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This Race Ain't Over Yet | September 2013

In August, REITs pulled back as further pressure from rising interest rates continued to negatively impact yield investments. As measured by the MSCI US REIT Index (RMS), REITs produced a total return of -6.9% for the month, which compares to -2.9% for the S&P 500 Index. Year to date, the S&P 500 has handily outperformed the RMS with a total return of 16.2% versus -0.1% for REITs.

In light of rising interest rates and our contrarian overweight to apartments, we will once again revisit our thesis on the property type and present a compelling argument for today being an attractive entry point. There is a race occurring right now between apartment builders and demand for apartments; a race which we think can be won by all parties, assuming economic conditions persist.

Demand "Drivers" for Apartments
As of August 31, 2013, apartment REITs are trading at one of the largest discounts to NAV among all Equity REITs based on concerns that demand will not be able to match the current acceleration in supply, and as a result, rental growth rates could decline further. However, our analysis of market conditions indicates demand is sufficient to keep virtually all apartment markets in equilibrium. National job growth for 2013, at 192,000 per month thus far, is slightly higher than the 2011-2012 pace of 179,000 per month, and unemployment claims continue to trend lower. The urban and coastal markets, where several REITs own communities, have seen most of the economic improvement.

Texas and, most notably, Houston serve as an example of how job growth can drive rents during times of elevated construction: Houston created 100,000 jobs from June 2012 to June 2013, and history shows that demand for one apartment unit is created for every seven new jobs. Using the 1:7 ratio, and assuming the job market stays consistent, Houston has demand for almost 14,000 new units. 2013 completions are expected to be 9,250 units, which would result in positive absorption of 4,750 units. With Houston's occupancy at 95%, it is no wonder its rent growth is projected to be one of the highest.

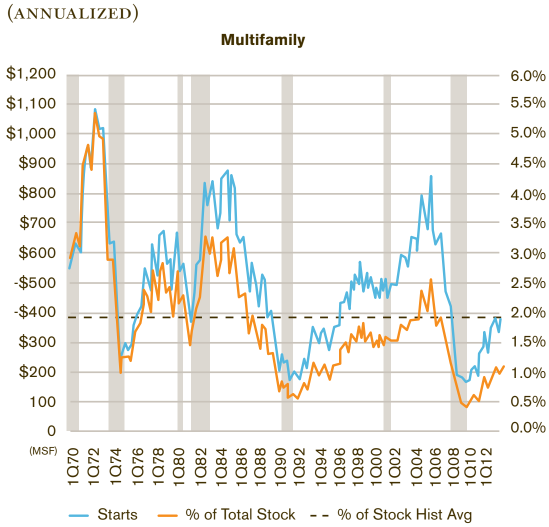
Household formations are on the rise due to the improving jobs picture, albeit the pace is slow. In 2013-2017, 6.5 million new households are expected to be formed in the U.S., with 1 million of those expected to end up in apartments. Contributing to the increase in household formations is the record 21.6 million adults that were living with their parents in 2012. As the economy brightens, some of the adults will form new households as they feel more secure in their job, but are not yet ready to buy a house.

Single-family homes are the apartment sector's main competitor. With interest rates still low in a historical context, there is concern that apartment dwellers will move out to purchase a home although, to date, the incidence of move-outs for home purchase remains well below historical averages. Importantly, after peaking in 2005, the homeownership rate has declined from 70% to 65%, and we expect it to drop further to the low 60's. The decline was exacerbated by the housing crisis of 2008+, which decreased home prices in most cities and, more recently, led to tougher underwriting standards by mortgage lenders. In essence, the American Dream of homeownership was dealt a severe, if not, crippling blow. In 2012, among the REITs in the Greenstreet coverage list, 13.6% of all apartment renters moved out to buy a house, down from 20.8% in 2005.

Today, other factors have been cited to account for fewer homebuyers such as lifestyle choices, higher student debt, and delays in getting married and starting families. Not surprisingly, only 23.5% of singles under the age of 35 own homes. As an example, only 9% of Equity Residential's (NYSE: EQR) urban-focused portfolio is occupied by two adults with one or more children. As people have decided to stay in apartments longer, the profile of the average renter has changed. The average length of stay for tenants of Associated Estates (NYSE: AEC) is now 20 months, up from just 15 months a few years ago. Camden Property Trust (NYSE: CPT) tenants' median income has increased from $63,000 to $78,000 since August 2011, not only as a result of economic improvement, but also from higher wage earners delaying homeownership due to the reasons listed above. Over the past 30 years in the U.S., the average age of marriage has increased 16% to 28.6 years for men and 21% to 26.6 years for women. If we use Europe as a leading indicator, we can expect the average age to increase closer to 30 years. Also, the decision to have children is being delayed as only 43% of families have children under 18, a 10% decrease since 1980. Lastly, renters are more likely to enjoy amenities such as restaurants, theater, sporting venues, and where mass transit affords a lifestyle divorced from long commuting times, which are usually in areas where home ownership is the most expensive.

As such, home affordability also weighs on the buy versus rent decision. Apartment REITs address this concern by targeting areas with low home affordability such as New York City, Boston, and San Francisco where the propensity to rent is high due to the high cost of single family alternatives. The national average for the home affordability index is 236, but the REITs we own are targeting densely populated gateway cities, which average 124, and even the urban cores of secondary cities. Since higher mortgage rates increase the cost of homeownership, rising interest rates should lower affordability nationwide and steer people toward renting.

FIGURE 1: MULTIFAMILY SECTOR CONSTRUCTION STARTS (ANNUALIZED)



Source: CBRE and Chilton Capital Management

Will Supply Take the Lead?

Attractive rent growth draws competition unfortunately, and if supply outstrips demand, it is harder to maintain occupancy and increase rents. As seen in Figure 1, construction starts are currently on the rise from their lows in 2008. The recession, for multiple reasons, caused a halt in new real estate developments. Since then, starts have doubled.

To put things in perspective however, as shown in Figure 1, 1% of multifamily stock is under construction, which is half of the historical average. With current obsolescence estimated at 1%, new supply is barely keeping up with units lost. According to Marcus & Millichap Research, forecasted 2013 completions of 145,000 units will lag expected demand of approximately 151,800 units, which will reduce the national vacancy rate 10 basis points to 5% by year end. Apartment REITs in our composite are enjoying record high occupancy rates and rental growth rates remain positive, albeit declining from a spectacular average of 6.0% in 2012 to a very healthy 4.8%, as estimated for 2013.

Apartments and the Rising Rates Effect

The recent headlines of rising interest rates have caused investors to wave the caution flag because REITs are viewed partially as yield vehicles and are capital intensive. Average dividend yields have moved from 3.5% to 3.9% in the past three months, and borrowing costs for 10 year debt have risen about 100-150 basis points. However, our analysis of the fundamentals suggests that apartment REITs should be able to produce growth in earnings and dividends in the 8-10% range for the next several years.

Rising interest rates also affect new apartment construction as they increase cost of capital for all players. Additionally, construction costs have increased anywhere from 10-20% over the past year, depending on the market. With costs to build on the rise, less predictable rental growth rates, and higher implied returns necessary to attract capital for new development, permits have already plateaued and many industry participants see a decline in deliveries beginning in the 2014-2015 period. Another factor giving the investment-grade REITs an advantage is the federal government's plan to have both Fannie and Freddie reduce volume of lending after long dominating multifamily lending by offering lower rates than other capital providers. Today, such REITs have a meaningful cost of capital advantage over most industry participants who rely more heavily on Fannie and Freddie.

Rising earnings and dividends are the best fuel in a race against rising rates. A quick look at AFFO dividend payout ratios and AFFO growth helps to demonstrate apartment REITs' ability to increase dividends. AFFO, or adjusted funds from operations, is a measure of the residual cash flow available to share-holders after maintenance capital expenditures. For 2013, the average apartment REIT AFFO dividend payout ratio is 75%, which compares to the historical average of 82%. Apartment REIT AFFO growth is projected to be approximately 8.5% for 2013 and 8.8% in 2014, and we expect dividends will at least match these growth rates.

FIGURE 2: APARTMENT REIT PERFORMANCE AND VALUATION

	Performance YTD	Prem/Disc to NAV
Apartment REITs	-4.8%	-17.7%
RMS	-0.1%	-2.9%

Source: Chilton Capital Management as of August 31, 2013. apartment REIT performance and valuation is market cap weighted.

Apartment REIT Valuation

As shown in Figure 2, year to date as of August 31st, apartments have produced a total return of -4.8% versus the RMS performance of -0.1%. However, with apartment fundamentals giving the "green light", the current market is providing an attractive entry point into the race. Since 1993, apartment REITS have averaged a 3% premium to NAV. Net Asset Value, or NAV, is a term used to describe the estimated net market value of the company after subtracting all debt. As of August 31st, apartments REITs trade at a -17.7% discount to NAV, as compared to the REIT average of a -2.9% discount. Furthermore, all five apartment REITs in our composite have significant embedded NAV growth via development. AvalonBay (NYSE: AVB), for example, is on pace to develop $1.0+ billion dollars annually for the next several years. If current trends remain in line with our forecasts, development should equate to about $4.00/share of value creation annually for this REIT.

Apartments are currently trading at prices that should provide attractive future returns by our analysis. Even though rent growth is decelerating, the fundamental outlook has improved due to a better jobs picture, the fact that apartment permitting has plateaued, and rising mortgage rates. We continue to favor REITs with high Class-A exposure and an urban footprint.

FIGURE 3: PORTFOLIO CHARACTERISTICS

Metric	ACC	CCG	EDR
1. Geographic Concentration	National	National	National
2. Avg. Distance to Campus (mi)	0.6	1.3	0.8
3. Avg. Total Enrollments	34,700	22,600	31,300
4. Avg. Acceptance Rates	64%	71%	62%
5. % National Top 150 Schools	53%	29%	65%
6. % Division 1 Football	79%	57%	65%
7. Avg. Asset Age (yrs.)	12	5	11
8. % Assets below 80% Occ.	1%	7%	11%

Source: Green Street Advisors report dated June 28, 2013

Not Your Father's Dormitory

Moving back a few years in terms of age of the target demographic, student housing REITS have also lagged the index and trade at a discount to NAV. Some unique aspects of student housing are the amount of beds per unit, lower operating margins, tighter lease-up windows, demographics of tenants, and increased management attention. Also different from apartments, student housing values are driven by: 1) Distance to campus, 2) Region of the country, 3) Age of the property, 4) Occupancy, 5) School Enrollment, 6) Acceptance rates, 7) School type (e.g., Public, Private, For-Profit), and 8) Division I football. In Figure 3, the three student housing REITs' portfolios are compared against the eight drivers.

Public-private partnerships between REITs and universities are the new "shiny car" in student housing. With universities facing tightening budgets, as of late, they have begun to outsource some of their services. Bookstores and on-campus dining services are just a few examples, and it appears that on-campus housing is next. Two REITs, American Campus Communities (NYSE: ACC) and Education Realty Trust (NYSE: EDR), have begun partnering up with universities to build and operate on-campus housing. In many cases, old dormitories are being replaced with modern student apartments filled with amenities unheard of several years ago. As a result, the school is more attractive to prospective students. For the REIT, the facilities are typically always full, require less advertising, and generate excellent risk-adjusted returns. As REITs continue to build relationships with universities across the nation, public-private partnerships are a trend that could begin to increase exponentially. Arizona State, Kentucky, and Princeton are just a few of the schools that have taken advantage of this format.

The development pipeline for student housing is robust: ISI Research found that US public universities have the capacity to house 22% of their enrolled student base on campus. The remaining 78% must live off campus, which provides REITs with an opportunity for development. American Campus Communities has a $433 million development pipeline of both on and off campus properties, which will create $1.00/share in NAV. Current NAV for ACC is $42.50, indicating 2.4% growth in NAV through development. For comparison, Education Realty Trust has a $552 million development pipeline, which would add $0.80/share in NAV, or 7.6%.

Put Your Money on Demand

Apartment and student housing REITs have underperformed the broad REIT market as of late. However, the future market fundamentals are favorable as demand should outstrip supply in many of the REITs' markets. With development as an internal source of growth, apartment REITs should be "starting their engines". AvalonBay's (NYSE: AVB) CEO, Tim Naughton, seems to agree.

"We are not particularly concerned by this level of [housing] production for a number of reasons… [First],the current level of apartment starts is generally in line with the past couple of expansions and basically matches the current level of job growth and household formation. [Second], supply is expected to peak at or near these levels by mid-2014."

Indexes are unmanaged and have no fees or expenses. An investment cannot be made directly in an index. The funds consist of securities which vary significantly from those in the benchmark indexes listed above and performance calculation methods may not be entirely comparable. Accordingly, comparing results shown to those of such indexes may be of limited use.

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RMS: 1279 (8.31.2013) 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