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Basking in Positive Conditions for Earnings Growth | May 2013

In April, REITs regained their lead over the S&P 500. As measured by the MSCI US REIT Index (RMS), REITs were up 6.7% for the month, bringing the year to date total return to +15.3%. In comparison, the S&P 500 was up 1.9%, for a year to date total return of 12.7%.

Around the developed world, economies are in a race to devalue currency and spark inflation. The low interest rate environment and projections for it to stay that way have driven investor money to higher yielding instruments. Lower interest rates have also helped to drive earnings, which have supported the higher valuations caused by the incremental inflows into yield instruments. We concede that these two drivers of valuations and earnings are temporal and continue to look for clues as to when things will change. However, core earnings growth from low supply and gradually increasing demand are also present, which has further supported higher multiples and (hopefully) is one of the reasons for the nearly $12 billion of net inflows into the REIT sector year to date as of April 18, 2013. Recall that the market capitalization of the REIT sector is about $550 billion. Earnings growth, both from low interest rates and from supply/demand imbalances, seems to support current multiples and the increased investor demand for REITs.

How Low Can They Go?

The Federal Reserve continues to telegraph an extended period of low interest rates lasting at least until 2015. Equity REITs have approximately $300 billion in debt outstanding with a weighted average interest rate of 4.9%, a record low level that should continue to decline. Recent debt offerings have been in the 3.0-3.5% area for 10 year maturities. A 1% decline in borrowing costs equates to approximately $3 billion in earnings growth for the industry. To keep this number in perspective, equity REITs will distribute about $16 billion in dividends this year. Thus, a 1% reduction in weighted average interest rate alone has the potential to boost dividends by 19%. With a weighted average maturity of about five years, REITs should see a consistent decline in interest expense on debt now outstanding.

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Another form of financing is preferred equity, a capital source we have been encouraging REITs to utilize for several years. REITs have about $25 billion of preferred equity outstanding. Preferred stock carries a fixed coupon and no maturity but can be called five years from original issue date. Public Storage (NYSE: PSA) is the largest issuer of REIT preferred equity and its recent activity serves as an excellent example of how they have become a major beneficiary of low rates. In the 15 months ended March 2013, PSA has issued $2.4 billion of new preferred securities with an average coupon of only 5.5% (most recently 5.2%). Most of the proceeds were used to redeem $2 billion of similar securities with an average coupon rate of 6.6%. Savings equate to about $22 million annually and enhance dividend paying capability by $0.13 per share. Albeit in varying degrees, other REITs have been repeating this process of redeeming higher coupon preferred stock and thus, enhancing the outlook for growth in earnings.

Credit upgrades have also been very helpful to reduce borrowing costs for many REITs and to open the door for more financing options available from public sources. In the past year, we count 21 Equity REITs that have been upgraded, including a few that have attained investment grade status. We own 10 of the names that have been upgraded. Being able to raise debt capital on an unsecured basis in the public markets provides a major advantage to the Equity REITs with investment grade ratings.

REIT balance sheets continue to improve in 2013, helped in part by over $7 billion in equity offerings, over $5 billion of unsecured debt, and another $3 billion of preferred equity.

Low dividend payout ratios (now 73% on Adjusted Funds from Operations, or AFFO), enable REITs to retain free cash flow as a source to fund capital expenditures or new development and/or acquisitions instead of issuing new common shares or adding to debt outstanding. This earnings retention provides Equity REITs with an internal source of value creation, long the best yardstick for sustainable total returns to shareholders.

Putting Capital to Work

Equity REITs enjoyed "first mover advantage" in this real estate cycle for new development given the wide open access to capital they enjoyed when many industry participants could only watch from the sidelines. Of the 32 REITs we own in the Chilton REIT Composite, 22 are involved in new development or redevelopment projects that promise to be accretive to both earnings and value per share over the new two to three years. With many REITs trading at premiums to Net Asset Value (NAV), the market is giving them the go-ahead signal to raise more capital and grow, both internally through development and redevelopment, and externally through acquisitions.

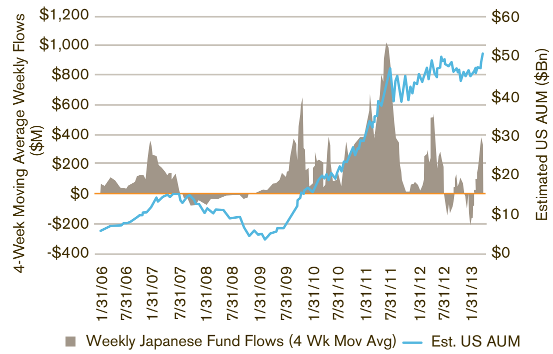
"Real" Growth

The primary driver of the 8-10% earnings growth we envision for the REITs over the next two years is the growth in same store net operating income (NOI) caused by occupancy improvement, growth in rental rates, and tight expense controls. Central to this growth story is the repositioning of portfolios into superior quality properties that are younger, better located, and more competitive. This transformation has been underway for many years and is the result of access to cheap capital and seasoned management teams. Although it varies by property type, growth in same store net operating income should average 3-4%. As we have stated in previous publications, the lack of new supply is driving the high visibility for growth in same store NOI.

Yield Hungry Japanese

Recently, a Wall Street Journal article highlighted the Japanese ownership of US REITs as a potential risk for negative REIT fund flows in the future. We have been following the Japanese flow of funds into REITs since it started in 2009 in earnest as a result of the positive carry between borrowing rates in Japan and dividend yields on US REITs. Though the positive carry still exists (and will likely exist for the foreseeable future thanks to loose monetary policy in Japan), the risk lies in the stretched dividend yields promised by the Japanese funds that are investing in US REITs.

FIGURE 1: JAPANESE FLOW OF FUNDS AND OWNERSHIP OF US REITS



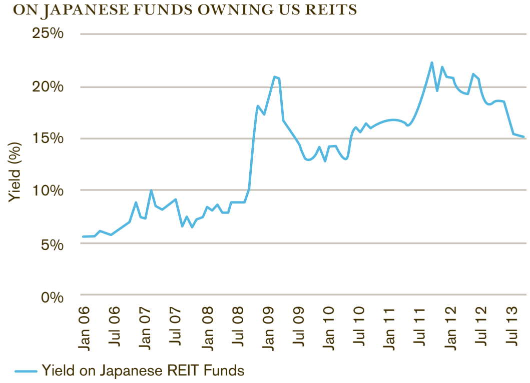
SOURCE: ISI RESEARCH, BLOOMBERG

In 2006, the average annualized dividend yield on Japanese mutual funds with a real estate focus was a little over 5%, which was not far from the 4% dividend yield offered on the MSCI US REIT Index. With a little leverage and picking some higher yielding REITs, the cash coming in could likely meet the distribution requirements. Even if the income in a given year came up short, the capital gains that REITs were generating could more than cover the difference. Fast forward to 2009, the value of the portfolios had dropped significantly, but the distributions stayed the same. The annualized dividend yield skyrocketed to over 20%, which began a massive flow of funds from Japanese investors to US REITs.

From July 2009 to September 2011, Japanese funds added $57 billion to US REITs. Thanks to the strong performance of REITs, they were able to maintain the high dividend yields by distributing capital gains. However, after REITs were up only 8.7% in 2011, some of them ran into trouble meeting the stated dividend yields and had to start cutting their dividends. For example, two of the largest owners of REITs are Shinko Asset Management Co. Ltd. and Daiwa Asset Management Co. Ltd. Combined, they own almost $25 billion in US REITs. In July 2012, Daiwa US REIT Fund – Monthly Dividend (Bloomberg: 04312045 JP) cut its dividend by 19% due to NAV diminution of 19% in 2011. Soon after, Shinko US-REIT Open (Bloomberg: 06311049 JP) cut its dividend by 13% following NAV losses of 19% in 2011. Subsequently, each fund experienced significant outflows which caused further selling of securities to meet redemptions.

Even after the dividend cuts, the funds were trading at effective yields of 17.5% and 17.0%, respectively. As more Japanese investors pulled out money due to dividend cuts, the fear was that a severe sell-off was going to occur in order to meet redemptions as the dividend yields became more in-line with the underlying investments. These fears appeared to be warranted as there were outflows of $1.6 billion from those two funds alone over the following months. However, Japanese investors returned to the space in the final two months of 2012, adding $800 million back into US REITs amidst dividend cuts by other US focused REIT funds in Japan.

FIGURE 2: AVERAGE HISTORICAL DIVIDEND YIELD ON JAPANESE FUNDS OWNING US REITS



SOURCE: ISI RESEARCH, BLOOMBERG

In January 2013, the Japanese government announced a $116 billion stimulus package to drive economic growth. Japanese investors continued the late 2012 trend and added another $1.4 billion to US REITs from January 1 to April 4, 2013. As of April 4, Japanese investors had $46.9 billion invested in US REITs through mutual funds.

Not to be outdone, the Japanese central bank announced a historic quantitative easing program on April 8, projected to be the largest in history as a percent of GDP. Their plan is to pump $1.4 trillion into the economy, which equates to $79 billion per month in bond-buying. This historic quantitative easing has driven the yen to record low levels versus the dollar and ensures low yields on government bonds for the foreseeable future. Additionally, part of the program involves buying REIT ETFs and J-REITs (Japanese REITs), which has driven up valuations of J-REITs and encouraged investors to look outside of Japan for better value. As a result, US REITs have received an incremental $300 million in net inflows from Japanese investors from the announcement through April 18.

As of April 18, the net effective yield on these funds was about 15%. Though we applaud the move from 20% to 15% yields, we would be much more optimistic on the stickiness of the Japanese fund flows if the yields were more realistic. We closely monitor all fund flows into the REIT sector, but we are particularly interested in the Japanese demand due to their large current size and the outsized dividend yields. Under the current scenario, their participation is a net positive, but we understand that it could change with a policy shift.

Nobody Likes FIRPTA

While on the topic of policy changes, an interesting bullet point from President Obama's budget proposal was the potential for an elimination of a tax on foreign investors in real estate. Called the Foreign Investment in Real Property Tax Act, or FIRPTA, this tax has historically dampened foreign demand for US real estate, and given US companies and investors an advantage on price. Though experts assign almost "zero" probability for the budget to pass, it is a positive that the government has admitted the negative effects of this tax, and has now put it on the table for potential elimination. The elimination of FIRPTA would increase interest in US commercial real estate from non-US entities, which would theoretically drive up values as bidding became more competitive.

Internet Sales Tax

We have mentioned this before, but there has been lobbying in DC to force online shoppers to pay sales tax, regardless of whether or not it is an interstate transaction. The latest attempt is in a bill called the Marketplace Fairness Act, which has passed a test committee for the Senate, allowing it to come to the floor for a vote in the Senate. It is worth noting that most retail REITs support an internet sales tax, and now web-retail giant Amazon is supporting it as well. In its current form, the bill would impose the liability on the retailer (with annual revenues above $1 million) to collect the sales tax, thereby forcing them to comply with sales tax from some 9,600 local tax authorities. If an internet sales tax were to pass into law, it would level the playing field with brick-and-mortar retailers that are the tenants in REIT-owned properties.

REIT Elite on Sale

Though the first three months of 2013 saw gains for the REIT sector as a whole, the blue chip REIT elite did not experience the same upside. When we wrote about the Chilton REIT Elite in August 2012, we owned six of the eleven members with a total allocation of 23.5%. In the first quarter, the valuation metrics relative to their lower quality peers narrowed to levels that made the REIT Elite extremely attractive from a total return perspective. By the end of the first quarter, we owned eight members with a total allocation of 26.7%.

Though we pride ourselves on our detailed analytical research, we believe buying high quality companies with the best management teams at a discount to NAV and at a relative discount is a no-brainer, even though it has modestly penalized our total returns year to date relative to the benchmark. Since inception in 2005, our investment strategy has remained steadfastly focused on companies that can deliver long term dividend growth and superior total returns, and our results since then demonstrate the high degree of success that we have achieved for our investors.

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RMS: 1476 (4.30.2013) 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.

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