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

For further information,
direct inquiries to Christopher L. Knapp,
Chief Executive Officer

info@chiltoncapital.com
www.chiltoncapital.com

The Importance of Capital Allocation within REITs | February 2015

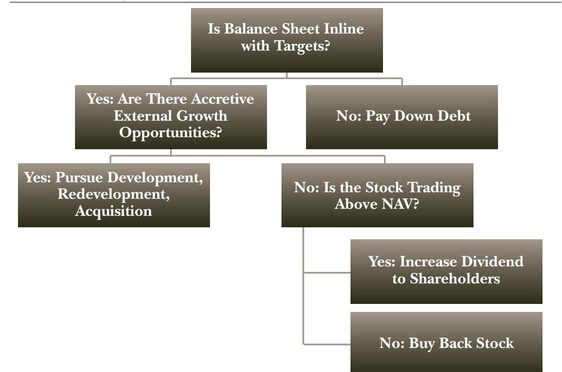
From 2008-2010, there were over $12 billion of REIT impairments as management teams had to write down acquisitions, land, and development projects pursued at the peak of the market. Additionally, the sharp decline witnessed with asset values forced dilutive equity raises by many companies to lower inflated leverage ratios and, in many cases, save the company from bankruptcy. Roughly 50% of all REITs were forced to cut dividends. In contrast, there were almost $200 billion in REIT asset and company sales (M&A) from 2006-2007 for which shareholders were rewarded with peak prices.

Many REITs that experienced the largest stock price declines can attribute a portion of the underperformance to questionable capital allocation decisions. The bottom ten performers in 2008 had an average construction pipeline of almost 7% of gross assets, while the top ten had less than 5% on average. As a result, the bottom ten performers expanded share count by almost 70% in 2009-2010 when stock prices were at multi-year lows. Only a few REITs had the balance sheet flexibility to even consider stock buybacks or pursue external growth at times when they could achieve multi-year highs for projected IRRs (Internal Rate of Return on an investment). Similar to the fact that low leverage REITs outperform those with high leverage over the long term, premium capital allocators tend to outperform their peers. A perfect example can be seen with Eastgroup Properties (NYSE: EGP) which not only maintained its dividend throughout this period, but was also positioned as a 'first mover' with its external development at a time when the real estate capital markets were essentially closed. Today, EGP trades at one of the highest premiums to net asset value (NAV) in its peer group.

Capital Allocation Tree

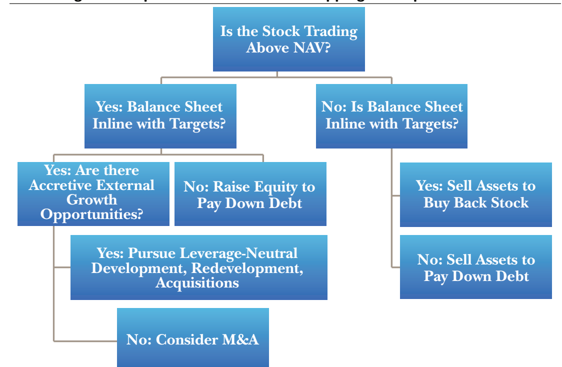
Real estate is a capital intensive, cash flowing business. Revenue should go first to maintaining and stabilizing the properties, using the remaining cash for priority outlays such as debt service, general & administrative expenses, and dividends to shareholders. Only then can REITs allocate any excess capital, or 'free cash flow', toward external growth, paying down debt, buying back stock, or increasing dividends. If there isn't enough free cash flow for external growth, the company will have to tap the capital markets to raise equity or debt (or both). Ultimately, each company needs to have a capital allocation plan that is clearly communicated to investors, and then followed to minimize negative surprises.

Figure 1: Capital Allocation Tree for Free Cash Flow



Source: Chilton Capital Management LLC

Figure 2: Capital Allocation Tree for Tapping the Capital Markets



Source: Chilton Capital Management LLC

Of course, the capital allocation decision is not that simple. Several factors including cost of capital, capital availability, asset pricing, rental

rate trends, and whether a company is trading at a premium or discount to NAV should influence the final decision. Figures 1 and 2 are simplified sample decision trees for capital allocation of both free cash flow and net proceeds from financing. In the sample capital allocation plan, for example, only REITs that are trading at a premium to NAV and have taken care of their balance sheet should consider external growth, assuming accretive opportunities are available.

Cost of Capital
Before a company can determine if a project is accretive, it must know its cost of capital. Surprisingly, many REITs fail to grasp the true cost of equity. Many fall into the trap of using the dividend yield or the FFO yield (Funds from Operations/Total Enterprise Value) on the stock. However, the cost of equity is equal to the expected return that investors require over the long term. The cost of debt is the estimated coupon rate the company could achieve on a debt offering with a maturity equal to the weighted average maturity of its liabilities. The blended cost of capital is equal to the weighted average cost using the company's composition of debt and equity. In general, the cost of equity is higher than the cost of debt. As such, it is tempting for companies to use excess leverage to lower the cost of capital, thereby justifying external growth.

Dangerous Accounting
IRR, or Internal Rate of Return, is a measure of the annualized expected return on an investment taking into account upfront costs (purchase price), annual cash flows (rental income minus operating expenses), and terminal value (sale price). A company should not pursue a project unless the projected *unlevered* IRR is higher than its cost of capital. Investors need to be wary of quotes of 'cash on cash' or 'return on equity' IRRs, which are able to be juiced with higher leverage. Projected IRRs should also be scrutinized for aggressive rent assumptions or lower exit cap rates. Finally, maintenance capital expenditure (capex) projections can be underestimated in order to produce an unrealistic IRR. For example, many private apartment owners quote annual maintenance capex of $300 to $400 per unit, regardless of age, while actual data from REIT filings suggest it is actually much higher. In contrast, apartment REIT Camden Property Trust (NYSE: CPT) assumes $1,000 to $1,500 on *brand new* apartments, and as high as $2,000 per unit for older properties. Over the past 20 years, high quality REIT management teams have learned to continually reinvest in their properties to consistently grow NOI (Net Operating Income) and avoid obsolescence.

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Development vs. Redevelopment
The rule of thumb for pursuit of a development project is a 150 to 250 basis point (bp) premium in yield compared to expected cap rate if it was sold. Ideally, the higher yield upon stabilization compensates the developer for the risks inherent with construction, including entitlement, lease-up, and costs; it also builds in a profit margin that can translate into growth in NAV. Again, CPT is conservative in its development assumptions by using untrended yields, meaning the projected yield assumes rents are equal to today's market rents. AvalonBay (NYSE: AVB), one of the leading apartment REITs, also stands out for its superb track record on value creation year after year. AVB estimates that development from 2011 to 2014 contributed $22 per share to the company's NAV.

Another popular use of capital is the redevelopment of existing assets. Redevelopment includes all 'revenue-enhancing' activities. Examples of redevelopment include, but are not limited to, adding square footage, new signage or exterior fascia, and installation of energy-saving applications. Redevelopment can occur at a property that already has cash flow and is in the operating portfolio, or it can apply to a recent 'value-add' acquisition. For example, CPT can install new granite counters, stainless steel appliances, fresh cabinets, and a newly tiled bathroom for $10,000 per unit. According to CFO Alex Jessett, CPT can do the redevelopment when a tenant moves out, creating only seven days of added downtime between tenants. In return, CPT can charge rent that is $100 higher per month on the redeveloped unit, which would generate an unlevered yield of 12% ($1,200 per year divided by $10,000 investment). As such, redevelopment is less risky and capital intensive than ground up, but typically produces higher yields.

M&A

The most important factor that would encourage a company to make an acquisition of another company is for the transaction to be NAV-accretive *while maintaining the same leverage*. Similar to increasing debt levels for private acquisitions or development projects, a deal can be accretive to NAV assuming higher leverage, but actually be dilutive if the company wants to maintain the same leverage as before the deal. As such, planned equity issuances should be included in the projections, which would necessitate that the acquirer be trading at a premium to current NAV.

The decision to sell the entire company to either a private or public owner should be based on the prospects for creating the highest total returns for shareholders. If the company believes its ability to consistently create value going forward is no longer predictable, and an offer is on the table that gives credit for current portfolio value plus future growth, then a sale should be pursued. In 2005-2007, many REITs were trading at record high premiums to NAV, which is normally a sign to grow the company, not to sell out. However, an astute REIT CEO or board of directors could have determined that external growth IRRs above their cost of capital were nearly impossible to achieve without increasing leverage using low cost short term debt.

Homage to 2005-2007 Sell-Outs

The 2005-2007 'sell-outs' (Equity Office Properties, Crescent, Arden, and Archstone to name a few) were absolutely correct to sell their companies. Shareholders were rewarded with pricing at all time highs, not knowing that the 'future growth' for which they received a premium would turn out to be highly negative in 2008, and only 35% of REITs would have recovered to peak prices as of December 31, 2014 (according to Green Street Advisors). Though out of a job, many of the management teams that sold out gained notoriety for their capital allocation. As a result, some of them were able to bring a new company public, or even tap the capital markets on reputation alone in what is called a 'blind pool' IPO.

While we will never know which companies turned down takeover offers at those peak prices, we do know which companies expanded their balance sheets with high risk developments and acquisitions at expensive prices and, in most cases, with too much leverage. The most extreme example was General Growth Properties (NYSE: GGP), which was forced to declare the largest real estate bankruptcy in history due to liquidity issues caused by too much short term debt. Fortunately, GGP has come back strong and is one of the leading owners of malls and street retail.

Change in the Debt Cost of Capital in 2015

As we predicted in the January 2015 REIT Outlook titled "US is the Best, or at Least Better than the Rest", quantitative easing by non-US central banks has driven the US Dollar up and global sovereign yields down. Much of this was due to fears surrounding global economic growth as large institutions, such as the World Bank and the International Monetary Fund, reduced their growth estimates for most major economies including China, the European Union (EU), and Japan. In contrast, the US growth projection was increased.

As growth assumptions have adjusted, global debt yields have compressed, pulling down US Treasury yields as well. This is likely to continue as central banks continue easing, placing pressure on sovereign yields and currency exchange rates. For example, the recent announcement of quantitative easing in the EU has reduced the USD/EUR exchange rate close to all-time lows. The flight to safety and growth in the US has driven down the 10 year Treasury yield to 1.7% as of January 30, from 2.2% on December 31, 2014. The lower cost of debt has caused a change in the cost of capital advantage between public and private real estate entities.

Today's Capital Allocation Environment

Today, most well-capitalized companies are trading at a premium to NAV, which means they should pursue external growth provided they adhere to the aforementioned exercise on projected yields versus cost of capital. However, private owners now have a cost of capital advantage for acquisitions due to the blended cost of capital that is significantly lower. We constantly see private players using 70% debt ratios, which are double that of the average public equity REIT. As such, acquisitions are generally not accretive for REITs today.

Accordingly, we favor REITs with prudent levels of development and redevelopment, as they both provide attractive growth opportunities today. We define 'prudent' as limiting to development to 15% of gross assets. We expect that M&A will be a theme as many REITs are trading at a premium to NAV and are not able to compete with private players in the private acquisition markets. If the cost of capital gap is

wide enough, we may witness privatizations of public companies that are trading at a discount to NAV. In 2014, Houston-based AmREIT (NYSE: AMRE) was trading at a steep discount to NAV before deciding to sell the company to a private bidder at a healthy premium to NAV, creating value for shareholders that would have taken years to materialize.

Prologis (NYSE: PLD) was one of the first REITs to report 4Q2014 earnings and issue 2015 guidance numbers. Though the company does not have a particularly stellar capital allocation track record, we can determine if their capital allocation plan is being executed correctly. As shown in Figure 3, PLD is trading at a premium as of January 27, 2015, and has plans to pursue external growth in 2015. Both the acquisition yield and development yield are above the company's cost of capital, and the spread between stabilized development yields and cap rates is at low end of a 150-250 bps range. However, PLD has not reached its balance sheet targets. As such, PLD will be creating value by pursuing external growth, but it should also consider paying down debt.

Figure 3: Prologis Example

Price as of 1/27/2015	**$47.13**
1Q15 NAV/Share Consensus*	**$42.54**
NAV Premium	**10.8%**
Target Net Debt to EBITDA	**6.0x**
Target Leverage Ratio	**30.0%**
4Q2014 Debt to Adjusted EBITDA	**6.8x**
4Q2014 Leverage Ratio	**32.4%**
Cost of Equity (1)	**6.5%**
Cost of Debt (2)	**2.7%**
Wtd. Avg. Cost of Capital	**5.3%**
2014 Development Yield	**7.7%**
2014 Wtd Avg. Cap Rate on Development	**6.2%**
Development Spread	**150 bps**
2014 Wtd Avg. Cap Rate on Acquisitions	**6.4%**
2015 Development Stabilizations	**$1.7-1.9 billion**
2015 Acquisitions Guidance	**$1-1.5 billion**

Source: Source: 4Q14 Company Documents
*Uses avg of BAML, Citi, Keybanc, ISI, Green Street Advisors, UBS, and Stifel Nicolas
(1) Chilton's required return for Core-classified REITs(2) Approximate Yield to Maturity for PLD Bonds due 2020, based on PLD's 5.5 yr wtd avg maturity as of 1/27/15

Premier Allocators Create Top Notch Returns

The Chilton target price methodology for REITs includes a subjective line item called 'management track record', which ascribes a premium or discount based on historical decisions by the management team. We believe that management teams who have a history of both creating value and avoiding value destruction deserve to trade at a premium to its peers. Conversely, companies that have an issue of running into trouble due to poor decisions should trade at a discount. For example, we ascribe PLD a 0% premium to their NAV as a result of their questionable merger with AMB Property Group and a large land bank amassed at peak pricing, driving leverage well above the current targets.

Except for 'junk rallies' and short term mispricing of risk, our REIT composite has consistently outperformed the benchmark and of course passive index-based strategies that are forced to include many poor capital allocators. As real estate is a long term asset, we believe our methodology will continue to beat the benchmark over long term periods.

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

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

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

Blane T. Cheatham
bcheatham@chiltoncapital.com
(713) 243-3266

RMS: 1826 (1.31.2015) vs. 1710 (12.31.2014) vs. 346 (3.6.2009) and 1330 (2.7.2007)

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