

When Cash Was King: A Look Back to 2006-2009 | March 2013

Six years after the February 2007 peak, REITs have finally gained back all of their credit crunch losses. As measured by the MSCI US REIT Index (RMS), REITs ended the month at 1,344, which compares to the prior peak of 1,330. The RMS produced a total return of +1.2% for the month of February, while the S&P 500 was up 1.4%. Year to date, the RMS has generated a +5.0% total return, which compares to the S&P 500 at +6.6%. With the latest peak in the rear view mirror, we believe it is important to revisit market sentiment from February 2007, our actions, and how we are positioning ourselves today.

Though we have some clients that ask us to stay fully invested, our traditional policy is to use cash as an active allocation tool to dampen downside volatility and risk. In a market of solid fundamentals where select metrics point to expensive valuations, we sometimes go to 5-10% cash to harvest gains, and then wait for a pullback to reinvest. In contrast, for the period between 2005 and 2008 where valuations were becoming so far above historical averages, we made the decision to go to a high of 40% cash, and even called clients telling them to allocate away from REITs.

As “long-only” investors, we have few defenses against extraordinary market conditions except to raise cash or send money back to clients. We did both starting in 2006. As long term investors in REITs through many cycles starting in 1972, what we saw unfolding in 2005 set off alarm bells in our coverage of equity REITs.

Here Comes the Boom

A bit of history is in order at this juncture. As we ended 2005, cap rates had never been lower for commercial real estate in the previous 25+ years that NCREIF (National Council of Real Estate Investment Fiduciaries) had been tracking this data. Cap rates, short for capitalization rates, are a primary tool to value commercial real estate using property net operating

income (NOI) generated. By mid-2006, REITs were trading at implied cap rates at the unheard level of 6% in an industry where it was more common to value income-producing real estate at an average closer to 9%. Heightened activity with mergers and acquisitions stoked REIT prices even further. By mid-2007, 25

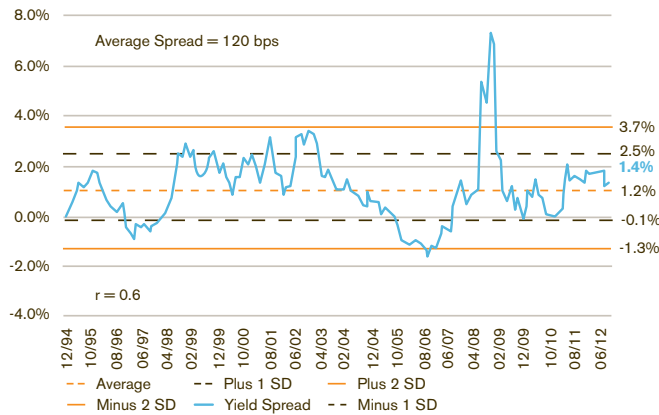
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REITs had been taken private over the previous three years, removing \$54 billion of equity value from public markets, and REITs were basking in the total return of 35% generated for investors in 2006. Average price to FFO multiples (Funds from Operations) were at 15.3x 2007 estimates versus a 12 year average of 11.0x at the time. Needless to say, going into 2007, REITs were considered pricey. Metrics relating how REITs were priced relative to common stocks and bonds were confirming the same.

We constantly monitor many different indicators in our ‘top-down’ approach which provides guidance as to the direction of the market. Two of the best indicators historically have been the spread between implied cap rate versus the 10 year Treasury yield and the spread between the REIT dividend yield versus the 10 year Treasury yield.

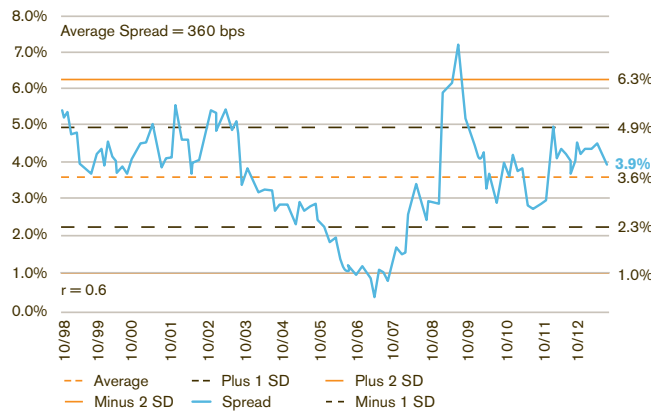
In Figures 1 and 2, note the historical average spread for the dividend yield versus the 10 year Treasury yield is 120 bps, and the average spread for the implied cap rate versus the 10 year Treasury yield is 360 bps. By the end of 2005, the dividend yield spread went negative for the first time since 1998 (about

FIGURE 1: SPREAD BETWEEN REIT DIVIDEND YIELD AND 10-YEAR US TREASURY YIELD



Source: Chilton Capital Management, Factset, as of 2/15/2013

FIGURE 2: SPREAD BETWEEN IMPLIED CAP RATE VS. 10-YEAR U.S. TREASURY YIELD



Source: Chilton Capital Management, Factset, as of 2/15/2013

one full standard deviation away from the mean), meaning that the yield on the 10 year Treasury note was higher than the REIT dividend yield. Similarly, the implied cap rate spread had dropped below 200 bps, also 1 standard deviation away from the mean. These were two signals that prompted us to begin increasing the cash allocation. As REITs continued to appreciate to the point in 2006 where both spreads were further than 2 standard deviations away from the mean, we made the call to go to almost 40% cash, and to tell clients to begin allocating away from REITs.

Fire Burn and Cauldron Bubble

During this period, same store NOI had begun to post modest increases following declines in 2002-2004. The low yields on acquisitions pushed many REITs and other real estate players to ramp up development programs substantially. Many were relying increasingly on short term funding sources helped by the promise of higher yields on stabilized projects. By mid-2006, floating rate debt represented almost 20% of the capital

structure of REITs. By comparison, today it stands at 13%. Capital was also plentiful for most industry participants. Thus, the supply of new real estate had begun to increase above historical levels in 2004 and continued until the music stopped in 2008. We were also seeing evidence that many real estate loans were being made at negative cash flows on the assumption that rents and occupancy would improve sufficiently to see the payments being covered. Furthermore, it was common for speculators to value vacant real estate at better pricing relative to comparable leased properties. For some REITs, capital allocation decisions were increasingly risky relative to the more conservative past.

Despite the apparent writing on the wall from financial metrics and real world anecdotes, the bubble had not yet burst in late 2007. Remember, the sub-prime mess in single family housing was casting a pall on real estate in general. By early 2008, concerns were growing about a weakening economy as rising energy prices were hurting the consumer's pocket-books, but few models forecasted a recession. Our decision to maintain high cash had been hurting our returns for the previous few years, but we felt even more conviction that it was the right decision. What we were about to witness in 2008 confirmed the old adage that bad management can ruin good real estate.

General "Shrunk" Properties

One glaring example of a management team that got caught up with the market sentiment at the time was General Growth Properties (NYSE: GGP). Fueled by short term, low cost debt and high leverage, GGP stock had risen from close to \$42 in mid 2006 to a high of \$67 in early 2007. On the earnings call in early 2007 relating to the fourth quarter results, the chief financial officer had the following quote:

"As you know, we have experienced a 15% increase in our stock price since the beginning of the year. We do not think it is irrational. It represents a rapid, albeit time-compressed recognition of the insufficient stock market multiple that was heretofore ascribed to our stable and growing cash flow and dividend streams. Given the underlying strength of our core business, we continue to believe that we can still generate above stock market average, total shareholder returns on this level going forward."

Since that earnings call, GGP's stock price has not been anywhere near where it was that day. At the time, the company had a debt to gross asset value of 63% versus the REIT average of 39%, and 25% of the debt was short term versus the REIT average of only 19%, which virtually eliminated any flexibility if the capital markets closed. In late 2008, the company missed a debt payment and the largest ever real estate bankruptcy soon followed. The value destruction for shareholders was substantial - the low on the stock was \$0.24 per share on March 5, 2009, a decline of 99.6% from its peak. With a new management team, leverage philosophy, and reorganized assets, GGP has since exited bankruptcy and now trades around \$20 per share.

Pop Goes the Bubble

By the time that Lehman filed for bankruptcy and the capital markets closed in September 2008, the composite was at 25% cash. Referring back to Figures 1 and 2, the spreads had completely flipped and were more than one standard deviation *higher* than the historical average in early September. After a ~50% drop in REITs in the 60 days following the Lehman announcement, valuations metrics were hitting historically cheap levels around 2 standard deviations above the mean. REITs were being priced as if they would not be able to raise any capital and the banks would not allow them to extend debt maturities. Just before Thanksgiving, we made the decision to invest a significant portion of cash into quality companies with solid balance sheets and few near-term maturities.

Six Sigma

However, January and February 2009 brought further declines of almost 40% before finding the bottom in March. On March 6, 2009, the dividend yield spread was more than 6 standard deviations away from the mean, or what is called a six-sigma event. Mathematically, a six-sigma event has the probability of occurring once every 6800 years, or a 0.00004% chance of occurring on a given day. The precipitous fall from the the peak of 1,330 in February 2007 destroyed approximately 74% in equity for REIT shareholders. Though volatile, the rally was in full effect following the capital markets opening up slightly for industry leaders Boston Properties (NYSE: BXP) and Simon Property Group (NYSE: SPG). We used this period to harvest gains and reinvest at lower prices, moving our cash position frequently from below 5% to above 10%. In 2010, the spreads again were at or near 1 standard

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deviation *below* the historical average, and we went back to a double digit cash position. By January 1, 2011, the composite had 3% cash, and has not gone back into double digits since. Similarly, neither spread has gone below the historical average.

Reliance Upon Metrics

We of course understand that the 10 year Treasury yield is artificially low right now, and do not consider these two spreads as the only indicators. They provide decent short to medium term calls on direction, but they must still be thought of practically. For example, the dividend yield spread does not take into account payout ratios, which were greater than 90% of cash flow in the 1990s and now average 73%. After making the necessary adjustment, the February 15th yield spread is closer to 200 basis points (versus 140 indicated). Additionally, REITs are at a point of the cycle where they are able to grow cash flow through rent increases and lower interest rate payments over the next 3-5 years. Given our estimates for annualized dividend growth of 8% over that time period, we believe REIT investors should be protected if the yield on the 10 year Treasury yield rises to 3.5% from 1.9% as of February 28.

Because REIT portfolio quality has been upgraded significantly since 1995, implied cap rates spreads *should* be lower relative to historical averages. Most property types are witnessing modest increases in occupancy rates. Thus, we see rent increases as a driver of better returns going forward. Better balance sheets, time-tested management teams, and minimal supply growth further augment the argument for the valuation of REITs to be priced for less risk than they have historically. As we do with the dividend yield spread, we cannot take the numbers at face value, and would feel comfortable even if the 10 year Treasury yield rose to 3.5% as in the example above.

For these reasons, we also look at NAV premiums/discounts, AFFO & FFO multiples, spreads versus high yield bonds and

investment grade bonds, and S&P 500 earnings yields. Combining these quantitative elements with our conversations with CEOs and CFOs, property tours, supply and demand indicators, and demographic observations helps us to have the conviction to make a cash allocation decision that may be considered contrarian.

2013 ≠ 2007

In summary, the 2005-2009 time period was a time of extreme volatility to the upside and downside where the cash allocation was an active position in attempting to protect principal. REIT valuations reached bottom on March 6, 2009 and allowed us to get back into the market at attractive prices, as well as offset some losses taken in the prior period. Thanks to the cash allocation and successful stockpicking, the Chilton REIT Composite surpassed its prior peak in December 2010, over 2 years before the MSCI US REIT Index. We view our current strategy of staying under 10% cash to be more typical of our investment style, but we cannot say with certainty that 2008-2009 will never happen again. However, REIT CFOs and investors have learned a tough lesson about balance sheet management

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and certainly are more aware of the risks that are inherent with short term debt, high leverage, and non-earning assets. Despite having surpassed the previous peak and boasting valuation metrics nearing expensive territory, our observations have given us the conviction to stay fully invested in anticipation of an elongated commercial real estate cycle.

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RMS: 1344 (2.28.2013) vs. 1280 (12.31.2012) vs. 1087 (12.31.2011) vs. 1000 (12.31.2010) vs. 792 (12.29.2009) vs. 933 (9.30.2008) and 1330 (2.7.2007)

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

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