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This Bull has Room to Run: Why 2014 is Not Comparable to 2007 | July 2014

With a total return of +1.2%, REITs are now up 17.7% year to date (YTD), as measured by the MSCI US REIT Index (RMS). In comparison, the S&P 500 was up 2.1%, and is now up 7.1% YTD.

Chilton Contrarians

Two World Cups ago, the developed markets were booming across nearly all asset classes. Sentiment, consumer spending, and appetite for risk were running close to all time highs. As we wrote in our March 2013 REIT Outlook titled 'When Cash Was King: A Look Back to 2006-2009', we did not share the same enthusiasm about the stock market in 2006. Though we can't claim that we knew more about the economy than the economists and 'experts' that didn't see the recession coming, our analysis concluded that stock prices did not accurately reflect the underlying risks.

A comparison between 2006-2007 and today of several valuation metrics and economic statistics shows many similarities, but the risks are entirely different.

2004-2006: Income Statements, Left-Side of Balance Sheets Look Great!

In retrospect, it seems obvious that excess on Wall Street pumped up the credit markets (both consumer and corporate), inflated asset prices, and created a bubble. Though the debt-addicts can be accused of being foolish, such consumers and companies were only doing so because perverse incentives were actually rewarding the behavior with more credit and higher asset prices.

Cost and availability of capital have long been recognized as tools to incentivize consumers and corporations to inflate or cool down the economy. Simply put, lowering the cost of capital increases the net present value (NPV) of projects, increasing the likelihood that the project will be pursued. Availability of capital also makes the pursuit of projects more likely as the weighted average cost of capital can be lowered through a heavier weighting to debt (because debt costs are lower than equity costs).

Consumers face the same decisions when deciding to buy a home. Consider two home buyers with different lenders. One buyer receives a 5/1 interest-only Adjustable Rate Mortgage (ARM) at 5% with 0% down payment, while the other buyer receives a 30 year fixed mortgage at 6.5% *and* has to put 20% down. On a $500,000 house, the interest-only buyer has $5,000 *less* per year in payments despite having a $100,000 higher loan than the fixed borrower. If housing prices were to fall, the interest-only owner could walk away with no equity loss, while the other owner could potentially lose the $100,000 of equity invested in the home. However, both would enjoy the same dollar gains in a rising market. Though the interest-only loan carried more risk for the bank, the borrower actually had lower risk of capital loss while enjoying the same potential reward.

In fact, the interest-only, zero down buyer could have the same monthly payment for a $600,000 house as the 30 year fixed, 20% down buyer on a $500,000 house. Assuming other bidders can obtain the same financing, the same house would likely sell for closer to $600,000 than $500,000. In this example, the price of the house is driven by the availability and cost of capital.

As we later found out, the eventual buyers of the mortgages had vastly underestimated the risk in their investment. But on the outside, a story of a home appreciating from $500,000 to $600,000 sounds like a positive for the economy.

All Economic Growth is Not Created Equal

As the availability and cost of capital tilted the risk-reward decision for homebuyers, the housing market created a large amount of wealth. Home prices nearly doubled from 2000-2007, meaning the lenders got paid off even at 100% Loan to Value (LTV) ratios, and equity owners enjoyed incredible cash on cash returns. Title companies, lenders, appraisers, and real estate agents benefited from this exciting new industry known as 'sub-prime', attracting startups and driving employment.

Figure 1: Adjusting for Risk in the Economy

	12/31/2006	3/31/2014
Index Levels Near Where They Were...		
Real GDP ($b)	$14,718	$15,824
S&P 500 Index Price (SPX)	1,418	1,872
MSCI US REIT Price Index (RMZ)	1,091	971
Consumer Doing Okay...		
Real Median Income	$54,892	$51,017*
Total Employed Persons (000's)	137,210	137,964
Employment Ratio	63.4%	58.9%
Median Home Price	$245,400	$265,700
Consumer Confidence Index	110	84
But the Economy Has Been Significantly De-Risked!		
Household Debt Service/Income	12.9%	9.9%
Personal Savings Rate	3.2%	4.0%
10 Year US Treasury Yield	4.7%	2.7%
Mortgage Debt Outstanding ($b)	$13,527	$13,267
Revolving Credit ($b)	$924	$862
*2013 full year		

Source: St. Louis FRED, Conference Board.

GDP grew by 3.8%, 3.4%, and 2.7% in 2004, 2005, and 2006, respectively, making it near impossible to argue that the US economy was doing poorly. Employment and wages continued to move higher. The real US median household income increased from ~ $54,000 in 2004 to $56,000 in 2007, while increasing home prices allowed equity to be taken out of homes and contributed to the economy through the consumption of goods and services previously out of reach by many. By far the largest portion of the US economy, Personal Consumption Expenditures (PCE) grew faster than GDP for the years between 2004 and 2006. Retail sales grew even faster, driving earnings for retailers, suppliers, and manufacturers. Consumer confidence was approaching all time highs, as shown among other comparative statistics in Figure 1.

Consumers and CEOs Pat Themselves on the Back

S&P 500 companies grew earnings at a strong clip over the same period, which created almost 8 million *net* jobs from 2004 to 2007. Real private corporate investment increased by huge numbers in those boom years, averaging 6.3% per year. Investors apparently agreed with companies' decisions to expand, rewarding them with higher share prices. The S&P 500 was trading at a 17.4x multiple in 2007, after producing total returns of 10.7%, 4.8%, and 15.6% for 2004-2006.

Given that commercial real estate is a byproduct of the economy, the boom spilled over to property fundamentals, development, and, of course, pricing. In the years from 2004-2006, REIT investors doubled their money (!!), as measured by the RMS. Landlords were able to raise rents across every property type, and occupancy was well above the long term average going into 2007. Surprisingly, new construction was only at the long term average, which meant the supply and demand dynamics were somewhat in check.

However, valuations reflected the boom scenario, as cap rates in the private and public market declined to all time lows. REIT multiples increased to all time highs, which gave companies the green light to raise capital and grow. Observed in a vacuum, the high multiples and low cap rates reflected the strong supply and demand dynamics for landlords.

Peeling the Onion

Outside of the vacuum, a quick analysis of the right-hand side of the consumer balance sheet revealed that much of the growth in consumer spending was done on credit, as household debt service as a percentage of income grew to over 13% versus a prior peak of 12% in 1986. Instead of being punished for having high debt, they were rewarded with a line around the block of other lenders or credit card companies willing to extend more credit.

"Outside of the vacuum, a quick analysis of the right-hand side of the consumer balance sheet revealed that much of the growth in consumer spending was done on credit."

In a similar manner, though the fundamentals were solid for commercial real estate, companies were being rewarded with higher stock prices even as their debt ratios were rapidly increasing. In the mall sector, General Growth Properties (NYSE: GGP) was rewarded the highest AFFO multiple among peers as of February 1, 2007, despite sporting the highest debt to gross assets ratio (64% vs peer average of 49%) and second biggest development pipeline as a percent of total market cap.

As the multiple of the REIT index broke historical records, the weighted average net debt to EBITDA ratio of the Bloomberg REIT Index (Bloomberg: BBREIT) rose to 13.8x by the end of 2006, a far cry from the 6.1x employed by REITs today. Further skewing the numbers, there were many REITs that employed merchant building programs to boost EBITDA –

earnings that would decline to zero only a few years later.

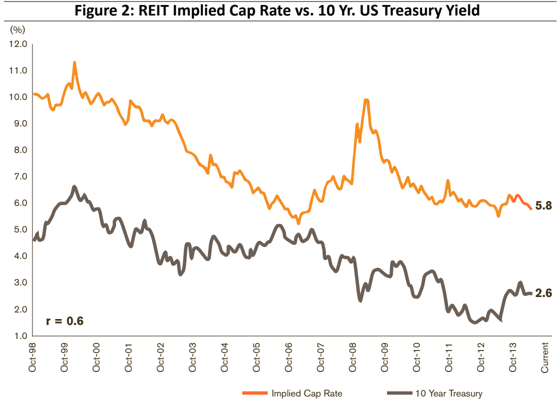
Apples, meet Apples

Like a true contrarian, we refused to pop the champagne bottles and congratulate companies taking on more risk. Our shouts at expensive valuations were not necessarily because we thought a 6% implied cap rate or a dividend yield below 4% were unsustainable – it was that the 10 year US Treasury yield was at 4.5%-5%. The 10 year US Treasury yield is commonly used as the 'risk-free rate' when analyzing the risk of an investment. A higher spread between the yield or projected IRR on the investment and the risk free rate indicates higher risk. Conceptually, this should make sense, as one would want to be compensated more for the investment if it carries more risk.

Historically, the spread between the REIT implied cap rate and the 10 year US Treasury yield has been approximately 360 basis points (bps). In late 2006, the spread went below 100 bps for the first time in modern REIT history. The spread between the REIT dividend yield and the 10 year US Treasury yield averaged 120 bps over the same period, but it went negative in 2006, again for the first time in history. We acknowledge that REITs should trade at above average multiples (below average spreads) when the supply and demand dynamics are favorable, but the spreads we observed were more than 2 standard deviations from the historical average, an extremely rare event statistically. We believed the record low spreads did not account for the increased risk from development, high debt ratios, or signals of deceleration in the cycle.

A typical real estate cycle lasts between 7 and 10 years, and 2007 marked the 6th year of that particular cycle. The economy and commercial real estate had moved the recovery stage, as

Figure 2: REIT Implied Cap Rate vs. 10 Yr. US Treasury Yield



Source: Citi Research, FactSet, and YieldBook. As of 6/20/14.

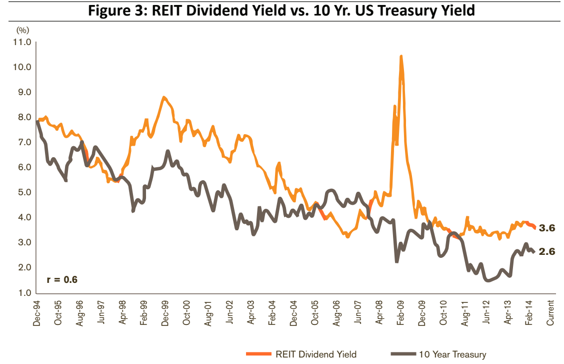
same store net operating income (NOI) and GDP growth were decelerating going into 2007. Therefore, the cycle was much closer to the 9th inning than the 1st inning. The smart REIT management teams saw the writing on the wall, employing a strategy to either sell properties or sell the entire company to private buyers, not an easy decision when peers are raising equity and expanding balance sheets along with their compensation.

Others were not so observant. Often fueled by too much short term debt, most REIT "projects" (think acquisitions and development) pursued in 2006-2007 destroyed value, which led to highly dilutive equity offerings.

Underlying Risks (or Lack Thereof)

In some respects, many of the valuation statistics from 2007 are starting to rhyme with 2014. Implied cap rates are back below 6%, and dividend yields are below 4%. We are 5 years into a new commercial real estate cycle, and have been experiencing positive economic growth since 2009. Once again, REITs are pursuing development across most property types, and the MSCI US REIT Total Return Index has surpassed the prior peak.

Figure 3: REIT Dividend Yield vs. 10 Yr. US Treasury Yield



Source: Citi Research, FactSet, and YieldBook. As of 6/20/14.

Except this time is different. REIT debt ratios are in check, development is limited to 10-15% of assets, and dividend payout ratios are at historic lows. The 10 year US Treasury yield is 2.6% as of June 20, 2014, implying a 320 bps spread versus the implied cap rate, and a 100 bps spread with the REIT dividend yield (see Figures 2 and 3).

Shockingly, the economy has yet to fully recover from the painful deleveraging process in 2008-2009, which has helped to keep interest rates and new construction historically low. GDP and job growth have been nowhere near what should be expected after a recession, and the labor market has only just recently regained all of the jobs lost in the Great Recession.

Figure 4: REIT Valuation Metrics, 2007 vs. 2014

	12/31/2006	6/20/2014	Historical Average
Implied Cap Rate Spread (bps) (1)	90	320	360
Dividend Yield Spread (bps) (1)	-120	100	120
Dividend Payout Ratio (1)*	84%	75%	81%
NAV Premium (2)	8.0%	-2.0%	3.0%
AFFO Multiple (1)	22.4x	19.9x	17.4x
FFO Multiple (1)	19.4x	15.7x	12.4x
Occupancy (3)	94%	94%	93%
SS NOI Growth (3)	4.1%	3.5%	2.7%
New Construction (4)	2.0%	0.9%	2.1%
Net Debt/EBITDA (1)	13.8x**	6.1x	6.7x***

Source: (1) Citi Research; (2) Bank of America Merrill Lynch
(3) Company Reports for 4Q2006 and 1Q2014; (4) CBRE and Citi Research.
*TTM Average **Debt/EBITDA ***Green Street Advisors 17 yr. avg.

Despite the shortcomings of the US recovery, it stands tall when compared to other developed countries and most emerging markets. As such, the demand to own high quality properties in supply constrained US markets shows no signs of slowing down. Therefore, we expect this real estate cycle to endure much longer than the average, leaving room for REIT prices to run.

Behave, or Wear the Dunce Cap

Even more impressive is the discipline on the part of investors. Companies trading at the highest multiples and NAV premiums are mostly those with the best balance sheets and growth stories. With the newfound scrutiny, investors have forced REITs to be disciplined with development. Private developers have had to employ the same discipline because bank and equity investors have remained skeptical on speculative development. In general, new construction has been mostly undertaken to meet demand, not just based on availability and cost of capital.

A New Mispricing of Risk

The current economic scenario is truly a goldilocks market for publicly traded REITs, and REIT pricing has yet to properly reflect all of the tailwinds that will blow for the foreseeable future. Headwinds like higher interest rates could temporarily derail REIT total returns, but our positive forecast for the underlying properties has very little near to medium term risk in it. In fact, higher interest rates will only help to further constrain new development, which would continue to tilt the supply and demand dynamics in favor of current landlords.

After five years of historically low new construction, it will require a major change in availability and cost of capital for commercial real estate to enter the hypersupply phase of the real estate cycle. We can't say when this cycle will end, but, if new development is done only to meet demand, debt ratios stay low, and stock prices remain congruent with the risk associated with each, this cycle will surely be smoother than those of the past. A long, smooth cycle will certainly qualify for our prediction as 'one for the ages'.

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RMS: 1544 (6.30.2014) vs. 1312 (12.31.2013) vs. 346 (3.6.2009) and 1330 (2.7.2007)

Please feel free to forward this publication to interested parties and make introductions where appropriate.

Previous editions of the Chilton REIT Outlook are available at www.chiltoncapital.com/reit-outlook.html.