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Apartment REITs: The Right Places at the Right Time | March 2015

The apartment REIT sector was the top performing major property type in the FTSE NAREIT U.S. Real Estate Index Series in 2014 with a total return of 39.6% versus 30.1% for the benchmark (Bloomberg: FNER Index). After finishing toward the bottom of the pack in 2013 on the heels of oversupply fears, sentiment shifted in 2014 as investors began to appreciate the cultural shift in demand and reacceleration in fundamentals occurring in the cities that dominate REIT portfolios. Management teams of our core apartment holdings have proven that they are excellent property managers and have strategically positioned the portfolios to consistently outperform the national average.

A Cultural Shift toward Renting

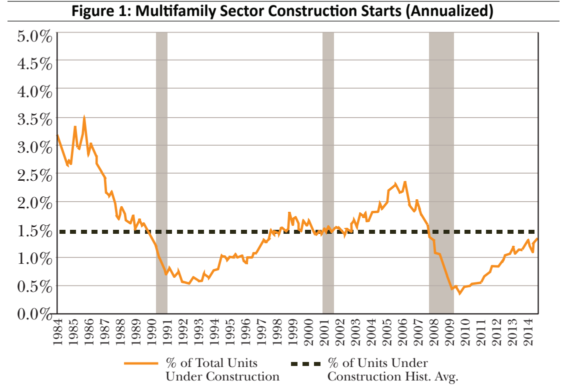
There has been a cultural shift towards renting in the United States since the Great Recession in 2008. A recent report by the NYU Furman Center found that only five of the nation's eleven largest cities were majority renter in 2006. By 2013, the total had increased to nine, and all but New York City and Atlanta experienced double digit growth in renters. The nation as a whole appears to be showing the same trend as the national homeownership rate declined to 64% in the fourth quarter of 2014, its lowest mark since 1994 and a 380 basis point decline from 2008.

Millennials, defined as individuals born between 1981 and 2000, are primarily responsible for the shift toward renting. Employment for younger adults has recently reaccelerated, and the number of young adults living at home has declined for the first time in seven years. With job growth expected to continue, the pent-up rental demand of 2.1 million young adults living at home should trigger further acceleration in demand, leading to rental rate growth despite elevated new supply.

Keeping Supply in Context

2014 was a watershed year in which demand outpaced new supply by 50,000 units, thereby increasing occupancy and supporting rent growth that averaged 3.8%. In 2015, the market will experience the influx of 350,000 new units, albeit well above recent years, but well below the 30 year average (Figure 1). However, we believe that demand from job and population growth should spur growth in household formations sufficient to absorb the new supply. In fact, our analysis concludes that new supply would have to be over 350,000 units per year for the next five years to keep up with demand. The chart also shows that we are in our eighth year of below average new supply, which hasn't happened since the early 1990's.

Figure 1: Multifamily Sector Construction Starts (Annualized)

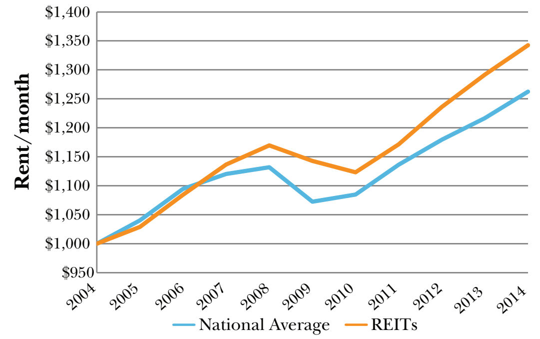


Source: CBRE and Citi Research, as of 2/20/2015.

The Strength of REIT Management

In the current cycle, apartment REITs have been able to produce significantly higher rent growth than the national averages, as seen in Figure 2. Much of the outperformance can be attributed to geographic locations of REIT portfolios, which tend to cluster in the major gateway cities. Another advantage of REITs is their economies of scale, which allows for operating efficiencies, bargaining power for expense items, and complex rental rate pricing

Figure 2: Historical Rent Growth



Source: Year end 2004 was used as the base year to represent growth over a full cycle.
National Apartment data is represented by Axiometrics' derived effective rent growth.
REIT data is represented by an equal weighting of results from AEC, AIV, AVB, CPT, EQR, ESS, HME, MAA, PPS, and UDR (ASN, BRE, and CLP, which were acquired by the companies above, were also included for time periods that they were publicly traded) found in company financials. As of 12/31/2014.

systems. The apartment REITs have been leaders in developing and advancing revenue management systems that strategically and efficiently balance rent increases and occupancy. In this report, we examine five cities which account for approximately half of our apartment REIT exposure: Los Angeles, New York City, San Francisco, Seattle, and Washington, D.C. Figure 3 shows Chilton's core apartment REIT exposure to the top five markets.

Figure 3: Apartment Units in Chilton Capital's Top 5 Markets

Core Apartment REITs Owned by Chilton	Los Angeles	New York City	San Francisco	Seattle	Washington, D.C.	Total Portfolio	Top 5 Markets as % of Total Portfolio
AvalonBay	11,657	10,433	3,702	4,525	14,902	82,487	54.8%
Camden	3,071	0	0	0	6,129	55,885	16.5%
Essex	14,171	0	16,264	12,174	0	50,645	84.1%
UDR	1,566	2,657	3,198	2,640	6,030	51,293	31.4%

Source: Company documents. Units include JV assets and assets in develoment. As of 12/31/2014.

San Francisco

San Francisco, along with the rest of the Bay Area, has been one of the strongest apartment markets in the nation. According to research by Socketsite, a website dedicated to San Francisco real estate, about 7,500 units have been delivered into the market since 2010, while employed residents grew by 74,000. In fact, in September 2014, San Francisco passed NYC for the highest rent level of the 25 largest U.S. metro markets at $3,392/month as a result of the recent supply/demand imbalance.

One of the most visible signs of the changing environment in San Francisco is the SoMa submarket. The "South of Market Street" submarket is bordered by Market Street to the North, Highway 101 to the East, and 16th Street to the South. Though it is currently a highly desirable place to live, work, and play, this was not always the case. Warehouses and industrial facilities characterized the area until a growth of jobs in the technology sector began a renaissance, converting shuttered buildings into "modern" office space preferred by younger workers. The neighborhood is located in one of the most accessible parts of San Francisco, provides quick transportation to the Financial District, and cities comprising Silicon Valley. It is also home to the San Francisco Giants.

Essex Property Trust (NYSE: ESS) owns Mosso, a 463 unit project, on the corner of 5th and Folsom. The property, which boasts a 98/100 Walk Score and is near the headquarters of Twitter (NYSE: TWTR), Zynga (NASDAQ: ZNGA), Foursquare, Yelp (NYSE: YELP), Yahoo (NASDAQ: YHOO), Square, and Box (NYSE: BOX), should benefit from a unique mixed-use redevelopment project by Forest City (NYSE: FCE.A) that is in the permitting stage. The project, called "5M" (for 5th and Mission), is only a block from Mosso and will comprise over one million square feet of office space, 150,000 square feet of retail, and 34,000 square feet of publicly accessible park space. Current rents for Mosso range from $3,045-$7,242/month for a unit. By our estimates using today's stabilized cap rates, Essex has created over $150 million in accretive value through the Mosso development, by our estimates.

Los Angeles

The Los Angeles apartment market has been slower to recover than San Francisco and Seattle, but certain submarkets are beginning to show strength that could rival its West Coast peers. L.A. has recovered all jobs lost from the recession, and experts project that job growth will remain robust. For 2015, job growth is estimated to reach 84,000 in the metro area, which compares to projected new supply of 10,000 multifamily units. The emergence of "Silicon Beach", the revitalization of Downtown, and LA Metro (light rail) expansion plans have contributed to the positive forecast for L.A.

Silicon Beach, a four mile stretch from Santa Monica to Venice, has become the heart of Los Angeles' fast growing tech scene. Some 800 startups in the area have attracted $1.3 billion in venture capital since 2011. Companies like Whisper and Snapchat can be found in Silicon Beach, and even large companies like Google (NASDAQ: GOOG) and Facebook (NASDAQ: FB) have set up shop in the area.

Downtown L.A. is currently experiencing a revitalization of sorts. Gone are the days when downtown would look like a ghost town after 5pm and on the weekends. Since 2011, over $7 billion has been put toward construction of the retail space, restaurants, and residential units, making it a coveted place to live, work, and play.

The LA Metro has plans to link these two business hubs, as well as others, with plans of five new subway/light rail extensions. Two expansions of note are Santa Monica and mid-Wilshire which are expected to see stations open in early 2016 and 2023, respectively. The expanding rail lines provide an opportunity for REITs to take advantage of Transit-Oriented Developments (TODs)—developments that are located near public transportation hubs. Successful TODs provide a greater sense of community and allow the resident to have a more convenient, affordable, and active lifestyle. As a result of the demand created by these types of assets, the Urban Land Institute has ranked locations near transit as a best bet for investors five years in a row. Essex and AvalonBay (NYSE: AVB) are just a few of the REITs that have existing assets and/or development sites along the projected routes which should see an increase in demand (and rents!) due to the ease of access to public transportation.

Seattle
Seattle has been one of the strongest metros for apartments over the past few years. Despite significant new supply, rents have risen about 18% over the past two years and are expected to rise another 7.5% in 2015 according to real estate research firm Pierce-Eislen. Seattle is mostly known for its two largest employers, Boeing (NYSE: BA) and Microsoft (NASDAQ: MSFT).

However, the city has recently been a hotbed for rapidly expanding tech companies. In mid-February, Facebook signed a 275,000 square foot lease for a majority of the recently completed Dexter Station in the South Lake Union neighborhood of Seattle. The lease would directly create demand for about 550 units in the area, as it is expected to bring 2,000 jobs to the market. Amazon's (NASDAQ: AMZN) growing campus, is also located in the South Lake Union neighborhood. In addition, Oracle (NYSE: ORCL), Alibaba (NYSE: BABA), Apple (NASDAQ: AAPL), Dropbox, Sears (NYSE: SHLD), and HP (NYSE: HPQ) have announced engineering centers in Seattle within the recent months.

Just a few blocks away from Amazon's eleven-building campus sits The Cairns, an apartment complex owned by Essex. Besides a great location, The Cairns provides tenants with some other unique amenities. The ground floor is home to the Cascade Specialty Market, a local grocery store, and Feierabend, a German pub featuring a full menu of German cuisine and beers. Monthly rent for The Cairns currently ranges from $2,332 to $2,747 per unit.

Washington D.C.
During the recession, Washington D.C. was recognized for its economic stability, thanks to job growth in government and related sectors. After the downturn, the metro expanded rapidly, leading to an influx of millennials and resulted in a building spree to keep up with demand. Elevated levels of supply didn't become an issue until demand was suddenly hindered by the sequestration budget cuts in 2013. Consequently, rent growth was negative for the year. However, the D.C. economy is starting to warm up as employment is expected to increase by 1.6% in 2015, and more than 17,000 units are expected to be absorbed as annual new supply finally reaches its cyclical peak. According to Axiometrics, the slowing supply growth and positive job outlook should lead to rent growth above 2% for the metro in the coming year, much higher than the flat growth seen in 2014.

The 14th Street strip from Rhode Island Avenue to Florida Avenue has been a benefactor of the rush of millennials into the D.C. Metro. The area, about two miles north of the National Mall and near two Metrorail stations, has been undergoing redevelopment for years. 14th Street, which used to be known for prostitutes and drug dealers, is rapidly gentrifying and is now known for its bars, boutiques, galleries, and restaurants. In a nine month period between 2012 and 2013, 24 new restaurants opened up on 14th. The retail market is also adapting to the growth, as the corridor is transitioning from food-based tenants to merchandisers.

The growth of the area gained the attention of UDR (NYSE: UDR) who, in 2011, purchased View 14, a 255 unit project at the north end of the strip. The complex features two rooftop terraces, a 24/7 concierge, and 16,000 feet of retail to serve its residents. Current rental rates range from $2,233/month for a one bedroom/one bath to $9,139/month for a two bedroom/two bath!

New York City
The New York City metro added over 100,000 jobs in 2014. However, the growth has been more balanced across industries than in past expansions. During the 1990's, the securities industry accounted for more than 10% of all private sector jobs added; since the Great Recession, it has only accounted for about 1%.

The Technology, Advertising, Media, and Information sectors (or TAMI) have been picking up the slack. The growth in TAMI has created additional demand for apartments as young renters who had previously been priced out are now entering the market. Due to the stable job outlook, landlords are expecting to push rents up 3% in 2015 despite an additional 17,900 units being delivered, according to Axiometrics.

The NYC apartment market has been the poster child for affordable housing programs since 1943 (formally). The need for programs arose due to rent profiteering that was occurring as a result of housing shortages in the city. Today, the programs are in place to keep neighborhoods stable and to allow for people of all statuses to afford living in the city. The most popular form of rent control in NYC is rent stabilization, which restricts the rent increases on privately-owned rent-stabilized apartments to levels set by the local rent board. There are approximately 1 million rent stabilized units in NYC today. Despite good intentions, rent control has made the rent levels on uncontrolled units skyrocket. First, it limits new supply in a market that already has a shortage, as investors prefer to allocate to industries with less governmental restrictions and red tape. Second, excess demand from controlled units floods into the already supply-constrained uncontrolled rental market, putting further upward pressure on rents. REITs and other existing landlords have found this a favorable environment. Affordable units provide predictable and stable rent increases, while the uncontrolled units get the benefit of limited supply. As of January 2015, the average rental rate for an apartment in NYC was $3,129.

Apartments in 2015 and Beyond

As the Millennial population continues to grow, we expect the cultural shifts to only get stronger. Their desire to live in urban areas, use public transportation, and enjoy a close proximity to amenities is altering the future of city planning and commercial real estate construction in cities all across America. Although the homeownership rate has not dropped below 63% since the census began tracking it in 1965, some experts predict that the homeownership rate could eventually dip below 60%.

Apartment REITs have positioned their portfolios to benefit from the shift underway in America's top economic and cultural cities. Though new supply is expected to be at above average levels in 2015, new supply in 2016 and 2017 will likely decelerate, while a strong job market and shifting demographics should help demand keep pace. As a result, we maintain our positive long term outlook for apartment REITs with impressive capital allocation track records, flexible balance sheets, targeted development programs, and desirable geographic locations.

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