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Quality Snobs: Recycling Capital into High Growth Markets
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The REIT roller coaster plunged back towards Earth in November, registering a -3.7% return for the month amid further concerns of the US government's inability to reduce the deficit and rising debt yields in Greece, Italy, and Spain. Year to date, the MSCI US REIT Index stands at +3.9%, while the S&P 500 is up 1.1%. In times like these, we as analysts have to take a step back and look at long term trends and business fundamentals to find the stocks with the best risk adjusted return and determine which management teams are on the forefront of creating shareholder value.

The 20th Anniversary of the Modern REIT Era
In the past 20 years, which has been deemed 'The Modern REIT Era', equity REITs have produced a compound total return of +11.0% annually for investors based upon the FTSE NAREIT All Equity REIT Index. In the comparable 20 year period ending November 30, 2011, few investment options and asset classes generated similar results, including the S&P 500 which produced an annual total return of +8.3%. What began as a vehicle for passive ownership of real estate in the years before 1991, eventually transformed into a more dynamic business model. Innovative management teams have demonstrated their ability to add value for shareholders in a variety of ways, many of which have been revolutionary for the real estate industry. Just a few examples of these are: the use of sophisticated revenue management systems, various internet applications for tenants or prospects, and a huge increase in the number of financing options available to REITs.

Kimco Realty (NYSE: KIM) came public in November 1991 in an IPO that became a watershed event for the REIT industry and equity REITs in particular by marking the start of 'The Modern REIT Era'. Prior to this time, the public markets could not compete with the low cost of capital provided by traditional private sources. It was often said that real estate was built to the availability of capital instead of demand! Excess equity flowing into the sector helped to create overbuilding, a typical characteristic of real estate cycles until the present time. That all started to change beginning with the Tax Reform Act of 1986. This act stripped favorable tax treatment from private investment (ex. 3 for 1 tax write-offs) and took with it a very valuable equity source. The decline in real estate values coupled with too much leverage then triggered the collapse of many banks and savings and loan institutions creating a serious credit crunch for the real estate industry. Real estate companies now needed a new equity source, or else they would face foreclosure by the lenders. The end result was that Wall Street could finally securitize commercial real estate on somewhat competitive terms. At the end of 1991, the market capitalization of all equity REITs was $9 billion. After Kimco, the market cap of the equity REITs exploded to $78 billion by 1996, and to a present day value of almost $400 billion. Now equity REITs possess some of the best management teams in the business and own 10-15% of the greatest real estate in the greatest places in the United States, and even expanding internationally.

Great Real Estate in Great Places
One of the themes we wrote about in 2010 was the value of owning "Great Real Estate in Great Places". For several months last year, we featured a different property type complete with fundamental analysis, relevant sector issues, and inherent risks. In the recent November 15-17 NAREIT "REIT World" Convention, we were able to have one-on-one meetings with the CEOs, CFOs, and COOs of eighteen of the REITs held in our client portfolios. Keeping an open dialogue with REIT management teams enables us to make an assessment on their optimism (or pessimism) on the market, address issues which they may not be willing to answer on official investor calls or meetings, and gain an insight into their philosophy on creating above average long term total returns for investors. At the top of the list for creating shareholder value is the decision to invest in new projects and divest of current projects. According to Ralph Block in his fourth edition of Investing in REITs, "Truly entrepreneurial management teams are always looking to improve investment returns, and sale and

reinvestment is a conservative and highly effective strategy." Called 'Capital Recycling', this strategy of selling mature properties to fund higher growth projects remains a common theme that is helping REITs be major beneficiaries of the current real estate cycle. Each company we met with is in the process of recycling capital into better real estate in better places. Accordingly, we have provided a summary of some new projects they are working on below.

UDR (NYSE: UDR) is a residential REIT with properties across the US that over the years has been selling off properties in "commodity" markets to focus on higher barrier locations. Prior to the NAREIT convention, management hosted a bus tour to showcase their recently developed Vitruvian Park multi-phase apartment community in Addison, a suburb north of Dallas. The company is in lease-up on Phase II of the Savoye, an incredible 347 unit project in terms of amenities and quality for residents, as well as value creation for UDR shareholders. The unique aspects of this site include the demolition of 1970's style apartments (120 acres, sufficient for 6,000-7,000 apartment units), and the construction of an adjacent public park funded by a $40 million contribution from the City of Addison. To help fund their portion of their committed $650 million for the project, UDR is selling suburban apartments assets in the Dallas area that could be more prone to competition. The stabilized yield for the final Savoye project will be in the 6.5% range but, especially after walking the property, we believe that it would easily sell at a cap rate below 5%. To give you an idea of the value creation from a transaction like that, selling a project with a 6.5% yield on $650 million at a 5% cap rate would produce proceeds of $871 million, a 34% increase over cost, unlevered. Using 40% debt, that investment would produce a return of 57%, plus the 6.5% annual yield.

Sovran Self Storage (NYSE: SSS) is a self storage REIT with properties down the east coast and in the southern US. SSS recently purchased twenty-two self storage facilities in Houston (18), Austin (3) and Dallas (1) for $111 million. The portfolio has an average age of 8 years, and all are considered class A properties. In conjunction with the purchase, SSS has put thirteen storage facilities up for sale with an average age of 24 years in less desirable locations.

Hersha Hospitality Trust (NYSE: HT) is a lodging REIT with limited service hotels concentrated in the Northeast, principally New York City and Washington DC. In the third quarter this year, HT sold eighteen non-core properties to Starwood Capital for $155 million. The Average Daily Rate (ADR) for these hotels was $109 in 3Q 2011. HT also made two acquisitions in two new markets for them: Los Angeles and Miami. Both are considered important "gateway cities" with superior growth prospects. The CFO highlighted the recent purchase of the 263 room Courtyard Miami Beach Oceanfront and an adjacent beachfront land parcel for $95 million, which has an ADR close to $180. In LA, HT purchased the 260 room Marriott Courtyard Westside in Los Angeles (Culver City), CA for $47.5 million, which has an ADR around $125.

Eastgroup Properties (NYSE: EGP) is an industrial REIT with properties across the US. We met with the CEO and CFO, who featured EGP's recent acquisition of 133 acres of land in Houston adjacent to its largest industrial park, a 2.3 million square foot park called World Houston. EGP purchased the property for $10 million and now has enough land to add an additional 1.6 million square feet to the park over the next several years. Including infrastructure improvements, EGP will be competitive with a land cost of about $3.45 per square foot. Target yields are in the 8.25-8.75% range.

American Assets Trust (NYSE: AAT) is a diversified REIT with apartment, retail, and office assets located mostly on the west coast and Hawaii. The CEO, CFO, and Chairman of the Board outlined AAT's plans for the Lloyd District Portfolio in downtown Portland, Oregon that it acquired for $92 million earlier this year. AAT owns four super blocks (16 regular city blocks) that include both income producing assets (six office buildings that are 90.5% leased as of September 30, 2011) and the potential for development (a FAR ratio of 12:1) over an extended period of time. A new light rail line into the Lloyd District should enhance the appeal of this location for both office tenants and new multifamily projects in the years to come. Planners envision a high density, transit oriented urban village of about

1.5 million square feet. The current yield on this asset is in the 8% range, but AAT is targeting a 12% yield after development. AAT came public early in 2011 with very low debt leverage and it used proceeds from its initial public offering to fund this acquisition.

BRE Properties (NYSE: BRE) is a residential REIT with apartments entirely on the west coast. As repeated to us by the CEO and CFO, BRE has ramped its apartment development pipeline to $1.3 billion in new projects, all focused on "infill" sites in the San Francisco Bay area and the Los Angeles area. As of September 30, 2011, the total investment in operating properties stood at $3.7 billion (historical cost), making BRE's development exposure one of the highest among public REITs. We believe this will provide a significant enhancement to the portfolio and increase shareholder value. At the same time, the company is selling out of assets in the Inland Empire, an area East of Los Angeles more prone to excess supply. We are seeing multiple examples of apartment REITs capitalizing on the urbanization trends that characterize property markets in most major cities, most notably New York and San Francisco. Even Houston and Dallas have experienced similar trends, albeit on a smaller scale.

Simon Property Group (NYSE: SPG) is the largest mall owner in the US. The CFO and COO spent a great deal of time discussing its views on the outlet business and how they believe SPG can take this property type into many global markets. SPG currently has Premium Outlets open in Japan, Mexico, and South Korea, while construction is currently underway on an outlet in Malaysia. In addition, closer to home opportunities appear to be substantial with the redevelopment of existing malls and separately, the acquisition of partner interests in existing properties in the portfolio. Recently, SPG announced approval from the Boston Redevelopment Authority for a 47 story residential tower containing 318 units and 115,000 sqft of retail leasable area representing a potential investment of $500 million. This tower will be part of SPG's 1.2 million sqft Copley Place Mall in Boston. In Houston, SPG is exploring plans to take one end of the Galleria Mall (2.2 million sqft) and add one or two towers in place of a redundant department store. At the King of Prussia Mall (2.4 million sqft), SPG recently increased its minority stake in the suburban Philadelphia mall to 96% and took full management control for the first time. An investment of about $1.1 billion was made to acquire the incremental 83.75% stake in this leading US mall. The company is underway with the demolition of an empty department store at the mall and will replace it with over 100,000 square feet of leasable area.

REIT Investor Christmas Wish List

Going into Christmas and approaching the New Year, we are certainly thankful for the multitude of lessons learned in the 20 years since the start of the Modern REIT Era. Though we remain 30% off of the previous peak, we do know that it will be reached again someday. We are thankful for the vast balance sheet work that has been done to REITs since the credit crunch of 2008, and the +200% return that REIT investors have received since March 2009 as a result. But there is still work to do.

Time has proven that REITs with too much leverage either do not last or are akin to "beached whales", with little flexibility. Aggressive balance sheet maneuvering, aggressive accounting practices, and aggressive expansion without regard to the long term consequences and internal strengths do not produce satisfactory long term total returns for investors. For Christmas in 2011, we have made a list of items we believe will make REITs stronger entities, more accepted by the generalist investor, and drive up multiples on earnings. For 2012 and beyond we would like to see more REITs…

1. add a layer of perpetual preferred equity as permanent capital
2. implement a program to ladder out debt maturities with long term fixed rate debt
3. disclose better supplemental data on capital expenditures and adjust dividends accordingly
4. maintain debt to GAV ratios below 35%
5. maintain net debt to EBITDA ratios below 5x
6. view growth in dividends as the highest priority predictable by investors and sustainable in all cycles through prudent capital allocation and risk management
7. implement programs to recycle capital into higher quality assets over time
8. use the flexibility to issue stock when it

trades at a premium to NAV to ensure they don't ever have to issue dilutive shares again!

Despite the lackluster growth of the US economy, many equity REITs are positioned for a positive growth scenario because of the following market dynamics: 1) a competitive edge with better properties in growth markets as an attraction for tenants; 2) lenders desire quality properties and are willing to provide record low long term interest rates; and 3) generational low levels of new construction.

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

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