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Office REITs: Poised for Rental Rate Growth | February 2014

In January, REITs finally reversed their course in terms of relative performance to the S&P 500 and to MLPs. As measured by the MSCI US REIT Index (RMS), REITs generated a total return of 4.3% for the month, which compares to -3.5% for the S&P 500 and 0.6% for the Alerian MLP Index (AMZX).

The Growth of the Yield Alternative
Due to the low interest rate environment created by the Federal Reserve, investors have been driven to search for yield in places other than fixed income. From 2008 to December 31, 2013, the MLP universe grew from a market capitalization of $90 billion to over $450 billion. Over the same period, the public equity REIT industry grew from a market capitalization $175 billion to $605 billion. In 2013, REITs set a record by issuing $46 billion of equity, while MLPs raised a total of $31 billion. An MLP was the largest IPO of 2013, and there were 19 REIT IPOs during the year, as well as 18 MLP IPOs. Additionally, Extended Stay (NYSE: STAY) and Hilton (NYSE: HLT) were two large lodging C-Corp IPOs during the year, and Crown Castle (NYSE: CCI) and Lamar Advertising (NYSE: LAMR), the first billboard REIT, converted to REIT status on January 1, 2014.

As measured by the AMZX, the yield on MLPs was 5.8% as of January 28, which compares to the REIT yield of 4.0%. To produce a 5.8% yield, MLPs employed a payout ratio of over 90% as measured by distributable cash flow (DCF). In comparison, REITs are currently paying out only 72% of their cash flow as measured by a similar metric, Adjusted Funds from Operations (AFFO). If REITs adjusted their payout ratio to the historical average of 82%, the yield would be close to 4.6%.

105 REITs raised their dividend in 2013, which resulted in an 8% weighted average increase. As a result of the 8.5% cash flow growth for the year, the payout ratio barely moved. In fact, the payout ratio has been essentially flat in the low 70%'s for the past five years. Over the next 3 years, Bank of America Merrill Lynch (BAML) projects annualized dividend growth of 7-8% for both REITs and MLPs.

From a tax standpoint, REIT dividends on average were classified as follows in 2013: 53% ordinary taxable income, 10% return of capital, and 37% long-term capital gains. In contrast, most of the dividend for MLPs is classified as return of capital, which lowers the cost basis and therefore translates to capital gains when the MLP is sold. However, MLP investors face significant tax issues because they are subject to K-1's while REIT dividends appear on a 1099-DIV with traditional equities.

Surprisingly, the correlation, or r-squared, between REITs and MLPs over the past 10 years is very low at only 0.15, meaning the two asset classes do not move in tandem with each other. Therefore, owning a combination of REITs and MLPs provides diversification as well as a growing income stream.

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All Real Estate is Not Created Equal: Office Focus
The cyclicality of real estate development is especially prevalent in the office property type. High potential returns per project have historically attracted speculative developers, meaning no tenants have committed to the space. There is a lengthy time lag between the planning and occupancy stages, including permitting, raising capital, and long construction times. Market equilibrium is difficult to achieve in the office sector because the economy could be very different at completion than when the plans were initially approved.

Come On Baby, Let's Go Downtown
With high stabilized yields, a suburban project with low land costs and a long term lease in-hand can seem like a slam dunk. The project may be a success for a five year hold, and possibly ten years. However, re-tenanting a suburban office project can prove difficult and expensive. Assuming the tenant's business stays healthy

(a bold assumption), the tenant may shift its business model or new management may want to move to a different suburb, or even to the Central Business District (CBD). Additionally, the ability to attract and retain top employees is increasingly influenced by a modern office layout and travel time to good residential neighborhoods and amenities. Even if the tenant doesn't leave, the threat can cause the landlord to cut rents and offer large tenant improvement (TI) packages to avoid an extended period of receiving no rent. The alternative is normally characterized with a period of vacancy and high costs to attract another tenant. Ultimately, the suburban office business does not normally give the landlord very much bargaining power, and timing the market consistently is difficult, if not impossible.

In contrast, CBD office buildings have significant land costs, more diverse tenant bases, more expensive rents, and a lower threat of new supply. The higher land costs necessitate greater density resulting in taller buildings and more costly rents to justify development. Typically, the elevated development costs can result in higher dollar gains, which attract a more sophisticated investor base. The assumption is that large capital pools have educated investment committees that understand the risk of office development and the long term costs of maintaining and managing the finished product. The result of relatively more disciplined development is shown in Figure 1, which graphs the vacancy and historical completions of the two office categories. CBD office buildings experience more muted peaks and troughs in comparison to their counterparts. The central locations near residential neighborhoods that are persistently desirable attract talent from all levels, but especially at the decision-maker level. The more diverse tenant base makes re-tenanting much more manageable, especially if the tenant is a smaller portion of the total rent in the building.

Don't Build it if They Won't Come

Given their access to capital, commitment to a dividend, and perpetual life, public REITs are generally prudent developers, especially in the office space. REITs have access to capital throughout the cycle, not just when the market is hot. Also, they plan to be long term holders of the property so they are concerned about durability and the tenant roster to minimize operating expenses such as maintenance capital expenditures and re-leasing costs. Finally, their commitment to paying a quarterly dividend restricts their ability to invest too much capital on speculative development projects, which essentially are non-earning assets. For capital allocation purposes, REITs will compare the return expected on development to the immediate cash yield available from acquiring a building, requiring a significant premium from the development to justify the risk.

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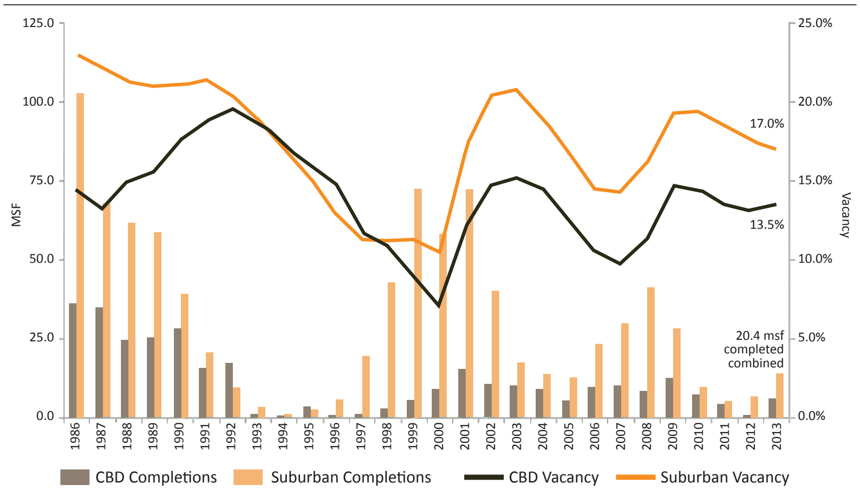
Due to the financial market turmoil in 2008-2009, very few office construction projects were able to be financed in the past 5 years. As a result, 2012 was one of the lowest years on record for new office completions, and 2013 was only slightly higher at close to 0.8% of existing stock, a far cry from the 1.7% average since 1988. Since 2008, the capital markets have become more disciplined, requiring more equity and pre-leasing to finance construction loans. As such, the markets with the most square feet under construction (San Francisco, New York,

Figure 1: Office Vacancies vs. Completions



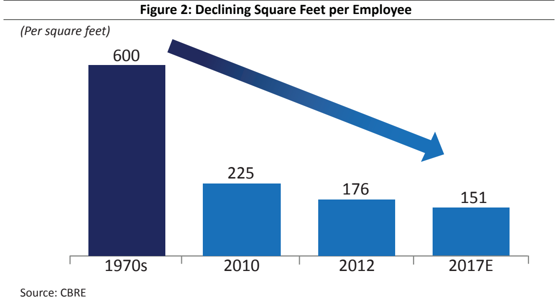
Source: Cushman Wakefield. As of 12/31/2013

Houston) are those that are currently experiencing the highest job growth.

Optimization of Demand

Despite a positive environment for landlords given the low new supply, the office sector has to consider how tenants are thinking differently about office space. The ability to telecommute via remote internet connections combined with rising rents have motivated companies to optimize their use of space. Figure 2 shows how significantly firms have decreased the space per employee in the past 30 years, a trend that CBRE believes will continue through 2017.

Figure 2: Declining Square Feet per Employee



Source: CBRE

However, rents have continued to increase, reflecting higher occupancy rates, rising replacement costs, and fewer suitable alternatives in many submarkets. The country has moved to a service-driven economy, increasing the number of jobs that require an office (Professional & Business Services and Finance & Real Estate). Because businesses are now looking at their leasing expenses on a per employee basis, they have been able to pay higher rent per *square foot.*

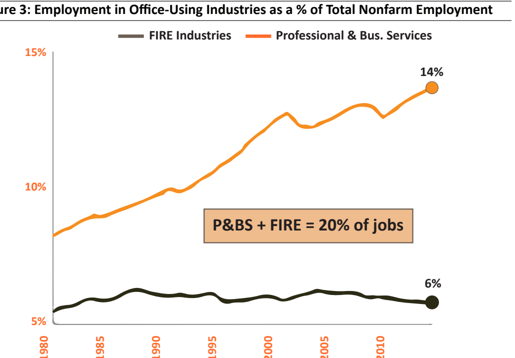
At the end of the day, demand for office space is still a byproduct of hiring, and the correlation between net absorption and office-using job growth is relatively high. Though the employment gains are not on par with historical recoveries, we are currently in a period of slow job growth, which will create pockets of rental rate strength where demand is greater than supply.

High Tech Companies are Picky

Growth in the tech sector has been driving the demand and subsequent development for office space in several markets. According to CBRE, High-Tech was the biggest contributor to nationwide leasing for the year through September 30, 2013. California, particularly San Francisco and West LA, continues to be synonymous with tech as 32% of all leases signed in the Western region were tech-related. With the lowest average age of employees, the tech sector is literally shaping office development. Younger employees want to work in buildings in vibrant urban neighborhoods with larger floor plates and open areas, more conference and meeting rooms, and fewer separate offices. The new space demands have made many older buildings obsolete, which shrinks the potential supply further, and thereby places upward pressure on rents in viable buildings.

Among office REITs today, Kilroy Realty (NYSE: KRC) is the most active developer with a development pipeline that would expand their real estate owned by 26%. KRC concentrates on the West Coast, and is in the process of a major portfolio transformation. The company has focused on developing and redeveloping buildings into collaborative workspaces that inspire creativity and feel a little less like work. Their pursuit of LEED certifications for all new buildings also appeals to the millennial generation's desire to minimize impact on the environment. As a result of these initiatives along with a first mover advantage, KRC has attracted large leases from companies like SquareTrade, SalesForce, and LinkedIn. Seattle, San Francisco, Silicon Valley, and West Los Angeles have become hotbeds for these companies, and, thanks to their balance sheets and access to the capital markets, the REITs have been on the forefront of office development to fan the flames.

Figure 3: Employment in Office-Using Industries as a % of Total Nonfarm Employment



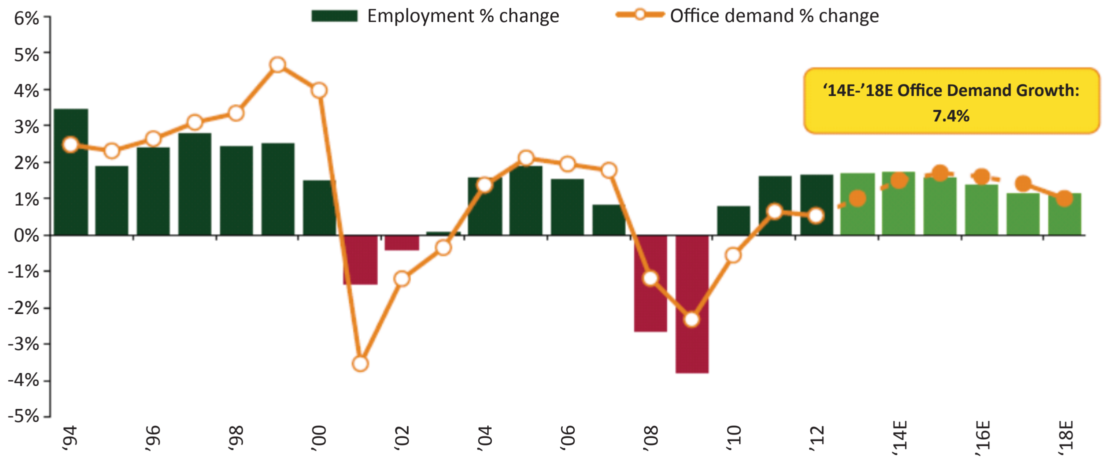
Source: Bureau of Labor Statistics, Green Street Advisors

For the entire West Coast, the biggest potential skyline changer is Boston Properties' (NYSE: BXP) project at Transbay in the South of Market (SOMA) district of San Francisco. With development costs over $1 billion, the tower would be the tallest on the West Coast with over 1.4mm sqft of rentable space. BXP paid $190 million just for the land! However, the building is not expected to deliver until 2017, which therefore leaves uncertainty as to what the leasing environment will be upon completion. As we would expect from a high caliber REIT management team, the company is waiting to achieve sufficient demand for the space before going forward with the project.

Wheels Finally Moving On This Cycle

Looking out to 2018, Green Street Advisors projects demand growth of 7.4% and supply

Figure 4: Strong Relationship between Employment and Office Demand



Source: Green Street Advisors, Bureau of Labor Statistics, REIS

growth of only 6.7%, which would create estimated rental growth of 25%. High barrier markets like San Francisco and West LA are projected to have rent growth of close to 35% over that time period, while the low barrier markets are projected to be much closer to the national average.

Despite the obvious risks to owning office buildings, such as inflation in operating expenses, reduction in demand due to the decline in government spending, the shrinking financial sector, and decreasing square feet per employee, the outlook for the sector appears promising after a slow recovery from the 2008 recession. The tech sector has been picking up the slack from government and finance, driving employment upward. As shown in Figure 4, the relationship is strong between employment and office demand. Importantly, the office REITs are experiencing accelerating same store net operating income (SS NOI) growth, while short lease sectors like apartments and storage are decelerating. REITs that are focused on high barrier submarkets will be beneficiaries of a US office sector in the early innings of a long term recovery propelled by historically low new supply.

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RMS: 1367 (1.31.2014) vs. 1312 (12.31.2013) vs. 346 (3.6.2009) and 1330 (2.7.2007)

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