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Multiple Problems with Claims that REITs are "Expensive" | June 2015

Public REIT valuations are under the scrutiny of many investment strategists, often referring to the group as "overvalued" relative to other investment options. Given that fundamentals for commercial real estate could hardly be much better, we find such conclusions inaccurate. Occupancy, rent growth, and same store net operating income growth are at cyclical highs, while new construction and uncertainty of future cash flows are at historic lows. Consequently, we are forced to conclude that fears about real estate pricing and valuation assume that rising interest rates will erode REIT multiples down to historical averages and increase property cap rates. However, historical REIT multiples have become essentially irrelevant when attempting to value REITs today, and interest rates are not even a top three driver of cap rates.

Interest Rates and Pricing

While equity REITs are not immune to rising interest rates, we believe many investors view the group more like bonds than equities. Real estate professionals that actually purchase and manage properties consider interest rates to be only the fourth most influential driver of real estate pricing. The top three drivers are, in order: liquidity of realty markets (now at an all time high), supply versus demand (a "landlord market" for most property sectors), and inflation (tame).

Today's REITs have the power of dividend growth to help dampen any long term impact from rising rates. Our estimates call for a 6% compound growth rate over the next four years. Given the dividend yield of the MSCI US REIT Index was 3.9% as of May 29, 2015, REITs can produce solid returns for shareholders even if multiples contract somewhat from today's levels and borrowing costs increase at the REIT level. If our estimates are accurate, the dividend yield would rise to 4.8% at current prices in the next four years.

Multiples vs NAV

Data for equity REITs during the Modern REIT Era, defined in this report as the period from 1995 to 2014, could incite concerns considering the market cap-weighted price to forward funds from operations (P/FFO) multiple averaged 12.8x, but stood at 15.8x as of May 15, 2015. A difference of 22% between the two numbers needs further explanation to ease investor concerns that equity REITs are appropriate for all investor portfolios at today's levels. Similarly, the weighted average price to adjusted FFO (P/AFFO) multiple has averaged 15.5x since 1999, but stood at 21.1x as of May 15, 2015, a difference of 26%.

Multiples can be extremely useful when attempting to value comparable companies. However, the usefulness of multiples breaks down when companies are not alike. A quick test of using multiples shows difficulty in applying them across property types. According to Bank of America Merrill Lynch (or BAML), the property type with the highest average AFFO multiple was residential at 17.4x, while shopping centers were almost 20% less at 14.3x. A simple eye test would tell an investor that an apartment company with assets on the West Coast should trade at a different multiple than a portfolio of suburban power centers in the Southeast. Thus, AFFO multiples do not fully account for differences in property type, quality, or location.

We commonly look at a person's "net worth" by summing up the market value of his or her assets, and subtracting liabilities. Similarly, we believe the best method to value a publicly traded equity REIT is to determine the market value of its assets, and then subtract liabilities. The result is known as "Net Asset Value", or NAV. In contrast to AFFO multiples, historical average NAV premiums of REIT property types have only ranged between -1% and +6% since 1996. BAML research shows that REITs have

traded at an average 1% premium to their NAV for the past 20 years, and we believe that REITs will trade somewhere close to that average for the next 20 years as well.

Importantly, the NAV method controls for differences in market dynamics, tenant credit quality, geography, property type, replacement cost, and cash flows (or rent). Given our forecast for predictable NAV growth into the future, we believe FFO and AFFO multiples will remain elevated relative to historical averages that were calculated using non-comparable data.

Index Composition

One of the issues with attempting to use historical multiples is that the universe on which the historical averages are based has changed significantly. As of July 30, 1999, the NAREIT Equity REIT Index included 174 companies boasting a combined market cap of $153 billion, resulting in an average market cap of $880 million. The three largest property types were Residential, Diversified, and Office. 53 REITs had debt outstanding with an investment grade rating, equal to 30% of companies in the index, and there were exactly zero REITs in the S&P 500.

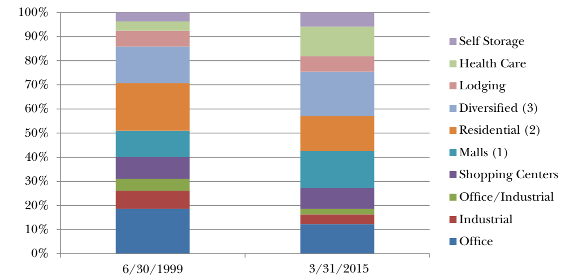
In contrast, the same index as of March 31, 2015 had 153 members, 24 of which were in the S&P 500. In fact, only 63 companies that were in the July 1999 index were still in the index as of March 31, 2015. Figures 1 and 2 show the drastic differences in index composition. The average market capitalization has increased from $880 million to $5.5 billion, and average daily trading volume has increased from less than $500 million in 1999 to $7.4 billion in March 2015. Essex (NYSE: ESS) is a prime example of the growth of market cap and liquidity, going from an enterprise value of $250 million 20 years ago to $20 billion today. The greater size and access to capital enable REITs to be competitive for any acquisition or development, especially those in the most desirable locations.

Figure 1: NAREIT Equity REIT Index Composition

	7/30/1999	3/31/2015
Number of REITs	174	153
Market Cap ($ millions) (1)	153,048	839,272
Avg Market Cap ($ millions)	880	5,485
REITs in S&P 500	0	24
# REITs with IG Debt (2)	53	62
% REITs with IG Debt by # (2)	30%	41%
% REITs with IG Debt by Mkt Cap (2)	54%	62%
Dividend Payout Ratio (3)	76%	72%
Debt / Gross Asset Market Value (4)	49%*	35%
Debt / Total Market Cap	51%	34%
Avg. Daily Trading Volume ($millions)	<500	7,400

Source: NAREIT, Bloomberg, Chilton Capital, Citi Research, Green Street Advisors
(1) Market Capitalization; (2) IG = Investment Grade; (3) Trailing 4 quarter avg; (4) Green Street Advisors Est. *as of 12/31/1999

Figure 2: NAREIT Equity REIT Index Property Type Allocations



Source: NAREIT, Chilton Capital. (1) Includes Outlets; (2) Includes Student Housing and Manufactured Homes; (3) Includes Freestanding Retail and Specialty

Asset Quality

"Location, location, location" has an overwhelming impact on key performance standards, and the better REITs have fully embraced upgrading portfolio quality in the past 20 years. While it is difficult to quantify, there has been a transformation of REIT portfolios from secondary cities to "gateway cities", and from suburban to urban. A gateway city refers to a dynamic, densely populated economic hub where commercial real estate has the highest long term investment appeal. Boston, New York City, Washington DC, Los Angeles, and San Francisco are examples of such cities where economic downturns are shorter and less extreme. In addition, it is more difficult to build new product, thus making the conditions more favorable for landlords.

Increasingly, downtowns of gateway cities are offering the most diverse and vibrant quality of life available in America, thereby attracting companies and employees. Not since the 1940's have cities been regarded as the best places to live. Each of the above cities was included in Cushman & Wakefield's top 10 list of cities with the most expensive office occupancy costs in the world for 2014 (in addition to Miami and Houston).

New York City, specifically Midtown, was ranked as the most expensive city for occupancy cost in the world. Today, public REITs account for 3 of the top 10 office landlords in New York City. This was not the case 20 years ago when exactly zero public REITs were top owners of real estate in NYC. A similar transformation occurred in San Francisco over an even shorter time period. As of 2013, four public REITs were in the top 10 owners of downtown San Francisco office space, owning over 19% of the market. In 2009, only two public REITs were in the top 10, and they controlled less than 7%.

Kilroy Realty (NYSE: KRC) is an excellent

example of the transformation that has occurred for many REITs. As of June 30, 1999, KRC owned only 3 million sqft (~26% of total portfolio) in a gateway city (Los Angeles), and over half of the portfolio consisted of industrial space. As of March 31, 2015, KRC owned over 9 million sqft (~73% of total portfolio) in gateway cities (LA, San Francisco, and Seattle), and no longer had any industrial properties. Impressively, KRC owns only 1 million sqft more today than it did over 15 years ago, but the portfolio is almost completely different. As evidence of the quality upgrade, KRC's weighted average base rent was less than $12/sqft as of June 30, 1999, which compared to more than $37/sqft as of March 31, 2015.

In a similar anecdote, office REIT Boston Properties (NYSE: BXP) trades at a premium valuation today thanks to its reputation for owning trophy properties in Boston, New York City, Washington DC, and San Francisco. However, if BXP had not made any portfolio changes since 1998, it would not warrant the premium valuation it garnishes today. Active portfolio management by BXP has been crucial for BXP to increase its stock price from $30.50 per share on December 31, 1998, to $130.03 per share on May 29, 2015, while paying out almost $55 per share in dividends. Out of its 25 million sqft portfolio from 1998, only 15 million sqft (or 60%) is still owned today; also, the legacy 15 million sqft comprises only 33% of the current portfolio. Recently valued at $4.3 billion by Green Street Advisors, BXP's most recognized asset, the GM Building in New York City, is more valuable than the entire company was on December 31, 1998 using total market capitalization.

We see examples in other property types as well. Weingarten Realty (NYSE: WRI), a shopping center REIT, recently completed a multi-year portfolio transformation that has dramatically improved its three-mile demographics, as shown in Figure 3. Hersha Hospitality Trust (NYSE: HT), a lodging REIT, has undergone a similar transition in the past 16 years. As of December 31, 1999, HT owned 13 hotels totaling 1,198 rooms, with 85% of revenue derived from suburban Pennsylvania. As of December 31, 2014, HT had interests in 51 hotels totaling 8,259 rooms, of which none were located in suburban Pennsylvania. For 2015, HT projects that 96% of revenue will come from urban gateway markets, including New York City, Miami, Washington DC, LA, and Boston. As a result of the transformation, HT has increased its revenue per available room (or RevPAR) from $39 in 1999 to $155 in 2014, a compound annual growth rate (or CAGR) of 10%. In comparison, Smith Travel Research estimates US RevPAR CAGR over the same period was 2%.

Figure 3: WRI Portfolio Transformation

3 Mile Radius Demographic	12/31/2005	3/31/2015
Population	101,936	111,365
Avg. Household Income	$70,105	$83,707
Number of Households	39,422	44,202

Source: Weingarten

Management Teams

It may also be difficult to quantify, but it is optically impossible to argue against the better capital allocation decisions employed by REIT management teams. This is a result of being cycle-tested twice over the past 20 years, with the biggest stress test coming in 2008-2010 when virtually all REITs survived to become even better companies.

The best REITs today are operating as fully integrated real estate companies, which contrasts sharply to the 1990's when "spread investing" was the popular mantra for asset growth. Spread investing is a capital allocation method that attempts to create value by simply acquiring an asset with a cash flow yield above a minimum spread versus the company's cost of capital. Unfortunately, spread investing does not look at the value of the asset at the end of the measurement period, nor does it limit companies to geographic areas or property types in which they exhibit a competitive advantage. Thus, many REITs gravitated toward higher yielding assets in multiple property types, which resulted in lower portfolio quality.

We cite Eastgroup Properties (NYSE: EGP) as an example of a REIT that has evolved from a multi-sector portfolio to one with a pure focus on industrial properties. EGP now allocates most of its capital to development of multi-tenant industrial buildings with 'park-like' settings that are located near major transportation hubs (airports, ports, distribution hubs). At the same time, it has exited smaller markets where it was not possible to cluster assets or attain a critical mass. A large number of the leading focused REITs today have evolved from multi-sector portfolios 20 years ago, including Cousins (NYSE: CUZ), KRC, Duke Realty (NYSE: DRE), and WRI to name a few.

REITs have become industry leaders for investments in technology and sustainability, thereby driving higher profit margins and minimizing obsolescence risk. In property types where it makes sense, REITs use revenue management

systems, call centers, and internet marketing to maintain market-leading occupancy and, usually, rent/sqft. In addition, REITs have been early adopters of sustainability programs that transfer tangible benefits such as reduced energy expense to the tenants while helping the environment.

Flexibility and Predictability

REIT CFOs have learned valuable lessons over the past 20 years. Debt/Total Market Cap ratios have come down dramatically from 51% on July 30, 1999 to 34% on March 31, 2015. The character of the debt is now mostly fixed rate with longer weighted average maturities. Importantly, management teams are now focused on the net debt to EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization) ratio, which provides a more reliable metric for a company's ability to cover it's debt obligations in good times and in bad. Net Debt/EBITDA ratios stood at 6.0x for REITs in Green Street Advisors' coverage universe as of March 31, 2015. Another useful metric for flexibility is interest coverage ratio (EBITDA/Interest Expense), which stood at 4.1x as of March 31, 2015, up from 3.5x on June 30, 1999.

The predictability of future growth in REITs is much higher today due in particular to low new supply of competing product and an economy generating increased demand. Occupancy in REIT portfolios stood at 94.5% as of March 31, 2015, which supports higher rents going forward. The weighted average dividend payout ratios (as a percent of AFFO) averaged 72% as of March 31, 2015, which compares to a historical average of 81%. The combination of predictable rent growth and low payout ratios supports our view that dividend growth should average 6% annually for the next four years.

CPI Hedonic Quality Adjustment

To our readers, "inflation" is usually measured by the CPI, or the Consumer Price Index. The objective of measuring changes in CPI is to track the price change for a basket of goods. Something our readers may not know is that the number is adjusted for 'quality'. For example, consumers may be paying more for televisions than they were 20 years ago, but the thickness (or thinness) and resolution has improved dramatically. Thus, the Bureau of Labor Statistics (or BLS) uses a 'Hedonic Quality Adjustment' to account for increased value that a consumer is receiving for his or her dollar.

The largest components of the CPI are 'Rent of Primary Residence' and "Owners' Equivalent Rent of Primary Residence", and the Hedonic Quality Adjustment attempts to adjust for an increased quality of living. Similar to better TVs, the Hedonic Quality Adjustment accounts for improvements in rented property or owned homes via the owners' equivalent rent (or OER). We would be the first to say that government does not get everything right, but the BLS seems to understand that changes in quality must be taken into account in consumer products, and especially in real estate.

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RMS: 1681 (5.31.2015) vs. 1710 (12.31.2014) vs. 346 (3.6.2009) and 1330 (2.7.2007)

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