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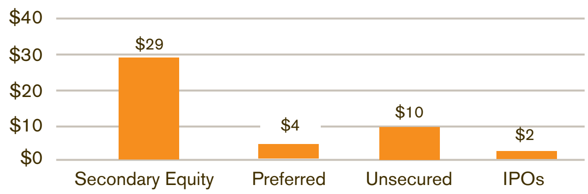
Do I Stay or Do I Go? | January 2012

Imagine for a minute that your trusted investment advisor comes to you with a business proposal. He or she is offering the opportunity to invest in a business that has an embedded growth rate of 8-10% in a diversified array of products for the next two years, and the potential for that growth to continue for the following three years. The demand for these products is increasing while the supply is decreasing, and the threat of an increase in supply is guaranteed to be at least a few years out. Imagine that he or she tells you that your investment will have immediate liquidity, complete transparency, and pay you a 4% dividend yield (and growing) per year. This is not a new business—the management team has been around for twenty years, and proven themselves to be competent. You would be crazy not to think about an investment like that, right? Then your advisor tells you that the investment is in commercial real estate… are you still excited?

You're apprehensive because a friend or a family member lost a large portion of his or her investment on a real estate deal in 2008, and have read headlines about foreclosures in residential and commercial real estate. You heard horror stories of too much leverage, new buildings staying vacant, and high fees. You already have equity in your home and maybe even some other real estate investments. But your advisor tells you he is talking about publicly traded equity REITs. These REITs have low leverage, properly incentivized management teams with documented experience, and provide immediate liquidity. They have diversified investments across the country in nine sectors with thousands of tenants. The demand for their high quality product is approaching 2006 levels, while the supply is shrinking by the tune of 0.50% per year at current construction levels. On top of that, the 4% dividend yield is only 70% of cash flow (as measured by AFFO, or Adjusted Funds from Operations), so REITs have a cushion to grow the dividend and the asset base.

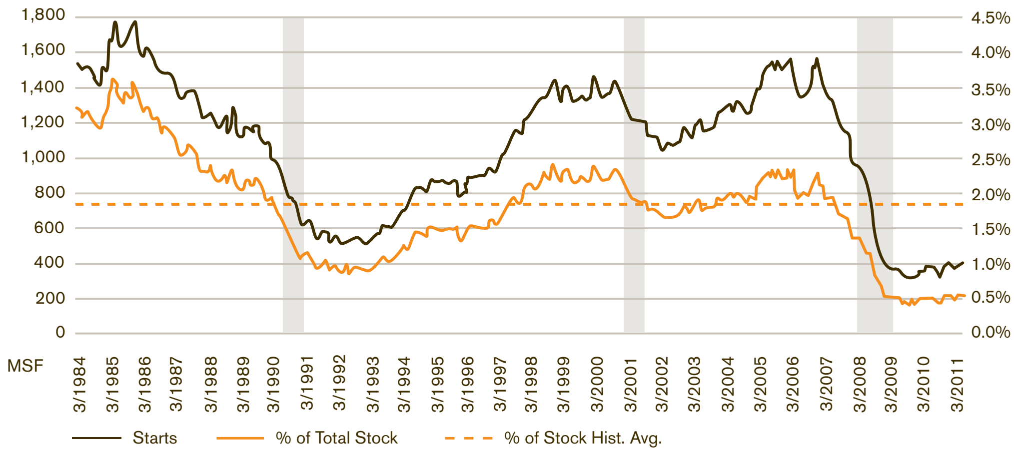
You do not have to imagine this scenario; the above facts are currently playing out in REITland. Because of the positive tailwinds for the sector today, we remain optimistic on commercial real estate for the foreseeable future, notwithstanding the political uncertainties. The slow but steady improvement in fundamentals should lend itself to positive surprises and few downside risks. Our stock selection favors equity REITs that possess pricing power, investment capacity and/or strong balance sheets, and management teams that have earned elite status with successful track records of value creation. Today we remain overweight apartments, storage, luxury retail primarily with "A" malls, and downtown office in major gateway cities such as New York and San Francisco. The best REITs have a clear competitive advantage in the real estate industry due to the high quality of properties that tenants favor and access to low cost capital from multiple sources, both equity and debt. For example, since 2009, equity issuance has surpassed $60 billion, which is significant when compared to the total REIT market cap of close to $400 billion currently. In 2011 alone, the public equity REITs have raised over $45 billion in the capital markets (see Figure 1). Generational low levels of new construction coupled with modest job growth in the private sector are slowly increasing demand. Landlords have begun to gain pricing power in many sub-markets and certain property types. Based upon our analysis, we should witness growth in earnings in the 8-10% range led by lodging and apartments over the next two years.

FIGURE 1: REITS HAVE RAISED $45 BILLION YTD THROUGH OCTOBER 2011



SOURCE: NAREIT, BANK OF AMERICA MERRILL LYNCH

FIGURE 2: THE SUPPLY OF COMMERCIAL REAL ESTATE IS SHRINKING



SOURCE: TORTO WHEATON AND CITI INVESTMENT RESEARCH AND ANALYSIS

The current construction levels and the nature of the new build cycle are accruing to the benefit of high quality commercial real estate. Currently, the blended starts of all property types as a percent of total commercial real estate stands at 0.5%, a historic low (see Figure 2). Additionally, the obsolescence rate of real estate is estimated to be 1% per year. So, the supply is actually *shrinking*.

Even if capital suddenly became freely available for developers today, it would still require two to three years before new supply would present a competitive threat for existing landlords. For most property types however, rents are not at levels that would produce satisfactory economic returns to justify new construction. The one exception is the apartment sector, where construction starts have recently rebounded from 50 year lows. Inevitably, replacement costs are destined to go higher, paving the way for rising rent levels on existing properties. At the November NAREIT conference, we surveyed REIT management teams about land values. The overall response was that land values dropped up to 50% from 2007, and are now back at or above those prior peak levels. Due to the volatile nature of real estate pricing, investing in commercial real estate, including REITs, does require an investor to adopt a longer term holding period to reap the benefits that inure as the real estate cycle achieves better occupancy rates and rents.

FIGURE 3: HISTORICAL DEBT/TOTAL CAPITALIZATION RATIOS

	2008	2009	2010	3Q11
APARTMENTS	56.9%	50.3%	41.4%	38.1%
HEALTH CARE	41.4%	33.5%	29.6%	36.4%
INDUSTRIAL	61.8%	47.1%	40.4%	54.8%
MALLS	64.7%	50.0%	41.5%	39.9%
OFFICE	59.4%	49.7%	45.7%	47.5%
STRIPS	48.3%	45.6%	41.0%	42.6%
STORAGE	25.4%	24.3%	20.5%	18.4%
TRIPLE NET	44.0%	32.8%	32.5%	39.1%
TOTAL	**51.3%**	**44.5%**	**38.9%**	**39.7%**

SOURCE: FACTSET, BOFA MERRILL LYNCH GLOBAL RESEARCH
* TOTAL CAPITALIZATION = DEBT + PREFERRED EQUITY+MARKET CAP

An extended period of low interest rates as telegraphed by the Federal Reserve adds to the investment case for real estate. REITs can deliver relatively high income today via yields of about 4% with dividend growth averaging 6-8% for the next 4-5 years if a portfolio is positioned in the right property sectors and geography. Today, balance sheet management is playing an important role as a driver of cash flow growth, as higher coupon debt is replaced with lower cost alternatives. Many REITs have been successful in raising unsecured debt with 7-10 year maturities at sub 4% cost and, in most cases, using proceeds to retire higher cost alternatives. However, due to the equity raised in the past three years, the debt as a percentage of total capitalization has dropped immensely. As shown in Figure 3, the current debt to total capitalization ratio stands at about 40% versus over 50% in 2008. REIT CFOs have adequately repositioned their companies and we believe they will be able to withstand an elevated level of stress in our downside scenarios.

In our coverage of the REITs, which has spanned over forty years, it has been rare that everything "goes right" simultaneously. Normally, one or more fundamental growth drivers present a headwind. Such is the case today. Yes, we would like better economic growth rates, positive leasing spreads across all property types, perpetually low interest rates, limited new construction and high yields on property acquisitions or development. Today, three out five are helping many REITs. Interestingly, REITs do not need to rely exclusively on external drivers for growth. Many investors overlook the internal growth drivers, such as what can be achieved from the reinvestment of cash flow not paid out in dividends. For example, REITs have invested in IT platforms that are assisting management teams to enhance efficiencies that manifest in higher margins from rents. And REITs continue to employ capital recycling to enhance the quality of assets that in turn provide an additional competitive edge (see our REIT Outlook for December at www.chiltoncapital.com/publications where we provide numerous examples). Between external and internal drivers, REITs have been able to produce consistency in investor returns which have averaged in the 10-12% range using ten and twenty year holding periods.

We are also positive on the opportunity offered by investing in the preferred equity of the REITs. As we have mentioned in previous letters, the 7.75% yield is attractive on a relative basis when compared to yield offered in 10 year treasury notes. And, given the Fed's current stance on interest rates, they should continue to be attractive as a yield instrument for the next few years. For an example of the return capabilities of the REIT preferred equity, the 5 year annualized return on the Wells Fargo Hybrid & Preferred Securities REIT Index (WHPSR) is +7.7% as of December 22, 2011. As a reminder, that 5 year return begins in 2006, so it includes the 2008-2009 debacle. In comparison, the S&P 500 and the MSCI US REIT Index had annualized returns of -2.2% and -5.6% over the same period, respectively.

This real estate cycle is going to be different from any we have witnessed in the past 40 years for the aforementioned reasons because we did not start with the typical problems of overbuilding. In the period following 2008, vacancy rates were temporarily elevated due to short term demand destruction that ensued following the financial meltdown. However, economic growth is helping produce new demand, albeit at a slow pace. And, for the reasons articulated, this cycle will be elongated and beneficial to existing landlords, especially the equity REITs. Slow and steady growth suits the public equity REITs just fine. With record low dividend payout ratios and rising earnings going into 2012, we are confident that investors will be satisfied by a growing 4% dividend yield and modest price appreciation. In summary, we are in a yield starved environment where REITs can go a long away toward providing investors, both large and small, a suitable investment solution. Not all real estate investment vehicles are created equal. We recommend skepticism and caution to investors when listening to advisors advocate 'high return, low risk' investments, particularly non-public REITs and limited partnerships. Many times, these 'once in a lifetime' investments are actually characterized by high fees to the sponsors, low returns to the investors, and high risk. Too much debt leverage in real estate has consistently been the number one culprit for negative or marginal returns. However, we also recommend that investors keep a piece of their total portfolio invested in commercial real estate, and we believe that the public equity REITs provide the best risk adjusted return potential. Major risk factors include a softening in the economy primarily declining job growth numbers and a spike in interest rates could hurt all yield oriented securities, including REITs. But in conclusion, and to answer the question that we began with, we are staying…fully invested.

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

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