Chilton
Capital
Management

1177 West Loop South, Suite 1310
Houston, Texas 77027

TELEPHONE: 713 650 1995
FACSIMILE: 713 650 1739
TOLL FREE: 800 919 1995

For further information,
direct inquiries to Christopher L. Knapp,
Chief Executive Officer

info@chiltoncapital.com
www.chiltoncapital.com

The Intersection of Classic Rock and Modern Pop | September 2014

In August, the REIT ascent continued thanks to another strong earnings season and further declining interest rates. As measured by the MSCI US REIT Index (RMS), REITs posted a +3.0% total return for the month, bringing the year to date (YTD) total to +21.3%. In comparison, the S&P 500 was up 4.0% for the month and now stands at +9.9% YTD.

A Demographic Showdown

Increasingly, the wants and needs of 'millennials' and 'boomers' are influencing our lives and having a profound impact on real estate of all types. Office building designs, retail, logistics, and housing are constantly being tweaked to cater to these two groups. Together, they constitute almost 55% of total income earned domestically, but one could argue they garner 90% of the attention. From a commercial real estate investing perspective, it is increasingly important to find management teams that are properly recognizing changing trends on the demand side to ensure their product remains relevant.

'Baby Boomers', defined as individuals born between 1946 and 1964, have owned the championship belt for 'most influential generation' since they were born. Their ability to reproduce and create wealth for America has been unprecedented, and their fingerprints are evident in business, culture, education, energy, and health care. Essentially, boomers shaped the ideal of the 'American Dream'.

However, the 'millennials', began to shake up the rankings a few years ago. Despite being young and historically unwealthy, their sheer population alone has given millennials a substantial influence over our society. Politicians looking for votes, colleges looking for students, and retailers looking for buyers have been consumed with figuring out what millennials want. Real estate owners are no exception.

'Millennials', 'echo boomers', or 'gen Y' are defined as those born between 1981 and 2000. According to the Pew Research Center, there are an estimated 83 million millennials as of June 2014, making them the largest demographic cohort. Baby boomers are not far behind with approximately 77 million members as of the same date.

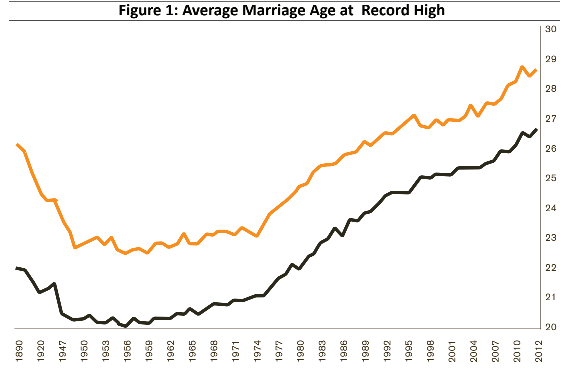
The millennial generation has become known as almost 'peter pan'-like in its desire to not grow up. They go to school for longer, live with/off their parents for longer, get married later, and delay having children.

Educated, Single, and Ready to Rent

Millennials' parents have welcomed their children back to their houses at a historically high rate. According to Pew, there were 22 million people living with their parents in 2012 between the ages of 18-31, which represents a pivot from previous generations where it was predominately the elderly that made up these 'multi-generational' households.

One of the reasons millennials have been reluctant to move out is their desire to live in an urban setting, where rent and home prices are more expensive. It takes longer to save for the security deposit, build a solid credit score, and search for a job that enables them to afford the monthly rent. In contrast, the average 22 year old in 1960 would have already been married

Figure 1: Average Marriage Age at Record High



Source: US Census Data.

and starting to talk about having children (see Figure 1)!

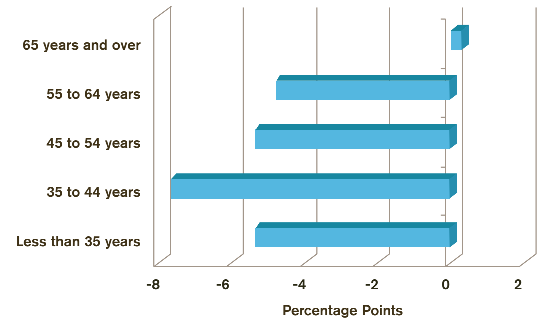
In 1991, households age 35 and under had a median net worth of over $27,000. In 2011, the same age group only had $6,700. One root of the cause is the record length and cost of education for the millennial generation. Thanks to the emphasis on education by parents of millennials, approximately 57% of the population above the age of 3 was enrolled in school as of 2012, which compares to a 51% average from 1971 to 1989. Therefore, the average millennial is not starting his or her career until several years later than prior generations. The later career start has in turn pushed back the decision to marry, which delays the decision to have children. According to the Washington Post,

> …over 90 percent of [millennials] believe they should finish their education before taking the big step. Fifty-one percent also believe that their career should be underway first. In fact, almost half say that it is 'very important' to work full-time for a year or two prior to getting married.

Additionally, the cost of education has gone up dramatically. College tuition has increased over 200% in the past 30 years, and government programs have enabled students to take on high levels of debt with low interest rates. As a result, the millennials have less financial flexibility to live on their own and then get married. According to the same study from the Washington Post, "Ninety-one percent of young adults believe that they must be completely financially independent to be ready for marriage…." In other words, both the later career start and the inability to grow wealth have contributed substantially to the millennials' decision to postpone marriage.

Even after moving out from their parents' homes, millennials are renting apartments much longer than the boomer generation. By renting better-located apartments while paying down their student debt, millennials are struggling to save enough for a down payment on a house. Furthermore, one of the most common reasons for purchasing a home is because a couple has decided to have children. The delays in marriage and first child birth have diminished the need to purchase a home, as shown by the 540 basis point (bp) drop in homeownership for the 35 and under age bracket in the past 10 years (Figure 2).

Figure 2: Change in Homeownership Rate by Age Group 2003-2013



Source: US Census Data.

Lifestyles of the Young and the Unwealthy

Another defining characteristic of the peter-pan generation is the desire to be healthy. As heart disease and lung cancer have become the most prominent killers of boomers and earlier generations, the latest push has been to eat right, exercise, and enjoy the outdoors. Companies like Whole Foods (NYSE: WFM) and Zoe's Kitchen (NYSE: ZOES) are adding stores in shopping centers owned by Kite Realty Group (NYSE: KRG) and Weingarten Realty (NYSE: WRI) while fast food restaurants are struggling.

Millennials have a historically short attention span, as shown by the decline in popularity in 18 hole golf. In its place, millennials have decided to spend their time at TopGolf, a driving range that tracks player accuracy while serving food and alcohol. EPR Trust (NYSE: EPR) has become a leading landlord for TopGolf across the country, in addition to other 'ticket-based' businesses like movie theaters, ski slopes, water parks, and concert venues.

Millennials have become more adept at technology than any other generation in history. With the advent of internet, wifi, smart phones, and computers, millennials have access to more information at previously unfathomable speeds from more remote locations. Millionaires and billionaires can be created overnight from the design of a simple app on a phone distributed throughout the world. It's no wonder the millennials have a shorter attention span than the boomers!

Boomers Aren't Helping

The boomers just don't want to quit. They are working longer than previous generations, and it is paying off for them. While most age groups have seen their portion of income shrink, the boomers have seen it grow. The 55 and over bracket has seen their share of income increase from 24% to 35% between 1994 and 2011. In

2013, the labor force participation of people over 65 was 18.5%, which compares to 13.5% only 10 years earlier. As the Boomers continue to move into this age bracket, the Bureau of Labor Statistics (BLS) projects the number will rise to 23%. Unfortunately for the millennials, this leaves fewer job openings.

"By 2025, millennials will represent 75% of the global workforce."

Perhaps out of the desire to stay close to their children after they move out, boomers have shown a renewed affection toward living in urban areas after retirement. Thus, urban populations are growing. The Census Bureau states that US metros with more than 1 million people grew by 1% in 2012 while counties that did not fit the criteria for a metro experienced a decline in population. Inadvertently, they have been driving up rent and home prices in the same areas that millennials are looking to live.

Higher Price/Sqft → Lower Sqft/Home

Houston is an excellent example of what happens when both generations are after the same thing. The city experienced the largest urban population growth in 2013 by adding 83,000 people. Consequently, Houston had the highest net absorption (demand) of apartments among all US markets in the twelve months ending June 30, 2014. In 2013, the median home price growth in the urban areas of Houston outpaced the growth in the suburbs. Prices inside Loop 610 rose 12%, while prices rose almost 20% between 610 and Beltway 8.

To cater to the millennials' thin checkbook, apartment landlords are building smaller apartments so millennials can afford to 'un-couple' from roommates or parents. Houston-based apartment REIT Camden Property Trust (NYSE: CPT) says that 80% of their units are now efficiency or one bedroom. Previously a mostly detached single family home market, Houston developers are attempting to lower price points by building high rise apartments and condos, in addition to townhomes. According to the 2014 Texas Condominium Mid-Year Sales Report, sales growth of condos and townhomes in Houston grew 600 bps faster than detached single family homes for the first five months of 2014. Across the country, both generations are buying into the 'live, work, play' urban environment, which has been the focus of apartment REITs AvalonBay (NYSE: AVB) and UDR (NYSE: UDR).

The decision by boomers to downsize into smaller urban homesteads also benefits self storage facilities. One of the four D's, 'Downsizing' is a large contributor of demand for self storage space. The other 'D's' are Displacement, Divorce, and Death. As such, ExtraSpace (NYSE: EXR) and Sovran Self Storage (NYSE: SSS) are experiencing record high occupancy rates.

Fewer Offices at the Office

Though the boomers are still the ones signing paychecks, the office space they are renting is increasingly catering to millennials for recruiting purposes. By 2025, millennials will represent 75% of the global workforce. As a result, in-demand office space has more collaborative areas, natural light, and outdoor common areas, but less square feet per employee. It is increasingly important to be near amenities such as restaurants, fitness centers, and public transportation. Office REITs Boston Properties (NYSE: BXP) and Hudson Pacific Properties (NYSE: HPP) have put an emphasis on Transit Oriented Developments (TODs) in urban areas across the country.

"...the 55 and over segment still makes up almost 18% of all mall shoppers, and they typically spend almost double the amount per visit of the 18-24 cohort."

Increasingly, we are seeing multi-use projects combining retail, office, lodging, and residential. A prime example is Macerich's (NYSE: MAC) development in Tyson's Corner, VA on the expanded Silver Line from Washington, DC that will have an office tower, a 300-room Hyatt Regency, and a 430-unit apartment high rise, in addition to the top 10 mall that was there previously.

The One Constant: Changing Retail Trends

Millennials currently spend about $600 billion annually. By 2020, the number is estimated to grow to $1.4 trillion, or 30% of all retail sales, Lululemon (NYSE: LULU), Starbucks (NYSE: SBUX), and Nike (NYSE: NKE) have been especially successful at catering to the lifestyle of millennials. Mall owners Simon Property Group (NYSE: SPG), General Growth Properties (NYSE: GGP), and Taubman Centers (NYSE: TCO) have been leasing to all of the above to boost sales at their properties.

However, the 55 and over segment still makes up almost 18% of all mall shoppers, and they typically spend almost double the amount per visit of the 18-24 cohort. Boomers have more free time, so there is potential for their share to grow if mall or outlet center owners can lure them into stores. They are also big fans of discount retailing, so outlet center owners like Tanger Outlets (NYSE: SKT) offer discounts based on age.

'The Things of Internet'

Boomers have also begun to embrace technology as now 72% of their age group has shopped online. Though they still prefer buying on a desktop, digital ads now need to appeal to both boomers and millennials. Industrial warehouse REITs Prologis (NYSE: PLD) and Duke Realty (NYSE: DRE) have been on the forefront of providing space to e-tailers as they optimize distribution. Area Development Magazine estimates that one third of big box warehouse leasing in 2012 was tied to multi-channel retail or e-commerce; one can only assume that the number has grown since then. Such warehouses need to be specifically designed for e-commerce tenants, including more parking, increased automation, and mezzanine build-outs.

Furthermore, boomers are driving data demand. 41% of Apple users and 35% of tablet owners are baby boomers. They are rapidly adopting smartphones, and now spend an average of 20 hours a week online. Surprisingly, between 2011 and 2014, the biggest growth segment for US Facebook users was the 55 and older group, which grew by 13 million, or over 80%! Data center REITs CoreSite (NYSE: COR), CyrusOne (NASDAQ: CONE), and Digital Realty Trust (NYSE: DLR), and cell tower owners American Tower (NYSE: AMT) and Crown Castle (NYSE: CCI) stand to benefit substantially from the multi-generational demand for data, both mobile and desktop.

Skate to Where the Puck is Going

There have always been threats of obsolescence for real estate owners. Similar to their battle with the catalog business in the 1990's, property owners are finding ways to drive spending at their tenants' stores despite competition from online shopping. Lodging companies like Host Hotels (NYSE: HST), Hersha Hospitality Trust (NYSE: HT), and Starwood Hotels (NYSE: HOT) are providing unique experiences (and customer protection) that can't be duplicated with AirBnB or HomeAway (NASDAQ: AWAY).

Millennials won't stay in Neverland forever. Student loans will be paid off, their net worth will grow, marriages will happen, and houses will be bought. However, their short attention span will likely be there to stay. Real estate owners need to be especially wary so that they are skating to where the puck is going, not to where it is. As of now, it looks like the puck is going to the millennials, but the boomers are still the referee.

Matthew R. Werner, CFA
mwerner@chiltoncapital.com
(713) 243-3234

Samuel E. Rines
srines@chiltoncapital.com
(713)243-3263

Blane T. Cheatham
bcheatham@chiltoncapital.com
(713) 243-3266

Bruce G. Garrison, CFA
bgarrison@chiltoncapital.com
(713) 243-3233

RMS: 1591 (8.31.2014) vs. 1312 (12.31.2013) vs. 346 (3.6.2009) and 1330 (2.7.2007)

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