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Equity REITs: Real Assets for Long Term Investors | August 2011

July was another good month for REITs, with the index appreciating 1.6% based on the MSCI REIT Total Return Index (RMS). Year to date, RMS performance stands at +12.1%, compared to +3.9% for the S&P 500 as of July 29, 2011. Investors have been able to shrug off fears about hitting the debt ceiling and a credit downgrade for the US, instead focusing on corporate earnings. REITs have been no exception thus far in beating earnings estimates from analysts. Through July 29th, 22 out of the first 40 REITs to report 2Q earnings have beaten consensus estimates, a trend which we expect to continue. Though there are unique factors that are driving each sector, management on each call have been positive about the long term prospects of their respective companies.

Time Traveling Back to 2001

As shown in the recent recession, the investment landscape can change quickly, and companies that are not prepared to make structural adjustments to their business model will be left behind. If you were able to go back in time to 2001 and tell investors or company management what was going to happen over the next 10 years, many listeners would be hard-pressed to believe what you had to say, and few would make the necessary changes to prepare for this foretold future. Though we can't predict what will happen over the next 10 years, we can evaluate how a company performed in the changing investment environment to predict how that company will navigate the next 10. Figure 1 highlights some of the differences (and surprising similarities) of the REIT industry in 2001 versus the REIT industry today. The first item that sticks out is the gain in acceptance of public REITs among investors. The growth in market cap, trading volume, presence in the S&P 500, and price/FFO valuation multiples portray a dramatic change in popularity. However, the number of equity REITs decreased during the 10 year period. With consolidation, the market's disciplined evaluation of IPO candidates, and the stress test of the recession, the average market cap of an equity REIT went from $900 million in 2001 to $3.5 billion today. It is worth noting that the statistic that bears the most resemblance in 2001 to 2011 happens to be the 10 year annualized total return. Though there may have been more volatility in the most recent 10 years, it is remarkable that the 10 year returns are so similar. This newsletter does not claim to predict the total return for the next 10 years, but figure 1 shows that there is going to be surprises on what will change and what will stay the same in the future.

	AS OF JULY 31, 2001	AS OF JUNE 30, 2011
NUMBER OF REITS	157	120
MARKET CAPITALIZATION	$142 BILLION	$415 BILLION
DIVIDEND YIELD	7.1%	3.3%
10 YEAR TREASURY YIELD	5.1%	3.2%
SPREAD OF REIT YIELD OVER TREASURY	2.0%	0.1%
ANNUALIZED TOTAL RETURN, LAST 10 YEARS	12.0%	11.7%
AVG. DAILY DOLLAR TRADING VOLUME	$394 MILLION	$3.6 BILLION
YTD EQUITY RAISED (INCLUDING PREFERRED)	$2.4 BILLION	$22.3 BILLION
YTD UNSECURED DEBT RAISED	$6.5 BILLION	$9.7 BILLION
YTD TOTAL CAPITAL RAISED	$8.9 BILLION	$31.0 BILLION
AVG. DEBT RATIO*	46%	40%
PRICE/FFO*	9.3X	17.5X
REITS IN S&P 500	0	15
PAYOUT RATIO (DIVIDENDS/FFO)**	68%	70%

* STRAIGHT AVERAGE ** AS OF MARCH 31, 2001 AND MARCH 31, 2011
SOURCE: NAREIT

Environment Ripe for Innovation

Further evidence of changes in the industry can be seen in the new revenue sources for some equity REITs in 2011. In 2004, the first data center REIT went public; now, the sector has 3 REITs with over $9 billion in market cap. In 2001, there was 1 timber REIT with a market cap of $1.9 billion; there are now 4 timber REITs with a combined market cap of $26 billion. Next up, the first wireless tower company is planning on converting to a REIT at the end of 2011. The newly converted REIT will become the 2nd largest in the index. The question is, what will be the next new sector emerge? Also, what new horizons will the current REITs expand into? A triple net lease REIT bought a vineyard in 2010 and leased it back to the seller and it now represents an income producing property. Last, what new markets will the public REITs enter? An office REIT recently bought a portfolio of buildings in Australia, while there are rumors that another office REIT is looking at properties in London.

This is happening due to a macro environment that is the most favorable to equity REITs in the history of the industry. While economic conditions are not as strong as we would like to see, conditions appear to be on a slow, but positive, upward trajectory. A more robust recovery could attract more competition in the form of new supply. However, new construction levels remain at generational lows. Real estate fundamentals have been improving for a year, most notably positive rent spreads across most property types and vacancy rates that have passed their peak levels. Admittedly, some demand problems will persist due to slower employment and retail sales growth rates, but we are convinced that the positives far outweigh the weakness in demand.

Capital, both debt and equity, is available to the equity REITs on very favorable terms and their professional management and balance sheet discipline has served to give them the edge in a very competitive market for tenants. The property sectors positioned to benefit the most over the foreseeable future include apartments, Class A regional malls, hotels, and central business district (CBD) office in major gateway cities such as New York, Boston, Washington DC, West Los Angeles and San Francisco.

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REITs as Long Term Investments

Investors may not fully appreciate the extent of portfolio upgrades that have occurred with the equity REITs over the past twenty years. The better REITs have gravitated toward "institutional caliber" properties that have shown resilience in good times and bad. One of the axioms in real estate that we learned in the early 1970's is that great real estate in great places is always coveted by buyers. This is where we find our favorites REITs today.

And, unlike so many cycles in commercial real estate over the past 40 years, "overbuilding" is not an issue and, accordingly, investors have better odds of witnessing commercial real estate benefiting from the inflationary forces that now characterize so much of the macro economic landscape. Eastgroup Properties (NYSE: EGP) has a 20+year track record of investing in industrial buildings across Sunbelt markets. In 1991, the investment per square foot for the portfolio was $29; by 2011, it had increased to approximately $52 per square foot. This represents a compound rate of almost 3% per year. AvalonBay Communities (NYSE: AVB) had an investment per apartment unit of about $64,500 per unit when it came public in 1993. By 2000, it had increased to $108,000 per unit and last year it stood at almost $150,000 per unit. The compound rate of increase equates to 5.0%. There have been upgrades to the quality of each portfolio through acquisitions and development, but both examples are presented to illustrate that investors are better poised to benefit from future inflation due to the aforementioned favorable fundamental factors in the current real estate recovery.

Since the legislation that allowed for the creation of REITs 50 years ago, the REIT universe has benefitted from new entrants finding new ways to create value. From the time when mortgage REITs were the only game in town to the evolution of equity REITs to include all of the major property sectors, the one constant has been that successful companies always find ways to innovate and adapt in a changing investment landscape. Early investors in companies like AvalonBay and Eastgroup may not have known that market forces would be beneficial for their properties to appreciate so much over time, but they did make an educated prediction that the companies would find ways to create value for shareholders in all types of environments over the long run. We place high premium on companies that have demonstrated this ability in the past, and continue to look for new companies that we could say the same thing about when looking back on the last 10 years in 2021.

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RMS: 1121 (7.29.2011) vs. 1000 (12.31.2010) vs. 792 (12.29.2009) vs. 993 (9.30.2008) and 1330 (2.7.2007)