price/AFFO)	20.3
Future AFFO Multiple	18.0
Interest Rate on "In-Place" Debt	5.0%
Refinance Interest Rate	3.5%
Same Store NOI Growth	3%
G&A as a % of Assets	0.5%
Maintenance Capex as a % of NOI	10%
Current NAV Premium (Price/NAV)	12%
Future NAV Premium	3%
Current Dividend Yield	3.4%
Dividend/AFFO Ratio	69%

FIGURE 3: BALANCE SHEET

in billions	**2013**	**2017**
Assets	850	850
Liabilities	340	340
Equity	510	510

AFFO Exercise

As of January 19, REIT assets totaled ~$850 billion and the market cap weighted average of debt/assets was approximately 40%, implying liabilities of $340 billion and equity value of $510 billion (Figure 3). The average interest rate on debt for the industry was approximately 5% with a 5 year weighted average maturity. The implied cap rate was 6%, which would indicate net operating income (NOI) of $51 billion for 2013. After deducting for interest and general and administrative costs (G&A), funds from operations (FFO) would be $29.8 billion. Adjusting for maintenance capital expenditures (Capex), AFFO would be $24.7 billion. Given a 20.3x price to AFFO multiple, the hypothetical purchase price would be $500 billion.

After growing NOI by 3% per year and refinancing 1/5 of debt each year at the new rate, AFFO grows to $34.5 billion. Applying a more conservative 18x multiple to AFFO results in an exit price of $620.8 billion, which would generate an annualized price return of 4.4%. Adjusting the current dividend yield of 3.4% for growth in AFFO, the average dividend yield over the 5 year period would be 3.6%. Therefore, the estimated annualized total return over the 5 year hold period is 4.4% + 3.6% = 8.0%.

FIGURE 4: AFFO EXERCISE

in billions	**2013**	**2017**
Start With NOI	51.0	57.4
Deduct (Interest)	(16.9)	(12.9)
Deduct (G&A)	(4.3)	(4.3)
FFO	29.8	40.2
Deduct (Capex)	(5.1)	(5.7)
AFFO	24.7	34.5
Apply AFFO Multiple	20.3	18.0
"Index Price"	500.0	620.8
Dividend Yield	3.4%	3.8%
Price Appreciation	**24.2%**	
Annualized	**4.4%**	
Average Dividend Yield	**3.6%**	
Annualized Total Return	**8.0%**	

NAV Exercise

Using the same NOI and maintenance Capex from Figure 4, we can arrive at "Economic NOI" which more accurately represents the cash flow from a portfolio. In determining NAV, we use the economic cap rate because it adjusts the private market cap rate for annual maintenance Capex. In this case, the resulting private market economic cap rate is 5.8%. After dividing Economic NOI by the economic cap rate, the approximate private market value of assets is $787.7 billion (see Figure 5 on following page). The final step to find NAV is to deduct the liabilities (from Figure 3), which produces an NAV of $447.7 billion. Assuming a $500 billion purchase price, the current NAV premium is 12%. Looking out to 2017 using the assumptions in Figure 2 and applying the historical average premium to NAV of 3%, we arrive at an exit price of $562.9 billion, which would imply an annualized price appreciation of 2.4%. Adding in the previously mentioned 3.6% average dividend yield, the resulting projected annualized return is 2.4% + 3.6% = 6.0%.

FIGURE 5: NAV CALCULATION

in billions	**2013**	**2017**
Start With NOI	51.0	57.4
Deduct (Capex)	(5.1)	(5.7)
Economic NOI	45.9	51.7
Divide by Private Market Economic Cap Rate	5.8%	5.8%
Private Market Value of Assets	787.7	886.5
Deduct (Liabilities)	(340.0)	(340.0)
NAV	447.7	546.5
Apply NAV Premium	12%	3%
"Index Price"	500.0	562.9
Price Appreciation	**12.6%**	
Annualized	**2.4%**	
Average Dividend Yield	**3.6%**	
Annualized Total Return	**6.0%**	

Sensitivity Analysis
In addition to forming a base case scenario for the next 5 years, our industry earnings model allows for tweaking of assumptions to project total returns under any number of scenarios. The assumptions used in the AFFO and NAV exercises comprise our base case projection. However, if SS NOI growth averages 4% for the next 5 years and the economic cap rate of the industry decreases to 5%, the expected annual total return almost doubles to 13%. Similarly, a 2% SS NOI growth assumption with a 24x AFFO multiple would produce an annualized return of 13%.

Conversely, the sensitivity model can give perspective on what would have to happen for REITs to produce zero total return for the next 5 years. For that to occur, SS NOI growth would have to decline to 0% and the economic cap rate would have to rise to 6.5% (above the historical average). If SS NOI is flat for the AFFO exercise, the multiple would have to drop to 14x (below the historical average) to generate a 5 year record of no return. We view both of these scenarios as unlikely.

6–8% Outlook
Accordingly, we feel comfortable projecting a 6-8% annualized total return over the next 5 years for the REIT industry. Though simplistic, the exercise demonstrates the power of refinancing debt at low interest rates, same store growth as a result of low new supply, and dividend growth. By using a lower multiple in 2017 and a small premium to NAV, we have attempted to build in a cushion for the prospect of higher interest rates. Furthermore, this model does not give any credit for accretive development or acquisitions, which could further boost NAV, AFFO, and dividends. Though more complex, we use similar models to project annual returns a majority of the REITs in our universe (over 75 companies!) to pick the 25-30 best opportunities for risk-adjusted total returns.

Matthew R. Werner, CFA
mwerner@chiltoncapital.com
(713) 243-3234

Bruce G. Garrison, CFA
bgarrison@chiltoncapital.com
(713) 243-3233

RMS: 1328 (1.31.2013) 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