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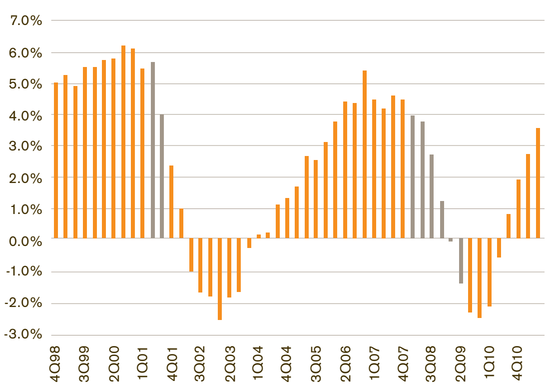
A REIT-Car Named Volatility | November 2011

REIT volatility continued in October thanks to uncertainty in Europe, though it helped to the positive in a major way this month. As measured by the MSCI US REIT Index (RMS), REITs finished October +14.4%, which compares favorably to the S&P 500 at +10.9%. Year to date, the RMS moved back into the black and now stands at +7.9% (vs +1.3% for the S&P 500). The first wave of earnings releases for REITs has thus far not given us any reason to abandon our long term bullish view for well-located high quality commercial real estate. We remain fully invested across client portfolios due to the positive trends we see and our current position in the "recovery" stage of the real estate cycle.

Commercial Real Estate Cycle

Sometimes, a picture is worth a thousand words. In Figure 1, the REIT Net Operating Income (NOI) cycle is pointing towards a positive near term trend and shows a healthy recovery off of the 2008 and 2009 fundamental deterioration. Figure 2 shows a similar cycle occurring in

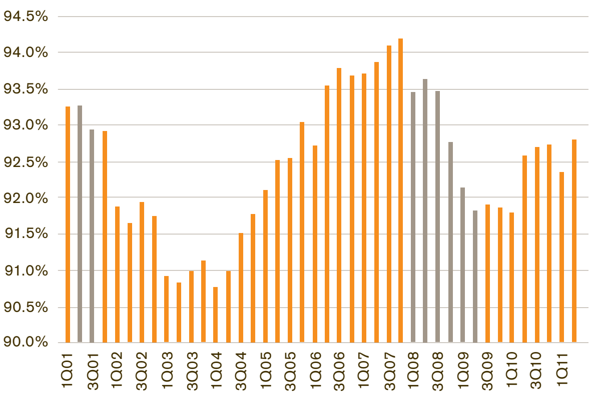
FIGURE 1: YEAR OVER YEAR CHANGE IN REIT NET OPERATING INCOME



Source: Company reports and Citi Investment Research and Analysis as of 6.29.2011

REIT occupancy through the 2nd quarter 2011. As we anticipate 3rd and 4th quarter numbers confirming this trend, we are eager to hear 2012 guidance to give us further confidence in the story from the CEOs and CFOs seeing the recovery firsthand. We are careful here to distinguish between REIT NOI and occupancy versus all US commercial real estate — the story is not the same for low quality buildings or those in undesirable locations. For example, though the average office REIT occupancy was over 90% as of 2Q11, the national office occu-

FIGURE 2: HISTORICAL REIT OCCUPANCY



Source: Company reports and Citi Investment Research and Analysis as of 6.29.2011

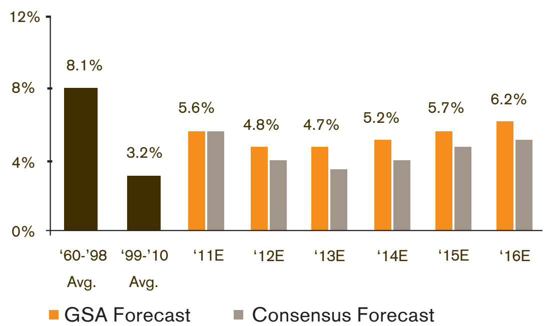
pancy was 84% according to CBRE (and declining!). This is further evidence of the flight to quality for tenants and for landlords that have the capital to attract them.

New Normal Supports Our Underweight on Shopping Centers

Shopping centers have felt the full brunt of the triad of high unemployment, the internet, and the rising personal savings rate. We are underweight shopping centers relative to the index. Our investment approach relies upon both bottoms up analysis of individual REITS and also our macroeconomic analysis that can spot trends early. These macroeconomic views will often show up through an underweight or overweight to a sector relative to the index.

On the US road to recovery from the recession, the question is whether the savings rate will drift back down towards the 1999-2010 average of 3.2%, or tick up closer to the 1960-1998 average of 8.1%. We think that the US savings rate will settle in at a 'New Normal' somewhere in between the two, as shown by estimates in Figure 3. This assumption means there will be less consumer spending (more savings = less spending), which will lead to the decline of weak shopping center models. The implications are: 1) smaller footprint for retailers; 2) focus on outlet stores; and 3) growth in internet sales. We believe that when the consumer does decide to go shopping at a brick-and-mortar store, he/she will choose to go to the large regional mall, outlet center, or well-located high quality shopping center. Accordingly, we

FIGURE 3: PERSONAL SAVINGS RATE



Source: Green Street Advisors

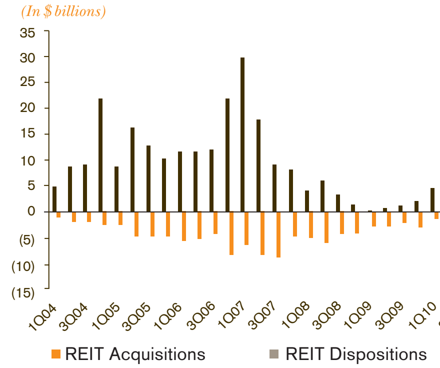
have an overweight to high quality regional malls (with some outlet center exposure) and an underweight to shopping centers. The only shopping center exposure in client portfolios is through high quality shopping centers in central locations and those anchored by grocery stores.

Merger and Aquisitions Update

On October 21, Duke Realty (NYSE: DRE) announced the sale of a large portion of their suburban office portfolio to Blackstone Real

FIGURE 4: HISTORICAL REIT ACQUISITIONS AND DISPOSITIONS VOLUME

(In $ billions)



Source: Citi Investment Research and Analysis

Estate Partners VIII for over $1 billion. The NOI to purchase price indicated a capitalization rate of 9%+, substantially above the weighted average implied cap rate for equity REITs which recently stood at 6.3%. This wide gap points to the weak fundamentals impacting suburban office in most cities and supports our underweight on the sector. On October 24, CubeSmart (NYSE: CUBE) announced the purchase of 22 self storage facilities from Storage Deluxe in the Greater New York City area for $560 million. While a game changer for CubeSmart, we believe the strategic benefits are outweighed by the dilution to net asset value (NAV) that was caused by financing a portion of the purchase price with the sale of new shares at a 20% discount to NAV. On October 4, Taubman Centers (NYSE: TCO) announced an acquisition of two high quality malls from Davis Street Properties for $560 million. TCO has by far the most productive mall portfolio based upon the metric of sales per square foot that averaged $615/sqft in the last 12 months as of September 30, 2011. There have been several other sizable transactions in 2011, but the point to take away is that the transaction market is alive and well, despite a relatively quiet August and September due to the US debt downgrade and financial sector woes (see Figure 4).

Though we do not own any of the above names, we closely monitor the transaction market to get a handle on the pricing of real estate to help us determine the most accurate Net Asset Value (NAV) of the stocks in our universe. Transaction volume also provides clues as to the liquidity available to players in the market. Further liquidity and strong market pricing of apartments will most likely lead to the sale of the Archstone residential portfolio, which is currently being explored by the owner Lehman Brothers (NYSE: LEHMQ.PK). This transaction would dwarf anything seen in the REIT sector since the privatization of Equity Office Properties in 2007 by Blackstone for $39 billion. Archstone was taken private by Lehman Brothers in 2007 for $22 billion.

New Supply, or Lack Thereof

Last, the undercurrent that we believe will buoy REIT fundamentals even if some of our downside scenarios occur is the new supply of commercial real estate to the market. According to FW Dodge, construction starts as a percentage of existing real estate stock was 0.54% in September. This compares with a 0.50% average over the last two years – coincidentally, REITs are up 200%+ over that same time period. To put this into perspective, the historical average of construction starts has been approximately 2.2% of stock since 1970 and 1.8% of stock since 1984. Even more compelling is that the normal obsolescence rate of stock annually has been about 1%. So, the supply of commercial real estate is actually decreasing. Between 1970 and 2009, the lowest recorded construction starts as a percentage of real estate stock was 1% in the early 1990s.

News about Europe, bank financial woes, and US government debt excess have proven to be powerful short term movers in the stock market, including in the public REIT market. However, we take a long term view and can't ignore the positive numbers we see or conversations we have with management. We are following all of the macroeconomic news closely, but we give greater weight to our REIT specific news, proprietary financial models, and 'boots-on-the-ground' reports from companies.

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RMS: 1079 (10.31.2011) vs. 1000 (12.31.2010) vs. 792 (12.29.2009) vs. 993 (9.30.2008) and 1330 (2.7.2007)