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Diversified REITs Can Be Uniquely Focused | November 2015

In August of 1999, there were 18 REITs in the NAREIT 'Diversified' sector with an equity market capitalization of $14 billion that comprised about 10% of the NAREIT All Equity REITs Index (Bloomberg: FNER). 16 years later, there were 35 Diversified REITs with a combined equity market capitalization of $111 billion that comprised 13% of the same index. As the market capitalization of the REIT industry exploded, institutional investors and analysts have urged companies to maintain a clearly communicated, focused strategy. Appropriately, those that have followed such advice have been rewarded with, in general, higher valuations and better total returns for shareholders.

Those who would prefer a focused strategy to a diversified one would say that a focused strategy improves operational efficiencies, allows portfolio managers to have control over sector allocation, and produces a more predictable cash flow stream that is easier to value. Since these all make sense, why are there almost twice as many Diversified REITs today as there were in 1999? First, the sector as defined by NAREIT is a 'catch-all', and it actually contains many companies with a focused strategy – just not a strategy that focuses on one of the other 13 property types. Second, not every company feels the need to cater to portfolio managers. It is the blanket decision to ignore certain companies that can create opportunities for outperformance if a manager is willing to spend time to understand the value creation proposition.

Definitionally Challenged
According to NAREIT, "Diversified REITs are Equity REITs that own and manage a mix of property types and collect rent from tenants. For example, diversified REITs might own portfolios made up of both office and industrial properties." Of the 35 companies in the NAREIT Diversified sector, 20 of them (with a combined market capitalization of $64 billion) have a focused strategy on one property type. Those property types vary between single family rental housing, multifamily, casinos, billboards, data centers, shopping centers, farmland, and prisons. The remaining 15 companies have a combined equity market capitalization of $47 billion, which would equate to 5.6% of the index.

Of the 18 REITs in the Diversified sector in 1999, none of them had a focused strategy on one property type. Thus, the "increase" in the Diversified sector according to NAREIT is entirely due to an increase in the number of focused companies with property types that do not fit into the other 13, and is not representative of an increase in companies that "own and manage a mix of property types…" according to NAREIT's definition. In actuality, the percentage of the index invested in Diversified REITs has decreased from 10% to our calculation of 5.6% using NAREIT's definition.

The Global Investment Classification Standards (or GICS) sub-industry classification also has a broad use of the Diversified sector. GICS is used by S&P, Dow, and MSCI, each of which has its own family of US REIT indices. The GICS Diversified sector includes 20 companies comprising 7% of the MSCI US REIT Index (Bloomberg: RMZ). One of the key differences between the GICS and NAREIT classifications is the lack of an office/industrial sector for GICS, which adds approximately 2% to the Diversified allocation for the RMZ. There are four other REITs with a total index allocation of 1.3% that derive at least 87% of their net operating income (or NOI) from one property type.

Chilton Sector Classifications
We subscribe to a mix of both the GICS and NAREIT sectors in that we have an industrial/office mix sector (like NAREIT), but we also use a 'Specialty' sector (like GICS) as the catch-all for companies with a focused strategy that does not fit into our other sectors. Figure 1 attempts to show some of the key differences between the Chilton, GICS, and NAREIT

Figure 1: Dissecting the Diversified Sector

Company Name	Ticker	Market Cap ($ millions) (1)	Property Type Breakdown	NAREIT Classification	GICS Classification	Chilton Classification
Alexanders Inc	ALX	1,943	40% Office, 60% Shopping Centers	Diversified	Retail	Shopping Centers
American Assets Trust Inc.	AAT	1,911	51% Shopping Centers, 40% Office, 9% Multifamily	Diversified	Diversified	Diversified
American Homes 4 Rent	AMH	3,519	100% Single Family Homes	Diversified	Residential	Residential
American Residential Properties	ARPI	544	100% Single Family Homes	Diversified	Residential	Residential
Armada Hoffler Properties	AHH	284	48% Shopping Centers, 38% Office, 14% Multifamily	Diversified	Diversified	Diversified
BRT Realty Trust	BRT	97	82% Multifamily, 18% Mixed-Use	Diversified	N/A	Residential
CoreSite Realty	COR	1,462	100% Data Centers	Diversified	Specialized	Data Centers/Tech
Corrections Corp of America	CXW	3,428	100% Correctional Facilities	Diversified	Specialized	Specialty
Cousins Properties	CUZ	2,218	97% Office, 3% Shopping Centers	Office	Diversified	Office
Digital Realty Trust	DLR	9,760	100% Data Centers	Diversified	Specialized	Data Centers/Tech
CyrusOne	CONE	2,338	100% Data Centers	Diversified	Specialized	Data Centers/Tech
Duke Realty	DRE	7,230	71% Industrial, 18% Medical Office, 11% Office	Office/Industrial	Diversified	Industrial
DuPont Fabros Technology	DFT	2,047	100% Data Centers	Diversified	Specialized	Data Centers/Tech
Empire State Realty Trust	ESRT	2,065	96% Office*, 4% Retail	Office	Diversified	Office
EPR Properties	EPR	3,416	56% Entertainment, 20% Education, 19% Recreation, 5% Other**	Diversified	Specialized	Diversified
Equinix Inc	EQIX	16,684	100% Data Centers	Diversified	Specialized	Data Centers/Tech
Farmland Partners REIT	FPI	119	100% Farmland	Diversified	N/A	Specialty
First Potomac Realty Trust	FPO	682	53% Flex/Industrial, 47% Office	Office/Industrial	Diversified	Office/Industrial
Gaming & Leisure Properties	GLPI	3,303	100% Casinos	Diversified	Specialized	Specialty
Geo Group	GEO	2,440	100% Correctional Facilities	Diversified	Specialized	Specialty
Gladstone Land	LAND	83	100% Farmland	Diversified	N/A	Specialty
Gyrodyne America	GYRO	40	Non-Determinable	Diversified	N/A	Specialty
HMG/Courtland Properties	HMG	12	80% Real Estate Sectirities, Loans, and Cash	Diversified	N/A	Specialty
Investors Real Estate Trust	IRET	1,024	61% Multifamily, 32% Medical Office, 4% Industrial, 2% Other	Diversified	Diversified	Diversified
Iron Mountain	IRM	6,396	100% Record Management and Storage	Diversified	Specialized	Specialty
Lamar Advertising	LAMR	5,459	100% Billboards	Diversified	N/A	Specialty
Liberty Property Trust	LPT	5,145	55% Industrial, 31% Office, 14% Flex	Office/Industrial	Diversified	Office/Industrial
Lexington Realty Trust	LXP	2,092	56% Office, 26% Industrial, 15% Infrastructure, 3% Retail	Diversified	Diversified	Diversified
NorthStar Realty Finance	NRF	4,232	39% Health Care, 20% Lodging, 16% Office, 9% Manufactured Homes, 9% Other, 5% Triple Net Retail, 2% Multifamily	Diversified	Diversified	Diversified
One Liberty	OLP	393	62% Shopping Centers and Triple Net Retail, 21% Industrial, 7% Flex, 10% Other	Diversified	Diversified	Diversified
Outfront Media	OUT	3,260	100% Billboards	Diversified	N/A	Specialty
PS Business Parks	PSB	2,336	51% Flex, 29% Office, 20% Industrial	Office/Industrial	Diversified	Office/Industrial
RAIT Financial Trust	RAS	446	32% Mortgages, 31% Property Management, 26% Multifamily, 8% Office, 3% Retail	Mortgage	Diversified	Mortgage
QTS Realty	QTS	1,765	100% Data Centers	Diversified	Specialized	Data Centers/Tech
Select Income REIT	SIR	1,829	61% Office, 39% Industrial	Office/Industrial	Diversified	Office/Industrial
Silver Bay Realty Trust	SBY	597	100% Single Family Homes	Diversified	Residential	Residential
Starwood Waypoint Residential Trust	SWAY	926	100% Single Family Homes	Diversified	Residential	Residential
Spirit Realty Capital Inc	SRC	4,534	87% Triple Net Retail, 8% Industrial, 6% Office	Triple Net Retail	Diversified	Triple Net Retail
Store Capital Corp	STOR	2,890	89% Triple Net Retail, 11% Industrial	Triple Net Retail	Diversified	Triple Net Retail
VEREIT	VER	7,584	63% Shopping Centers/Triple Net Retail, 22% Office, 15% Industrial	Diversified	Diversified	Diversified
Vornado	VNO	18,982	83% Office, 17% Retail	Diversified	Office	Office
Washington REIT	WRE	1,849	56% Office, 25% Shopping Centers, 19% Multifamily	Diversified	Diversified	Diversified
Whitestone REIT	WSR	337	75% Shopping Centers, 14% Flex, 11% Office	Diversified	Diversified	Shopping Centers
Winthrop Realty Trust	FUR	523	61% Multifamily, 35% Office, 4% Other***	Diversified	Diversified	Diversified
WP Carey Inc	WPC	6,675	43% Industrial, 29% Office, 16% Triple Net Retail, 8% Other, 5% Self Storage	Diversified	Diversified	Diversified

Source: Company Reports, Green Street Advisors.
*Includes Empire State Building Observatory NOI as "office"
**Based on Investment Value, using Company Classifications
***Based on Consolidated Gross Asset Value. FUR is currently undergoing a liquidation process
(1) As of October 28, 2015

Diversified sectors. The two major differences in the Chilton methodology in comparison to GICS and NAREIT are that we use Data Center / Tech for the data center and cell tower REITs, and that we classify companies with at least 70% of portfolio Net Operating Income (or NOI) from one property type into that respective sector. For example, GICS classifies Duke Realty (NYSE: DRE) in the Diversified sector, while NAREIT classifies DRE as an Industrial/Office Mixed REIT. However, DRE derives about 71% of its NOI from industrial properties, 18% from medical office buildings (MOBs), and 11% from office buildings. Therefore, we classify DRE as an Industrial REIT.

Chilton Diversified Sector

The resulting Diversified sector contains a wide array of companies that have some interesting similarities. We characterize quite a few of them 'uninvestable' due either to a low market capitalization or being externally advised. The majority of the investable companies in the Chilton Diversified REIT sector is comprised of the following companies: American Assets Trust (NYSE: AAT), Armada Hoffler (NYSE: AHH), Investors REIT (NYSE: IRET), EPR Trust (NYSE: EPR), Lexington Property Trust (NYSE: LXP), VEREIT (NYSE: VER), Washington REIT (NYSE: WRE), and WP Carey (NYSE: WPC). LXP, VER, and WPC come from a non-traded background, so their strategies tend to be focused on finding yield, which leads them to broad geographies and property types…and risks.

Each of the remaining companies occupies a niche despite focusing on multiple property types. AAT, AHH, IRET, and WRE have a unique geographical focus, while EPR focuses on property types that are traditionally ignored by institutional investors. These five companies deserve consideration for inclusion into a REIT portfolio even if the manager believes he or she would rather have the power of sector allocation.

Un-National Geographic

AHH and IRET offer investors exposure to geographic markets that would be impossible to attain through any other investment. AHH derives 64% of its portfolio NOI from the greater Hampton Roads market in Virginia. The highest percentage that any other REIT has in the same area is 18%. Though it was an IPO in 2013, the predecessor company had been in existence for over 35 years. The company's prominence in the area has generated significant relationships with municipalities, universities, and other government entities that are impossible to duplicate with any other REIT.

These relationships have resulted in AHH winning numerous public-private partnership deals with excellent risk-adjusted returns.

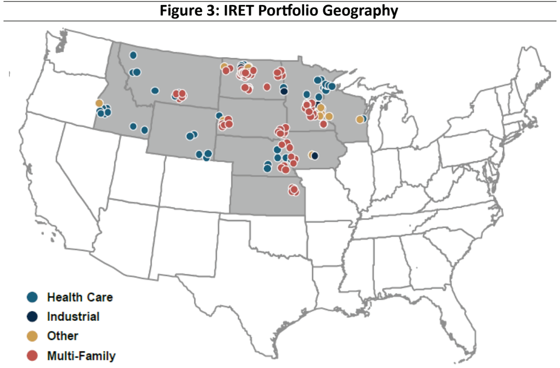
The crown jewel of the portfolio is the Virginia Beach Town Center, a massive development in downtown Virginia Beach. According to CEO Lou Haddad, "Town Center is home to over 115 commercial tenants, 410 hotel rooms and 640 multi-family units – including three high-rise buildings one of which is the tallest building in Virginia. In addition to 750,000 square feet of office space, there are 15 restaurants, a performing arts theater and 30,000 feet of conference space". Exposure to the region, relationships with local entities, and development expertise make AHH an extremely unique addition to any REIT portfolio.

Figure 2: Virginia Beach Town Center

Source: Company Supplemental.

IRET derives 30.5% of its portfolio value (by historical cost) from the area surrounding the Bakken shale, specifically North Dakota and Montana. Outside of IRET, there isn't another REIT with more than 5% of its value from the same two states. Figure 3 shows IRET's property locations, including some of the different property types. The company has a long history having been in existence since 1970, and experience in the development and management of multifamily, health care, office, retail, and industrial properties. The company is in a tough environment today with oil prices down almost 50% in the past year, but it clearly has a niche that will disproportionately benefit investors when demand in its market area is high.

Figure 3: IRET Portfolio Geography



Based on Proforma Portfolio in Company Presentation.

Invest with the Experts

WRE and AAT have geographic focuses, but their markets are very common in other REIT portfolios. However, they do boast local market expertise from a long operating history that should give investors comfort in their capital allocation decisions. WRE is one of the oldest public REITs in existence, tracking its IPO back to 1960. The company focuses solely on Washington, DC and the surrounding areas, and has extensive experience in the office, medical office, multifamily, and retail sectors. WRE is one of only two companies that can boast 100% exposure to the market Washington, DC metro area (includes Maryland and Northern Virginia). The other company, First Potomac (NYSE: FPO), owns more suburban office and industrial/flex buildings in its portfolio, making WRE the high quality Washington, DC choice. Therefore, WRE is extremely useful for active portfolio managers who would like to control their exposure to Washington, DC.

AAT's geographic footprint may be slightly more spread out than WRE's, but the company's 2011 IPO gave investors the unique ability to invest alongside a self-made billionaire. Though AAT has been publicly traded for almost five years, the current Chairman and CEO Ernest Rady started the predecessor company in 1967. Under the privately-held umbrella, Mr. Rady had numerous successful investments, including founding the Insurance Company of the West and Westcorp (sold to Wachovia in 2006 for $3.9 billion), and even part owner of the San Diego Padres. However, his first business deal in 1967 was an apartment complex, and commercial real estate has since been a passion for the 78 year old.

The company went public at $20.50 per share, and Mr. Rady did not sell a single share. In fact, since the IPO, Mr. Rady has maintained his 35% ownership of the company by purchasing shares when there are secondary offerings. As of October 28, 2015, AAT closed at $42.85 per share, valuing Mr. Rady's stake at nearly $700 million, and producing a total return of 141% for shareholders along the way.

AAT's geography is 'coastal', meaning almost all of its assets are located within 5 miles of the Pacific Ocean. Among them are the iconic Waikiki Beach Walk in Hawaii, the Landmark in San Francisco, and, its only non-West Coast asset, Alamo Quarry in San Antonio. Picture of each of these can be found in Figure 4.

Alamo Quarry is a 600,000 sqft shopping center with four 200 ft high smokestacks leftover from its days as a cement factory. Anchor tenants include Whole Foods (NYSE: WFM), Regal Cinemas (NYSE: RGC), and Nordstrom Rack (NYSE: JWN). The center is one of the strongest retail destinations in Texas.

Figure 4: AAT Irreplaceable Assets

Source: Company Presentation.
Clockwise From Top Left: The Landmark, Waikiki Beach Walk Retail, Alamo Quarry, Waikiki Beach Embassy Suites.

Waikiki Beach Walk is a mixed use property with almost 100,000 sqft of retail and a 369 room Embassy Suites, a brand owned by Hilton (NYSE: HLT). The retail portion had average tenant sales per sqft of $1,089 in 2014, which places it among the top class A malls and high street retail in the country. The Embassy Suites Waikiki is the highest performing hotel in the Embassy Suites brand for the country, and the second highest in the world.

Finally, AAT owns the Landmark, an 11-story office building with a prime San Francisco location at the beginning of Market Street. It is 100% leased to Salesforce (NSYE: CRM) and Autodesk (NASDAQ: ADSK), and boasts the San Francisco Bay as its next-door neighbor.

Incomparably Diversified

EPR Trust (NYSE: EPR) describes itself as somewhere between specialized and diversified, "focusing" on three distinct property types. We would argue that there is even more diversification when looking within the three property types. Notably, there aren't any other REITs that invest much in *any* of EPR's property types. Originally founded as a company to do sale-leasebacks with Regal movie theaters, the company has diversified into waterparks, concert venues, ski resorts, charter schools, and TopGolf facilities. Investors must buy into the company's 'five star' investment criteria as it has the ability to be opportunistic in any of the above-mentioned property types, thus making it fairly difficult to predict.

Ignore at Your Own Risk

The Diversified property type can be ignored by those who may think that they are too sophisticated to need to outsource their property type allocations. However, they would be missing out on some very unique geographies, assets, property types, and expertise. We believe that there are some Diversified companies that will be able to grow dividends and net asset value per share at a more consistent pace throughout a cycle due to their ability to be opportunistic when a particular property type becomes attractive. The strategy is working well in 2015: as of October 28, 2015, the average year to date total return of the Chilton 'Investable' Diversified REITs (excluding WPC, WSR, VER, and LXP) was +8.5%, which compares to +2.4% for the MSCI US REIT Index over the same period.

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RMS: 1732 (10.31.2015) vs. 1710 (12.31.2014) vs. 346 (3.6.2009) and 1330 (2.7.2007)

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