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

The 2016 Chilton REIT Forecast | February 2016

2015 Review
Prior to the start of 2015, REIT investors would have been optimistic on 2015 total returns if they knew the economy would add an estimated 2.7 million jobs and that the 10 year US Treasury yield would be only ten basis points higher on December 31, 2015 than December 31, 2014, even after a Fed rate hike. Remarkably, the price-only MSCI US REIT Index (RMZ) was 1.5% lower on December 31, 2015. Thus, after factoring in estimated cash flow growth, as measured by Adjusted Funds from Operations (or AFFO), of 9.5% and 6.6% (according to Citi Research) in 2015 and 2016, REIT 1 year forward AFFO multiples were 18.6x as of December 31, 2015, which compares to 20.0x as of December 31, 2014.

The decline in AFFO multiples should be surprising considering that real estate prices actually increased by 10% for the year according to Green Street Advisors, a commercial real estate research firm. The capital markets were healthy as there were ten announced transactions of entire REITs, including three that were purchased by private equity giant Blackstone (NYSE: BX). The REITs that did not get acquired returned more cash to shareholders in the form of higher dividends and initiation/fulfillment of stock buyback programs, while maintaining flexible balance sheets and free cash flow. On average, REITs bumped their dividends by 10% (as estimated by Citi), and yet payout ratios remained at a historically low 72%, as measured by dividends/Adjusted Funds from Operations (AFFO). REITs achieved an average debt maturity of 5.4 years as of September 30, 2015, and debt ratios remain similar to last year.

Then what was the driver of negative REIT returns (before dividends) last year? Answer: Fund flows. Totaling $6.2 billion, domestic REIT mutual funds and ETFs had net outflows for the first time since 2007. In our conversations with prospects, we hear a variety of reasons for the negative sentiment. Namely, REITs: 1) are up so much since 2009, and look expensive; 2) use substantial leverage, which means they are risky; 3) will underperform when interest rates go up; and 4) must be at cyclical peak or bubble because they and other commercial real estate owners are selling properties. These risks are worthy of a response. However, we believe all of them are already discounted in current stock prices. Even assuming some of these risks materialize, we believe a bear case would result in total returns of +6-8% for 2016. Using conservative assumptions, our base case is for total returns in the +10-12% range for 2016.

What Goes Up Must Come Down?
As measured by the RMS, REITs have produced a total return of 381% from the bottom of the market on March 6, 2009 to January 22, 2016. The price-only index (RMZ), the relevant metric for valuation, is up 262% over the same period, equivalent to 21% on an annualized basis. We would concede that a 21% annualized increase in REIT prices is more than what someone would expect over a normal 7-year period, which is equal to the length of the prior cycle.

We also would concede that REIT prices increased by more than the values of their underlying properties. As measured by Green Street Advisors, the commercial real estate owned by REITs has increased by 100% from March 31, 2009 to December 31, 2015. Assuming an average leverage of 40% for the holding period, this would imply a 167% increase in REIT prices.

However, using March 6, 2009 as the starting point for performance measurement is a bit unfair given that REITs - in the midst of the great recession - were trading at a historic discount to the value of their underlying properties (called Net Asset Value, or NAV) mostly due to fears that broad systemic risks could result in REIT bankruptcies. From January 31, 2007 to March 31, 2009, the Green Street

Commercial Property Price Index fell by 33%, or 55% assuming 40% leverage, while the RMZ fell by 72%. This led public REITs to trade at a 40% discount to the value of their underlying properties on March 31, 2009.

Impressively, REITs responded decisively to the collapse in share prices, cutting dividends to bring down payout ratios and raising equity (albeit dilutive) to enhance balance sheet flexibility. Fast forward to today, and REITs are armed with the lowest payout ratios and best balance sheets in history. They have benefited immensely from the subsequent and sharp increase in property values post recession, but they also have actively improved the quality of their portfolios through new development, redevelopment of existing properties, and asset recycling. The most common asset recycling strategies included selling older properties, eliminating assets more susceptible to obsolescence, and addressing millennials' preferences such as adding more urban and/or transit oriented locations with plenty of amenities. Today, REITs can say comfortably that they have the best portfolios in their history.

As a result of the portfolio activity and the rise in property values, NAVs have grown dramatically, and yet REITs were still trading at a 12% discount to NAV as of January 22, 2016 according to Bank of America Merrill Lynch. Going forward, we see significant room for NAV growth as current projects in the development pipeline are stabilized and existing properties demonstrate increased Net Operating Income (NOI) due to high occupancy rates and rent growth.

Debt-Do's and Debt Don'ts

Leverage and real estate have always gone hand-in-hand. Most Americans have a mortgage on their homes, and most commercial real estate is also leveraged, either at the property level (secured) or owner level (unsecured). As such, the average debt/gross asset value (D/GAV) ratio for REITs was 34% as of September 30, 2015, and the average Debt/EBITDA (D/EBITDA) ratio was 5.8x, according to Green Street Advisors. In comparison, the average D/GAV ratio for the S&P 500 was 25% and average D/EBITDA was 2.0x as of the same date. However, does a higher leverage ratio alone lead to the conclusion that REITs are more risky than traditional stocks?

The reality is that leverage alone is not a 'risk'…the risks lie within the amount, type (secured vs unsecured, recourse vs non-recourse, fixed vs floating), maturity schedule, and the ability to make interest/principal payments. In general, investors should feel more comfortable with leveraged real estate than leveraged 'widgets' due to its high terminal value and relatively predictable cash flows, which allows for higher availability and cheaper cost financing than for the average widget company. Importantly, the risks associated with leverage diminish with a portfolio of properties that allow REITs to be protected by hundreds, if not thousands, of leases with a multitude of tenants across virtually all sectors of the economy.

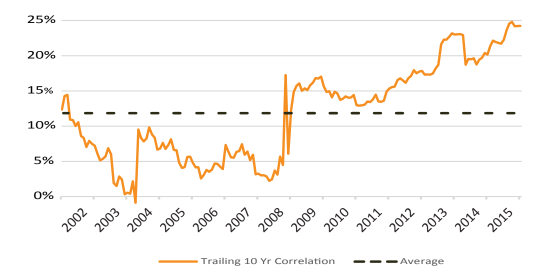
Thankfully, most REITs have embraced low leverage ratios and laddered maturity schedules. Together, the steps taken to lower the leverage profile of REITs have significantly lowered business and financial risk. As of December 31, 2008, the average REIT D/EBITDA was 8.3x and the average D/GAV was 54%, which compares to 5.8x and 34% as of September 30, 2015. In addition, the weighted average maturity of REIT debt was 5.4 years. This low leverage should give REITs a 'first mover' advantage if there is dislocation in the capital markets like we witnessed in 2008-2009.

No Interest in REITs during Rising Rates?

No doubt that many of the sellers of REITs in 2015 were doing so to get out of the way of a potential Fed rate hike. As we predicted in this very publication, the Fed's rate hike did not move long term interest rates upwards. In fact, long term rates fell, and REITs soared over 2% in the week following the rate hike. Even so, as of January 28, the REIT dividend yield stood at 4.3%, which compared to the 10 year US Treasury yield of 2.0%. The implied spread of 230 basis points (bps) compares to a historical average spread of 110 bps, indicating that long term interest rates could rise 120 bps and REIT prices would only be inline with the historical average assuming no change in REIT prices.

To provide further credence to our argument that REITs can handle a scenario of increased interest rates, we use a stress test that employs a 10 year US Treasury yield of 4% at the end of 3 years. In addition, our models project that REITs will increase dividends by an average of 5% annually over this period (dividend growth could be much higher if payout ratios increase back to historical averages). Even assuming REITs maintain the current historically low payout ratios, we project a 5% annualized total return over a 3 year period assuming the REIT dividend yield is at the historical average 110 bps premium to the 10 year US Treasury yield, or 5.1% (4%+1.1%). Another statistic that should comfort investors that are worried about REITs during times of rising rates: the correlation between REITs and fixed income (as measured by the Barclays Aggregate Bond Index) is extremely low, as shown in **Figure 1**.

Figure 1: REIT Correlation with Fixed Income



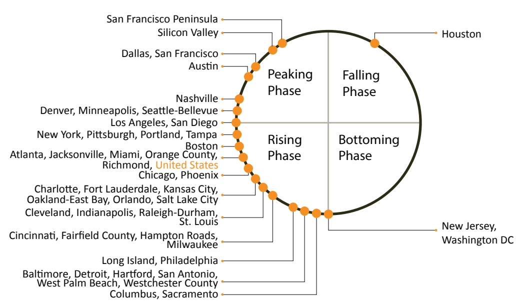
Source: Bloomberg, Chilton Capital Management LLC. Data from January 1992-December 2015. REIT performance represented by NAREIT All Equity REITs Index. Fixed income represented by Barclays Aggregate Bond Index.

To the extent interest rates rise, it would take years before it would have a noticeable effect on the earnings growth of REITs due to the high weighted average maturity and low debt ratios today. Also, with a weighted average interest rate of 4.7% on REIT debt maturing in 2016 and 2017, REITs are still enjoying lower rates upon refinancing with blended debt costs currently around 4%.

If REITs are Selling, Why Buy?

REITs were net sellers (including privatizations) in 2015 for the first time since 2007, a year that brings with it memories of a cyclical peak before a violent crash. The reality is that every cycle is different, and REITs are built for changes in real estate prices due to their nature as 'infinite life' investment vehicles. Asset recycling from mature properties or slower growth markets into properties with potential for higher growth is something that REITs are doing throughout the cycle. The lack of acquisitions and increase in dispositions and privatizations should not be looked at in a negative light. Instead, investors should be applauding REITs that have been disciplined in their capital allocation, focusing on maintaining low leverage and growing NAV instead of attempting to increase earnings through higher leverage.

Figure 2: US Office Real Estate Cycle



Source: JLL Research. As of 4Q 2015

As shown in **Figure 2**, commercial real estate around the country (in this case, office) does not move through the cycle in tandem. This chart would look different for each property type, which is just another tool that management teams can use in their capital allocation. REITs have used the economic diversification of the country to their advantage by creating portfolios that will ensure the existence and profitability of the company in almost any economic environment. This diversification enables REITs to recycle proceeds from sales in markets that are deemed 'expensive' into markets that may be undervalued.

Furthermore, as an active manager of a portfolio of REITs, we have the ability to change exposures based on geographies, strategies, or property types that may be at different points in the cycle.

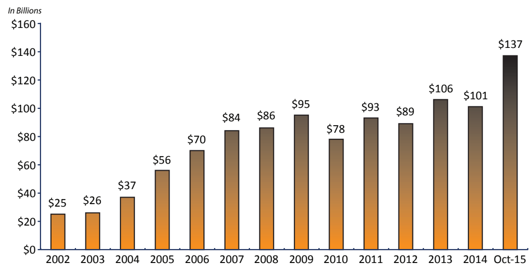
Is +6-8% Bear-able?

As of January 22, 2016, REITs were trading at a 12% discount to NAV, implying that either REITs are 12% undervalued or private real estate is 9% overvalued (assuming 30% leverage). Even if the pricing of public REITs proves to be a predictor of a fall in the values of private real estate, REITs would be able to produce a total return of +6-8% assuming they trade at a 1% premium to NAV by the end of the year.

We have long postulated that we are in an elongated real estate cycle that is attributable to many key factors. Coming out of the great recession, a more disciplined development cycle emerged where most players have embraced a greater aversion to risk. This coupled with tougher lending standards, higher labor costs, and the transparency of commercial real estate fundamentals has resulted in dampening new supply in virtually all property sectors. Our conservative base case assumes public and private real estate pricing meet somewhere in the middle, which we believe would produce a total return in the range of +10-12%.

If there is no move in private cap rates, we would expect to see an acceleration of REIT M&A, which could prove to be a catalyst in closing the discount to NAV at which REITs are trading. In fact, as of October 2015, private equity funds had $137 billion in cash available for investment into US commercial real estate, an all-time record (see **Figure 3**). Additionally, increased foreign investment in US public REITs and commercial real estate thanks to FIRPTA (Foreign Investment in Real Property Tax Act) reform should provide support to current cap rates, while the separation of Equity REITs from Financials in the GICS

Figure 3: Total Dry Powder Available for Real Estate Investment



Source: Prequin, HFF

classification system should bring more attention to the often underweighted asset class of Equity REITs. In a best case scenario where cap rates remain firm and the above catalysts bring REITs to trade inline with their current NAVs, we would project total returns to be between +16% and +18%. Regardless of the moves of the entire REIT market, we believe we have assembled a portfolio of REITs that give our clients the best chance of producing total returns above the benchmark, while taking less risk.

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

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

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

RMS: 1695 (1.31.2016) vs. 1753 (12.31.2015) vs. 346 (3.6.2009) and 1330 (2.7.2007)

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