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Embedded Growth on Aisle 9 | 1st Quarter 2012

The US is enjoying its position as the 'least bad' economy in the global marketplace, as international investors are fleeing tumultuous markets in Europe and Asia for greener pastures. In March, REITs climbed back to 2012 highs to finish the month up 5.2%, as measured by the MSCI US REIT Index (RMS). Year to date, the RMS has a total return of 10.7%, which compares to a 12.6% total return for the S&P 500 over the same period. We feel the outperformance of the S&P 500 versus the RMS is a function of the S&P 500 being undervalued, not the RMS being overvalued. During the month, the Fed decided to continue its plan to keep interest rates where they are, signaling that the recovery is fragile and that they are sticking with their plan to keep rates low through 2013.

Even so, we admire CFOs that are thinking long term. When we see five and seven year debt deals, we have to model refinancing risk and a higher interest rate at maturity. In our target price model, uncertainty and higher debt costs are two things that detract from earnings predictability and our calculated intrinsic value. Instead, we applaud CFOs that have gone the other direction to issue longer term debt or preferred equity, albeit at higher interest rates. We believe any short term dilution from a higher interest rate will be recaptured in longer term appreciation of share price reflecting balance sheet strength.

More than a dozen REITs have been active in the capital markets in recent weeks, during which time they raised over $2 billion of perpetual preferred equity at very reasonable rates. This is permanent capital that has no maturity and fits nicely in the capital structure of any REIT. In most cases, existing issues with higher dividend yields were redeemed with the proceeds. Kimco (NYSE: KIM) was able to raise $400 million in perpetual preferred equity with a 6.00% coupon, and Public Storage (NYSE: PSA), long the leader in the issuance of preferred shares, was able to raise

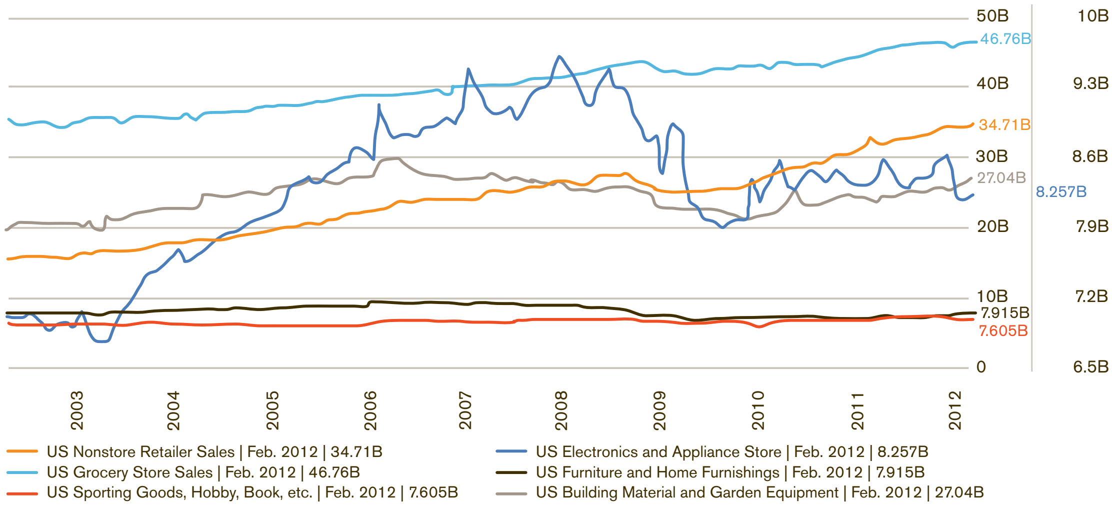
FIGURE 1: POSITIVE RELATIONSHIP BETWEEN DEBT MATURITY AND NAV PREMIUM

SOURCE: SNL FINANCIAL AS OF MARCH 14, 2012

a similar amount at a 5.75% coupon rate. We believe these large issues of permanent capital raised at such low rates (5.75% is a new record for REITs!) gives investors more confidence in the long term viability of the business, more certainty on the ability to pay fixed charges, and enhances the sustainability of dividends on common stock outstanding. Data from SNL Financial in Figure 1 shows that, in fact, there is a positive relationship between the certainty of financing costs and the net asset value (NAV) premium over the stock price. Unfortunately, most REITs do not see what is so obvious to us and to Simon Property Group (NYSE: SPG), as shown in a recent transaction.

Simon Property Group (NYSE: SPG) is considered by most investors to have one of the best track records of balance sheet management, buy/sell decisions, and operational excellence. In March, they made headlines with the announcement of two simultaneous acquisitions totaling $3.5 billion. SPG agreed to pay approximately $2 billion for a 28.7% stake in Klépierre (PAR: LI), a leading European retail real estate company. The other acquisition was to buy the remaining stake of a portion of the Mills portfolio from its JV partner for $1.5 billion. To pay for these assets, SPG raised $1.2 billion in equity, and

FIGURE 2: GROCERY STORE SALES PROVE MOST RESILIENT AMID GROWTH OF INTERNET SALES



SOURCE: YCHARTS.COM

then $600 million of 2.150% notes due 2017, $600 million of 3.375% notes due 2022 and $550 million of 4.750% notes due 2042. This results in a weighted average coupon of 3.39% and a weighted average term of 14.7 years. This is the kind of balance sheet management we look for in a REIT. Coincidentally, SPG trades at an 11% premium to NAV as of March 14, 2012.

All Properties Are Not Created Equal: Strip Centers

Strip centers have long played a large role with the REIT industry. At the dawn of the modern REIT era, strip centers represented the largest sector by market capitalization at 27%. Today it stands at 8%. Some of the oldest REITs in the United States specialize in this property type, including Federal Realty (NYSE: FRT) and Weingarten Realty (NYSE: WRI). Some of the stalwarts from the past, now out of the public market, include NewPlan Realty, Bradley Real Estate Trust, and IRT Properties. Strip centers usually contain 100,000 to 300,000 sqft and are typically anchored by a supermarket.

The strip center sector differs from other REIT sectors in that it is an extremely local business. Analysis shows that customers at a strip center usually come from within a 3 mile radius. Most often, strip centers with higher median household income and population density within 3 miles have higher sales per sqft, and therefore can charge their tenants higher rent. A strip center REIT also has to find the right mix of tenants and anchor that will draw the most traffic to their stores. Common options for anchors have been grocery stores, electronics stores, sporting goods stores, department stores, and home goods stores. In order to identify the most profitable long term anchors, we monitor data on where consumers are spending their money. Figure 2 shows the sales of the retailers that are in the anchor categories mentioned above. The rise of the internet sales ('nonstore retailer sales') over the past 10 years has been at the expense of brick and mortar retailers, namely electronics, home goods, and sporting goods retailers. However, grocery store sales have been resilient throughout the cycle, a very important key to having the right anchor for a strip center. On that note, we are tracking litigation for states to charge sales tax for online purchases, which will help level the playing field for 'bricks and mortar' retailing versus the internet. Simon Property Group was successful in getting this passed in Indiana, and is hopeful that other states will follow as well.

Small Shop Space

After finding the anchor, the REIT must look for the small shop tenants to feed off the traffic generated from the anchor. Traditionally, the small shop rent per sqft is double or more the amount of the anchor rent, though the size of each small shop is usually less than 10,000 sqft. Essentially, it's where the landlord makes a profit on the center. As of December 31, 2011, the average small shop occupancy for REITs was 82.5%, while the average peak small shop occupancy was 90.5%. The credit crisis of 2008-2009 caused many mom and pop tenants to struggle and, in some cases, force them to give back space. The strip center REITs are finally rid of these weak tenants and are now filling that space with newer, higher credit tenants, where they were previously receiving zero rent. We believe this embedded organic growth will materialize over the next few years. If some of these REITs can get their small shop occupancy halfway back to the all time high from here, there will be significant value creation in the form of higher earnings and higher NAVs.

Strip Center Supply

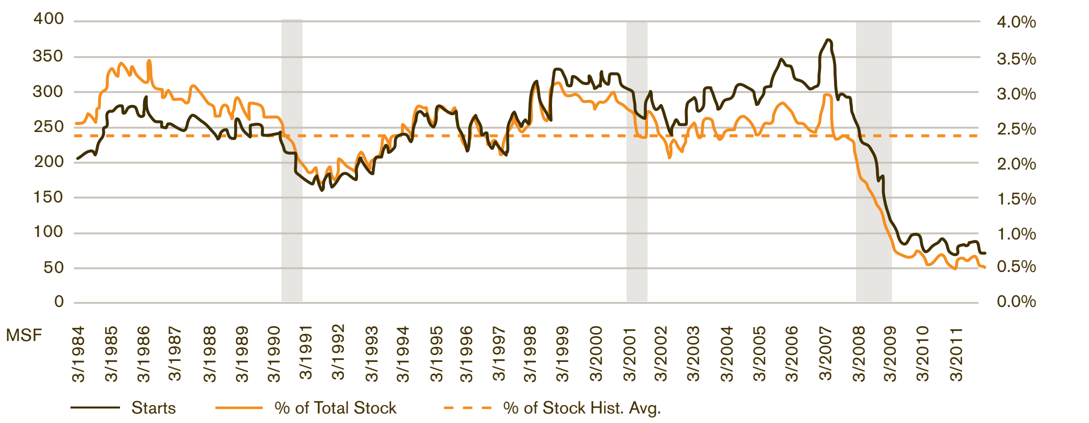
As with the other REIT sectors, the construction of new retail centers remains at all time low levels. On a recent property tour in Houston, we learned that there will be fewer completions of retail centers in 2012 than in 2011, according to projections by REIS, Inc. Despite Houston being one of the best markets in the country for employment gains right now, the same lack of new supply that is seen elsewhere due to the aforementioned theme of smaller footprints for brick and mortar retailers still exists. In Figure 3, note that the percent of total commercial retail real estate under construction nationwide is close to 0.5%, a record low and far below the long term average of 2.4%. We see this as a benefit to the companies that own the top one or two centers in a particular submarket, as they will face less competition from new construction, and hopefully grab market share from those centers on the margin.

A "New Normal"

Having the best center is especially important in the 'new normal' environment in consumer spending. Real Consumer Spending (PCE) has averaged a 3.4% annual increase with only 2 years of declines from 1960-2007. Following consecutive declines in 2008 and 2009, we are still far below that average in 2011. Additionally, the personal savings rate averaged 8.1% over the same period, but dropped to below 2% in the years leading up to the peak of the market in 2007. Since the spending peak, we have climbed back towards 5%. We believe that the decline in consumer spending is not going to be temporary. Instead, we believe consumers are going to revert back towards the long term average of savings to 8.1% and the growth in consumer spending will stay below the long term average, which means that there is a 'smaller pie' for the strip centers to compete over.

Retail REITs are aware of the decline in demand of their product, and have been making adjustments to their business model to accommodate the new environment. Most strip center REITs have initiated programs to sell the bottom 10-20% of their portfolio

FIGURE 3: NEW CONSTRUCTION OF RETAIL REMAINS AT ALL-TIME LOWS



SOURCE: TORTO WHEATON AND CITI INVESTMENT RESEARCH AND ANALYSIS AS OF DECEMBER 31, 2011 while developing or acquiring additional high quality properties. Typically, REITs want to own the top one or two centers in the best 3 mile radius in a submarket. Using their superior access to capital and proceeds from selling assets, the REITs are in a capital recycling program to upgrade the quality of their portfolio with the intent of maximizing shareholder value.

Chilton Outperformance Potential
As stated in previous letters, we believe we can create significant alpha for our clients through superior stock picking and sector allocation. Due to all the reasons listed above, we consciously began overweighting regional malls and underweighting strip centers several years ago. However, there are still opportunities to make money in the sector today. Year to date as of March 22, strip centers are the 2nd best performing REIT sector with a total return of +13.2%. Within the sector, the total returns of the individual fifteen strip center REITs range from +1.1% to +23.2%. Our philosophy that certain strip centers will be winners at the expense of others leads us to believe there will be further deviation of returns between the strip center REITs, and our investment process will enable us to create outperformance in the sector for our clients.

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

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

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RMS: 1204 (3.30.2012) 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)