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

All Properties are Not Created Equal: Industrial Sector Focus | March 2012

REITs finished February with a total return of -1.1% as measured by the MSCI US REIT Total Return Index (RMS). In comparison, the S&P 500 had a total return of +4.3% for the same period. Year to date, REITs are now up 5.3% while the S&P 500 is up 9.0%. Despite some of the macroeconomic and political news remaining uncertain, the REIT fourth quarter earnings calls have been upbeat. CEOs are optimistic on the supply/demand dynamics in their markets, and CFOs remain exuberant about the low cost and high quantity of capital available to them. As an example, Health Care REIT (NYSE: HCN) raised $1.1 billion during the month in an overnight equity offering and the stock price barely moved. There is high investor demand for REITs with proven management teams in areas with solid growth profiles.

Before jumping into the meat of the letter, we would like to make a quick aside at the outset on taxes - specifically to the effects of President Obama's tax proposal on REIT dividends. In it, he outlines an increase in the tax rate on qualified dividends to the ordinary income rate (top rate of 43.4%) from the current 15% flat rate. He also proposes to raise the rate on capital gains to 23.8% from 15%. We do not have an opinion on whether or not this will pass. However, we do know that most of REIT dividends are already taxed at the ordinary income rate, so the impact on the after-tax yield to investors would remain basically unchanged while investors receiving qualified dividends from traditional corporations would suffer a large diminution. As a reminder, on average, REIT dividends are comprised of 68% ordinary income, 12% return of capital, and 20% long term capital gains. Overall, we are confident that REITs would actually gain an edge on other high yield equity instruments in an after-tax yield comparison (ex. Utilities, Telecom, Financials).

With that out of the way, we would like to make an addendum to our "Great Real Estate in Great Places" recurring theme by telling the story of the industrial sector. To differentiate this from the previous letter we wrote in February 2011 focusing on industrial REITs, we will introduce a new theme: "All Properties are Not Created Equal".

Focus: Industrial REITs

Many give credit to Theocritus for first coining the concept "beauty is in the eye of the beholder" in the 3rd century BC. The industrial sector of the REIT industry may not be as aesthetically captivating as others such as the luxury hotel business, but we think a sector that is fundamentally poised to offer above average returns is a beautiful thing indeed. We think there are companies and management teams that are positioned to take advantage of a supply/demand imbalance and thereby produce outsized total returns for our client portfolios.

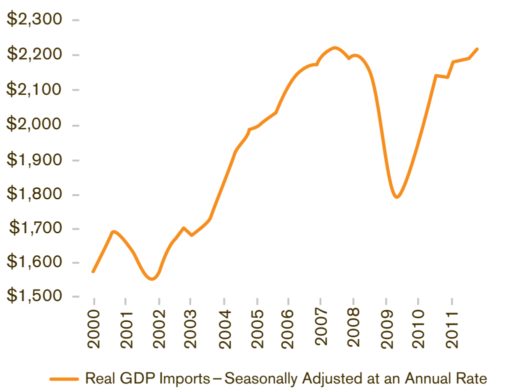
The untrained observer may not find industrial buildings attractive, but tenants find they can drive their business efficiently using a mix of office and warehouse space, high ceilings, multiple store front entrances, and dock high loading areas (elevated loading docks typically in the rear of the facility where large trucks can unload cargo). Due to their flexibility, industrial buildings are attractive to a wide range of tenants. Top tenants for some of the industrial REITs include the US Government, Lockheed Martin, Wells Fargo, and AARP, among others.

Industrial Space Demand

A measure of demand is net absorption, which is defined as the amount of leased space in an area after deducting the space that was vacated during the period. Net absorption in the US was 120 million sqft for 2011, the strongest reading we've seen since 2007, and a stark contrast to the negative 136 million sqft figure in 2009. Several industry sources estimate that net absorption will be in the range of positive 150-175 million sqft in 2012, creating a solid backdrop for the sector.

There are multiple indicators that help us to gauge the overall health of the operating environment in the industrial sector. Businesses typically store goods as inventory in an industrial warehouse before the product is sold to the consumer. When consumer demand increases, businesses increase inventories and import more goods to accommodate this heightened demand. We can track this in part by looking at change in business inventories. Business inventories have rebounded by 18% from the trough in 2009 on a seasonally adjusted basis as of December 31, 2011. Another leading indicator of demand for industrial space is real GDP imports (Figure 1). At $2.2 trillion as of December 31, 2011, real GDP imports are currently rivaling pre-crisis levels, and are up 24% since lows seen in 2009. Air cargo volumes and shipping activity are currently at elevated levels as businesses continue their restocking efforts. Comments from industrial REIT CEOs indicate that shipping container volumes were up 6% year-over-year for ports that reported data through December 2011. All of these factors give us the confidence that things are going to turn positive soon in a sector that is still having to lease out space at lower rates than the expiring leases.

FIGURE 1: US REAL GDP IMPORTS (IN BILLIONS)

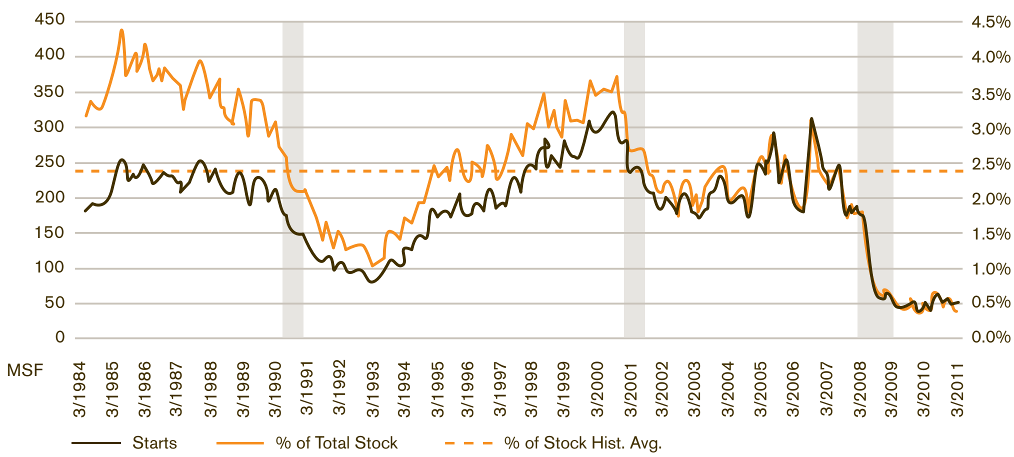


SOURCE: BLOOMBERG, BUREAU OF ECONOMIC ANALYSIS, CHILTON CAPITAL MANAGEMENT

Industrial Space Supply

Adding to the backdrop of the favorable net absorption figures, the supply of industrial real estate remains at historical lows. This is the case due to little new construction, reflecting more stringent banking regulations, higher aversion to risk from equity sources, and tighter construction financing in the marketplace. Recall that, on average, 1% of real estate becomes obsolete each year. Figure 2 shows that the current amount of industrial real estate under construction amounts to 0.5% of the total, which points to a positive environment for the industrial REITs. Our conversations with REIT management teams suggest that their superb access to capital gives them a one to two year advantage over private developers to meet increased demand with new development. Currently, landlords are renewing leases at lower rates than the expiring lease. To be proactive, REITs have been negotiating shorter leases than usual

FIGURE 2: INDUSTRIAL REAL ESTATE UNDER CONSTRUCTION REMAINS AT HISTORICAL LOWS



SOURCE: TORTO WHEATON AND CITI INVESTMENT RESEARCH AND ANALYSIS with the hope of re-signing them at higher rates in the near future. As demand picks up and supply remains low, this should give pricing power back to the landlords resulting in higher rental income for industrial REITs and allowing them to convert land into income-producing warehouse space.

Industrial REIT Companies

We have mentioned in past letters that capital recycling is a major theme for REITs; the industrial sector is certainly no exception. REITs are shedding their non-core assets in out-of-favor markets for properties located in growth oriented, high-barrier markets. A steadily improving economy and increased port traffic have aided West Coast markets and the energy-fueled Houston market in achieving relatively high occupancy rates while increasing rental rates – a positive sign for these best-of-breed locations. Not only does Houston boast the fourth largest port, but according to CBRE Econometric Advisors, Houston averaged 0.9% annual rent growth for the 10 year period ending September 30, 2011 while the rest of the country saw an average annual decline of 2.2%. Additionally, the Houston industrial market has one of the highest effective rent rates of $5.75 per sqft compared to the national average of $4.75 per sqft, signaling high demand.

One industrial REIT, PS Business Parks (NYSE: PSB), recently made a splash into the Northern California market with a $520 million portfolio acquisition of 5.3 million sqft, evidence of support for the positive fundamentals in this geographic area. As of December 31, 2011, 41.0% and 12.2% of PSB's portfolio is located in California and Texas, respectively. PSB has a dividend yield of about 2.7% and a market cap of $1.5 billion. With a weighted average occupancy of 89.2% as of December 31, 2011, PSB owns, operates, develops and acquires multi-tenant flex, office and industrial commercial properties totaling 27.2 million sqft. PSB has carved out a niche by focusing on smaller tenants. Though they are able to accommodate larger tenants, PSB believes their leasing team differentiates itself by closing a high volume of transactions in the 5,000 sqft and smaller range where competitors are not as aggressive. Through our primary research of cold-calling leasing agents, they reiterated to us that many of their smaller tenants do not use brokers, which saves both the lessee and lessor time and money.

ProLogis (NYSE: PLD) is the largest global player in the industrial sector. It pays a 3.3% dividend and has a market cap of $15 billion. PLD is the result of a recent merger between two of the top industrial REITs, AMB Property Group and PLD. With 600 million sqft of space in 22 countries, this global powerhouse is levered even more than competitors to a recovery in global trade and consumption. Risks remain in part due to a $2 billion land bank that essentially represents a non-earning asset. However, with a recovery in demand, PLD would be well-positioned to ramp development starts that could become a nice addition to net asset value based upon the historical track record of its prior developments.

Lastly, we would like to touch on Eastgroup Properties (NYSE: EGP), which boasts a total return of 1,422% (15.3% per year) since the start of the Modern REIT era (12/31/1992 - 2/22/2012). Eastgroup specializes in multi-tenant business distribution buildings for customers typically in the 5,000 to 50,000 sqft range in major Sunbelt markets in the US. We recently toured EGP's 2.4 million sqft World Houston facilities in North Houston led by a member of the firm's management team. The World Houston property sits adjacent to Bush Intercontinental Airport and represents a total investment of $140 million. EGP recently purchased a 130 acre golf course adjacent to the existing buildings, which gives the company sufficient land to add an additional 1.5 million sqft of rentable space over the next several years. When finished, we believe this industrial park would set a new high-water mark for pricing in the Houston market with a low capitalization rate applied to the stabilized income stream in a hypothetical sale. By digging through recent SEC filings, we conservatively estimate total costs, inclusive of development costs, on the combined property to be $250 million. Using an estimated stabilized yield of 8.5%, we calculate this contributes $21 million to Net Operating Income (NOI). If this asset were to be sold at a 6% cap rate, the value would be

$354 million, implying value creation of $104 million over cost, or $3.86 per share. As of February 27, 2012, EGP common stock traded for $48.90 per share.

There are 12 companies that have significant industrial exposure with a combined market cap of $31.5 billion and an average dividend yield of 4.3% as of February 22,2012. As of this same date, industrial REITs traded at 14.6 times FactSet's 2012 FFO estimates and a 1.1% average premium to their net asset values (3% if the lowest outlier is removed), seemingly rich valuations at first glance but warranted given the favorable fundamental backdrop. As shown, the performance of industrial REITs is highly correlated to global GDP growth and thus a sustained economic recovery is a necessary ingredient to our estimates of earnings over the next two years. While strong GDP growth provides solid fundamentals, the quality of the locations, buildings, and management teams should give them a strong advantage relative to competition. As analysts, we remain committed to finding companies that are best positioned to create value for shareholders in all economic environments. Even during the worst times for occupancy EGP achieved 96% occupancy in Houston, which represented 16.9% of the total property portfolio. As of 4Q11 total portfolio occupancy was up to 93.9% and the Houston portfolio remained strong at 95.2%. Through our analysis of the economic climate, speaking with management teams, visiting sites, and participating on earnings calls, it is evident that the recovery is catching on in other select cities.

Please feel free to forward this publication to interested parties and make introductions where appropriate.

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

Benjamin W. Atkins
batkins@chiltoncapital.com
(713) 243-3266

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

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

RMS: 1144 (2.29.2012) 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)