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

# Industrial Occupancy up with Manufacturing | November 2012

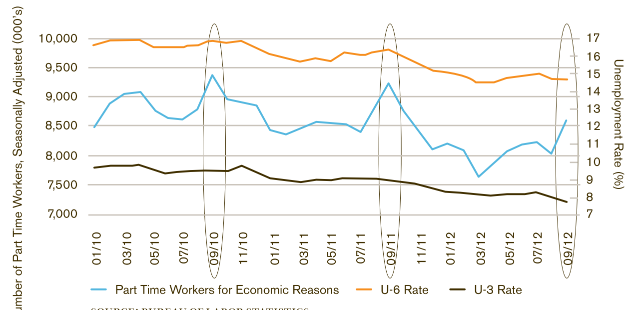
REITs pulled back in October along with the broader markets as investors fretted over economic and political uncertainty, exacerbated by the upcoming fiscal cliff on New Year's Day, 2013. The MSCI US REIT Index was down 0.8% during the month, bringing the year-to-date (YTD) total to +13.9%. This compares to the S&P 500's October and YTD performance of -1.8% and +14.3%, respectively. One of the more surprising news items during the month was the September jobs report released on October 5th. The headline unemployment number dropped from 8.1% the prior month to 7.8%, signaling that businesses must be feeling confident about their future and making commitments to new hires. We feel it is part of this publication's onus to project an outlook, which must be defended or revisited when there is a fundamental change in the variables. To properly assess if things have changed, we dig deeper into the employment numbers and discuss implications for REITs. Separately, we re-examine the current landscape for REIT preferred equity from both the investor and the REIT point-of-view, as the demand for current income has pushed yields into territories not seen before.

**The Iceberg Below the Surface**

The September jobs report was *seemingly* strong with impressive employment growth accompanied by increases in the labor force participation rate and the employment to population ratio. However, the report had a number of moving pieces, distorting the true strengths and weaknesses of the labor market. There are two, separate surveys taken every month by the Bureau of Labor Statistics (BLS): The Household Survey samples households and the Establishment Survey polls businesses. Both surveys measure employment, but the definitions differ. While the Establishment Survey only covers people employed by nonfarm businesses, the Household Survey includes domestic workers and those who are self-employed or work in agriculture. In September, the household survey reported an increase in total employment of 873,000, but the Establishment Survey reported an increase of 114,000 jobs. Because the Household Survey is the source of data for the headline unemployment rate, the additional 873,000 jobs resulted in a decrease in the rate to 7.8%.

However, the headline unemployment rate, also called 'U-3', counts part-time workers who want to be working full-time as employed, a number which had averaged a decrease of 8,000 per month in 2012 through August. In the September 2012 report, the Household Survey showed a 582,000 increase in seasonally-adjusted part-time workers for economic reasons. This accounts for much of the difference between the two surveys, and was a driver of the U-3 unemployment rate decline. For a broader view of how the economy is doing, many economists look at the most strict measure of unemployment, the 'U-6' rate. The U-6 employment figure includes those under-employed or marginally employed in the numerator, which includes part-time workers for economic reasons. The September employment report showed the U-6 rate remained unchanged from August at 14.7%. In fact, the September 2011 employment report showed an increase of 483,000 part-time jobs after averaging a decrease of 32,000 per month for the previous 8 months...and the U-6 rate *increased* by 20 bps despite a decrease in the headline unemployment rate of 10 bps! Figure 1 shows that the September 2010, 2011, and now 2012 employment reports had a large increase in part-time workers that brought down the U-3 unemployment rate, but had no real effect on

FIGURE 1: PART TIME WORKERS' EFFECT ON THE UNEMPLOYMENT RATE




SOURCE: BUREAU OF LABOR STATISTICS

the U-6 rate. Though we would have liked to see signs of robust employment growth which would drive up demand for real estate, the September 2012 report confirms our outlook of slow job growth.

**A Manufactured Employment Report?**
Though the actual number can be debated, everyone can agree that there are some jobs being added. This certainly has been evident in the increases in occupancy we have seen across many REIT property types. Looking deeper into the BLS statistics, we spot several trends that are helping particular property types. While the housing recovery has yet to pick up to long-term trend levels, construction employment is showing some life as commercial and residential building have bounced off of a bottom, particularly in apartments as we discussed in the September 2012 REIT Outlook.

One of the brighter lights in the current recovery is the growth of manufacturing employment from the post recession lows. Manufacturing employment at the end of the great recession was at a 5 decade low of about 11.5 million employees, thanks in part to the auto sector collapse and persistent wage pressures from China. The auto sector made a remarkable comeback with some of the employment returning, and the other "low value by weight" manufacturing sectors posting strong job growth. Sectors that produce goods with a relatively low value/weight ratio are typically industries where strong job growth has occurred since the end of the recession. All are "heavy" with high shipping costs making them less attractive candidates for outsourcing and importation, such as chemical and petroleum products, autos, and machinery.

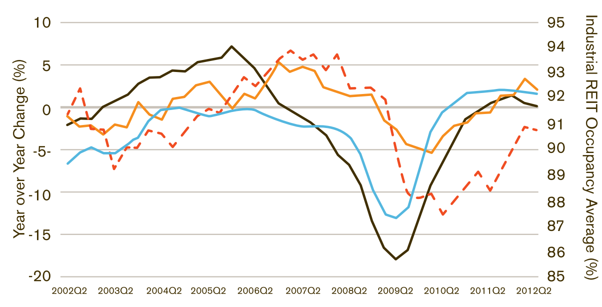
Employment in manufacturing has increased by 4% from the 2010 bottom, but remains down over 30% since 2000. However, there are reasons to be optimistic. Chinese wages have begun to increase, and the Yuan has been allowed to appreciate against the dollar. This, combined with a much more productive workforce in the US and a fuller appreciation for the costs of off-shoring, is leveling the playing field. While it is somewhat early to make a case for a manufacturing renaissance in the US, the pieces do seem to be falling into place for a continuation of the recovery.

**Manufacturers Need Real Estate**
Industrial REITs have been aware of the recovery in manufacturing for the past 12 months as occupancy and demand for space has come back. On the 4th quarter 2011 earnings call for DCT Industrial Trust (NYSE: DCT), CEO Phil Hawkins stated, "…what's offsetting that or at least partially offsetting the lack of housing is manufacturing. And so the manufacturing business is up and that generates a fair amount of activity for smaller and local and regional tenants. And that's, I think, that's what's driving in part the recovery…." In Figure 2, the connection between industrial REIT occupancy and the recent growth in manufacturing and construction jobs is evident. Industrial REIT occupancy has come back from a low of 87.5% on March 31, 2010 to 90.9% as of June 30, 2012, while we are seeing the first increases in manufacturing employment since June 1998.

*"…we are seeing the first increases in manufacturing employment since June 1998."*

So far, all of the increase in same store NOI can be explained by occupancy growth, as rents have not returned to the levels at which the leases were signed five years ago. However, occupancy increases without any significant help from a single-family housing recovery means that industrial REITs are poised to get their next leg of same store growth from higher rents when the housing market finally does come back.

FIGURE 2: MANUFACTURING AND CONSTRUCTION JOB GROWTH IS DRIVING INDUSTRIAL REIT FUNDAMENTALS




SOURCE: FRED, SNL NOTE: INDUSTRIAL AVERAGE CONSISTS OF EQUAL-WEIGHTED BASKET OF DRE, EGP, PLD, LRY, PSB, DCT, FR, AND STAG.

**REIT Preferred Stock in Investor Portfolios**
We have found the relatively high yields available from REIT preferred stocks to be very attractive to our client base looking for yield.

Today, the blended current yields are approximately 7.25%. Our research of REIT common stocks gives us a significant advantage when selecting preferred stock issues for our client portfolios due to our time-tested fundamental analysis. We then use a variety of analytical tools to screen the most attractive names including coupon, yield to call, debt ratios of the REIT with preferred stock included, and the payout ratio on adjusted funds from operations (AFFO). AFFO is the primary benchmark for operating performance that we utilize for REITs.

These tools enable us to have the conviction to go beyond investment grade to find preferred stocks with higher yields. Accounts are typically populated with 10-15 names that allow for diversification by property type and geographic dispersion. One caveat is that liquidity is fairly limited with preferred stocks since the combined amount outstanding equates to only $25 billion and the amount issued per series is typically under $250 million. However, due to favorable interest rates and investor demand, we have witnessed a record volume of new issues in 2012 totaling about $8.0 billion with yields ranging from a low of 5.375% to 8.25%.

There is one major risk factor with preferred stocks that investors need to consider: There is no maturity date. Thus, they are vulnerable to rising interest rates. As rates move up, prices come down. In addition, most are issued with a five year non-call; but after that time elapses, the issuer has the right to call the issue at par. If the REIT can issue a new series at a lower rate, often proceeds are used to payoff higher coupon issues that are callable. This phenomenon helps explain why issuance this year has set records given the low interest rate environment. Specific to our portfolios, redemptions have brought down the blended yield by about 50 basis points from this time last year.

**If Chilton REIT Team Could Play CFO…**

We wish more REITs would issue preferred stock. The reason most often cited to us by management for the reluctance to issue preferred stock is the very low interest rates available with debt. Equity REITs today are borrowing 10 year money as low as 3% and a few can float debt for 30 years under 5%. Thus, a CFO will compute the cost of the option of not paying back the preferred at the spread to debt being sold. For example, a REIT we visited recently used the example of 10 year money they could borrow at 3.0%, versus a preferred stock with a coupon of 5.5%. That spread would approximate 250 basis points or 2.5% per year for the amount borrowed. So, if a REIT is borrowing $200 million, the "option" cost would be $50 million over the life of the debt. However, we would argue this comparison is too short term-oriented.

The benefit of not having to refinance at a higher rate becomes more valuable as we increase the time period assumption. When using a longer time period (30 years) to assess the breakeven between a capital structure with all debt versus a mix with 10% preferred stock, the "cost of the option" disappears if the initial 10 year money has to be refinanced at only 5%. If rates for the 20 years after the initial 10 year maturity average higher than 5%, the preferred stock more than pays for itself through interest savings.

Furthermore, the addition of preferred stock increases the weighted average maturity. The typical capital structure of a REIT today includes 60% equity and 40% debt, with a weighted average maturity of 5 years. If the REIT were to replace 10% of the debt with preferred stock, the weighted average maturity would almost double to 9.5 years, using 50 years as the maturity for the preferred stock.

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We strongly believe the weighted average maturity of a REIT's debt (including preferred stock as debt) will increase in importance to investors in the years ahead as we get closer to seeing normal interest rates. REITs with longer maturities should have the benefit of higher multiples on their stock price (i.e. lower cost of new common stock), which managements should view as enough rationalization to go ahead and pay the "option" cost for issuing preferred stock. The REIT world already has a prime example: Public Storage (NYSE: PSA). It trades at one of the highest multiples and trades at a 30% premium to net asset value (NAV) per share in an industry where the average premium is closer to 10%, according to Green Street Advisors.

**Time to Hit the Balance Sheet Gym**

As we mentioned in the August 2012 REIT Outlook, one of the characteristics of the 'REIT Elite' is a sound balance sheet with low debt ratios. Though some may look at preferred stock as merely a higher cost form of debt, we believe the long term benefits far outweigh any near term cost. Given the cyclical nature of real estate and infinite life of a REIT, it behooves a CFO to prepare his or her company for scenarios where credit markets close and refinancing rates rise. Though we don't plan on 2008 happening again, stocks with 2008-resistant balance sheets will garner premium valuations. Most REITs have taken advantage of the historic low rates today to de-lever and ladder out debt maturities at lower costs; however, our hope is to see some REITs take it a step further using preferred equity and industry-low debt ratios so that there is increase in the number of REIT Elite members before rates begin to rise.

**Samuel Rines**
srines@chiltoncapital.com
(713) 243-3263

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

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

RMS: 1227(10.31.2012) 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*