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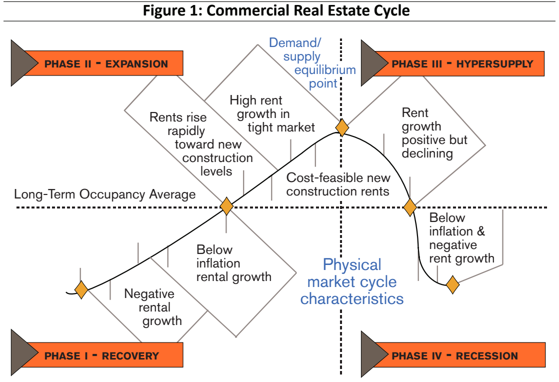
The Chilton REIT Roadmap | April 2014

In March, REITs pushed forward with another month of positive performance on the heels of solid earnings reports and relatively low interest rates. As measured by the MSCI US REIT Index (RMS), REITs produced a total return of +0.5% for the month, which compared to +0.8% for the S&P 500. Year to date, REITs have generated a total return of +10.0%, while the S&P 500 stands at +1.8%.

Elongated Expansion Phase

We have advocated for several years that this real estate cycle will be elongated, and one for the record books. The four distinct phases include: Recovery (Phase I), Expansion (II), Hyper Supply (III) and Recession (IV). Currently, the United States is just now passing from Phase I to Phase II, even though the recession ended four years ago! Importantly, except for apartments, new construction remains at historically low levels. Including obsolescence, net new supply is barely registering. Many property types have not witnessed the rent levels necessary to trigger widespread building, and tenant demand remains modestly positive except in certain cities, such as San Francisco, Seattle, and Houston. Equity REITs are poised to be major beneficiaries of this environment for years to come, and investors should focus on the healthy dividend growth that will follow.

Figure 1: Commercial Real Estate Cycle



Source: Glenn Mueller, Dividend Capital Research.

Research Methodology

It is our belief that exhaustive fundamental research can enable active management of a REIT portfolio to achieve returns above passive management, such as ETFs that mimic an index. In fact, our mission is just that: to produce returns, net of fees, which eclipse index returns for equity REITs. We begin this process with a "top down" review of each sector, such as apartments, office, and retail, and then look for the geographic areas of the country with the best economic growth, namely jobs and income growth. Jobs and wage growth projections are based on data from Wall Street research, our on-staff economist Samuel Rines, conversations with local brokers, meetings with management, and property tours. We then use our "bottom up" analysis to find the stocks that offer the best total return, adjusted for risk.

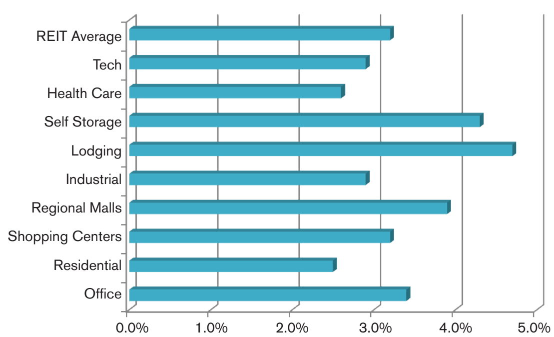
Top Down

The key statistic to watch in a cycle is same store net operating income (SS NOI). SS NOI measures the progress from one period to the next on identical assets held in both periods. Over the next five years, we estimate a 3% annual gain (see Figure 2) across all property types on average. Although the country as a whole is just entering Phase II of the real estate cycle, property types and geographic areas differ considerably. For example, industrial REITs have had lower SS NOI growth than apartments since 2011, but we expect this to change in either 2014 or 2015. Part of that has to do with apartments being a short lease term sector which allows them to take advantage of rising market rents much quicker than a longer term lease sector like industrial. However, the main reason for the difference going forward is new construction. Apartment rents and occupancy grew very quickly in the 2010-2011 period due to the fall of the homeownership rate, driving rents above their prior peak, which sparked a wave of development that has only recently caught up to demand. In contrast, industrial rents have only recently recovered in certain markets to the point where new construction can produce returns adequately above those available on acquisitions. As such, the lack of new supply is supporting both occupancy and rental rate gains, which are accelerating SS NOI growth for industrial REITs, while apartments are experiencing a deceleration of SS NOI growth.

Bottom Up

Individual company forecasts start with a base rate assumption determined by our "top down" analysis of where the company's property type and geography are in the cycle. Afterward, we apply more exact assumptions for SS NOI based on their unique occupancy, mark to market on leases (portfolio rate versus market rate), lease expiration schedule, and expense variables. The final component of total portfolio NOI is from external growth. An assessment of planned projects, cost of capital, balance sheet, and management track record helps to form assumptions for new NOI from acquisitions, development, and redevelopment.

Figure 2: Estimated Annualized Same Store NOI Growth 2014-2018 by Sector



Source: Green Street Advisors. 4Q 2013 Reports.

The Ultimate Valuation Tool: NAV

We have described how equity REITs grow net operating income from both internal and external sources. We then produce an estimate of net asset value (NAV) per share for each REIT. This is done by applying an appropriate capitalization rate ("cap rate") to total NOI in order to calculate the market value of REIT properties. A portfolio cap rate represents a blend of like transactions in the private and public markets for properties similar to those in the portfolio. For example, we value Douglas Emmett's (NYSE: DEI) office portfolio at a 5.10% weighted average cap rate based on recent cap rates on its properties between 4.50% (Beverly Hills, Santa Monica) and 5.75% (Encino). Similarly, a 3.70% cap rate assumption is reasonable for DEI's apartment portfolio based on cap rates between 3.50% (Santa Monica, Brentwood) and 4.25% (Honolulu). Since 87% of DEI's NOI comes from office and 13% from multifamily, we calculate a blended cap rate of 4.9% for DEI's total portfolio. To arrive at market value, annual portfolio NOI is divided by the blended cap rate, so a lower cap rate would increase portfolio value, and vice versa. Finally, liabilities are deducted to arrive at NAV, and then divided by the number of shares to find the NAV per share. Over the long term, REITs on average should trade at a slight premium to NAV due to the value of their management teams. Historically, the average premium to NAV has been 3%, which is in-line with the premium as of March 21, 2014.

Price Target

Though the historical premium has averaged 3% for all REITs, there is a large discrepancy among individual companies. Companies with flexible balance sheets, a track record of value creation, and a reputable management team have tended to trade at above average premiums, while REITs that lack those qualities have traded at a discount on average. As such, we deduce a premium (or discount) to NAV for a given company by analyzing historical data, assessing balance sheet flexibility, and measuring efficiency. In the case of DEI, CEO Jordan Kaplan has been at the helm of the company since the IPO and guided them to strong same store growth. They have a niche in the West LA and Honolulu office and apartment sector, and have an average balance sheet, as measured by weighted average maturity of debt, percent of debt that is fixed, and debt as a percent of gross asset value. Therefore, DEI should trade at a slightly above average premium relative to its office peers (office rents comprise 87% of DEI's total). Our time horizon for each investment is two years, so we use our projected annualized NOI two years in the future and a conservative cap rate (usually 10 to 25 bps higher than today's cap rates) to estimate a two year forward NAV. Applying the premium to NAV produces the price target at the end of a two year hold.

Total Return = Price Appreciation + Dividends

Most investors new to the REIT space are generally aware of the 90% payout of net income requirement by the IRS to sustain REIT status, but few realize that equity REITs have the luxury of paying dividends from cash flow generated by the portfolio. Depreciation is a significant non-cash charge that lowers taxable income, but permits the equity REITs to have flexibility to pay a dividend above taxable net income if they choose. Therefore, due to high depreciation, a dividend payout ratio based on net income is essentially meaningless for REITs. A REIT's ability to pay and increase their dividend is measured by Adjusted Funds from Operations, or AFFO. In its most simple form, AFFO is deduced by subtracting interest expense, general and administrative costs, and capitalized property expenditures from reported GAAP NOI to better gauge actual cash generated. By analyzing the debt composition and maturity schedule, we can project future interest expense. G&A is usually based on a percent of invested assets or NOI. Similarly, capitalized expenditures (non-revenue-enhancing) are estimated by using a percent of NOI based on historical company averages.

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We model individual company AFFO at least three years into the future, and sometimes up to ten. We then assume a payout ratio (dividend/AFFO) based on conversations with the company and historical track record to project future dividend increases. Across most property types, we are witnessing improving fundamentals, namely higher occupancy rates and rising rents, which should translate into annual dividend growth averaging 6% for the next five years according to our models. Adding credence to this projection is the historically low AFFO payout ratio of 74% that equity REITs maintain today, which compares to the historical average of 82%.

Adjusting for Risk

The three categories of risk are Core, Value-Add, and Opportunistic. Core companies require the lowest projected total return to be named a buy, while Opportunistic companies require the highest. Core companies tend to have the most flexible balance sheets, best management teams, and highest quality portfolios, while Opportunistic companies tend to have more risk to the story, which could be due to development, balance sheet, or management team. If the projected total return is above the return required for the ascribed level of risk, the REIT is classified as a buy. A projected total return less than zero would be a sell, and anything in-between is a hold. The required return helps us build a buy price, while the sell price is the price at which the total return becomes negative. We monitor current prices compared to the buy and sell prices on a daily basis.

Long Term Assets Deserve Long Term Holds

Commercial real estate is a hard asset that can be touched and will last a lifetime if properly maintained. We recommend a long term investment time horizon since many fundamental catalysts in real estate involve long lead times. Just consider the construction cycle itself: typically, 3-5 years between conception of a project, engineering and permitting and then the actual construction period.

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Maximizing value for a property by rolling leases over and assembling the optimal tenant roster at the right price and square footage can take many years, depending on the length of leases. Sometimes unlocking value means waiting for a down cycle to gain an advantage over a competitor to attract that tenant, make an acquisition at a discounted price, or find land for a future development.

A full real estate cycle usually lasts 7-10 years, so REITs usually assess an external growth opportunity by looking at the 10 year IRR (internal rate of return). Similarly, most spread-based REIT valuation statistics are based on a 10 year hold (either Treasury notes or investment grade bonds). As such, REITs should be in every investor's portfolio throughout the cycle, and investors should view short term volatility as merely an extra tool for active managers to take advantage of discrepancies in pricing. We believe our top down and bottom up process will enable us to produce returns, net of fees, above the estimated 6-8% total returns expected over a full cycle for a passive index, while taking on less risk.

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RMS: 1443 (3.31.2014) vs. 1312 (12.31.2013) vs. 346 (3.6.2009) 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