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

Industrial REITs: Day in the Sun has Finally Come | March 2014

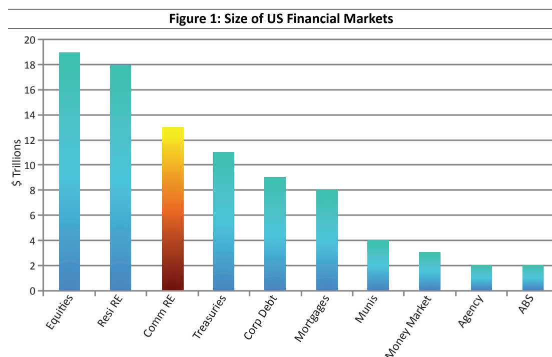
Whether the weather, REITs were able to extend their year to date (YTD) gains against the S&P 500 by posting a +4.9% total return in February, bringing their 2014 total return to +9.4%. In comparison, the S&P 500 produced a total return of +4.6%, good for a 1.0% YTD total return.

Finding the Right REIT Allocation

In January, we gave examples of the maximum REIT allocation for target date funds, ranging from 10% to 20%. Such allocations are usually calculated using 'portfolio optimization' based on historical performance and risk data. Another way to construct a portfolio is to start with an 'index weight', and then decide to overweight or underweight a sector, or asset class. By looking at the combination of all of the US financial markets in Figure 1, we are able to observe the 'index weight' for the country.

According to Green Street Advisors, the US commercial real estate market is estimated to comprise $13 trillion, or approximately 15% of the $89 trillion total. Taking out residential real estate, the percentage increases to 18%. Therefore, those with less than 15% could unknowingly be underweight commercial real estate despite attempting to maintain broad economic exposure.

Figure 1: Size of US Financial Markets



Source: Green Street Advisors, SIFMA. As of January 31, 2014

Institutional and high net worth investors have been catching on, but there is still more work to be done. In an April 2013 survey by UBS of 60 of their top institutional investors, 59% of respondents recommended a 5-10% allocation to real estate securities, 23% recommended an 11-15% allocation, and 12% recommended 15% or more. We believe 15% is a good start to a commercial real estate allocation, and an overweight during the growth period of the cycle is warranted, depending on income needs.

The original purpose for the creation of the REIT was to allow the individual investor to access commercial real estate in the same manner as large institutions. In a survey by Morgan Stanley of individuals with at least $1 million in assets, direct commercial real estate ownership and REITs finished number 1 and 2 in response to the question of what they believe would be the best alternative investments for 2014. As fixed income has become expensive with unappetizing yields, wealthy individuals have recognized the upward trajectory for the commercial real estate cycle over the next 3-5 years and made it an overweight in their portfolios.

Hot or Sticky Money?

We mentioned briefly in our May 2013 REIT Outlook that one of the risks with public REIT performance is the flow of funds. In general, it is something that is nearly impossible to predict and causes stock price movements incongruent with fundamentals. In particular, we have been watching the flow of funds from Japanese investors into US REITs. Their use of mutual funds with stated yields above the underlying investments forces them to sell stocks to make distributions. After a year in which the MSCI US REIT Index was up only 2.5% compared to their stated yields of 15% or more, there were significant NAV declines which may result in withdrawals. If any funds wish to stop the NAV bleed via a dividend cut, they may also cause withdrawals.

However, Japanese investors have poured another $1.0 billion into US REITs so far in 2014 through February 28. By Citi's estimates, such funds have to sell $1.2 billion of REITs each quarter to cover the distributions. The rationale for fund managers to pay yields above 15% must rest on the fact that REITs have generated compound returns of almost 30% over the past five years and the dollar to yen exchange rate has been an added benefit to the Japanese investor. Fortunately, the assets under management in these funds are declining while the REIT total market capitalization has been growing, thereby reducing the risk of a price decline due to a sudden reversal of fund flows. By our calculations, Japanese mutual fund investment in US REITs has decreased from almost 10% of the total US REIT market capitalization in 2011 to 6% as of February 28, 2014. Though it is unpredictable, we are comfortable that the current ownership of US REITs could absorb redemptions by Japanese mutual funds even in an extreme scenario.

All Properties are Not Created Equal: Industrial

It's a close race between the industrial and self storage property types for the least ascetically pleasing award. As such, many casual observers could assume that all industrial warehouses are pretty much the same, with the only differences being size and location. Though size and location are still a big part of the tenant's decision, there are other factors that they consider as well. Much like the tendency for tech tenants to favor open areas on large floor plates for their offices, there are certain industrial buildings that will attract a certain type of tenant.

Figure 2: Industrial Building Types Overview

	Building Type					
	Manufacturing	Warehouse			Flex	
			Distribution			
Primary Type	*General Purpose*	*General Purpose Warehouse*	*General Purpose Distribution*	*Truck Terminal*	*General Purpose Flex*	*Service Center/ Showroom*
Primary Use	Manufacturing	Storage, Distribution	Distribution	Truck Trans-shipment	R&D, Storage, Office, Lab, Light Mfg, High Tech Uses, Data/Call Center	Retail Showroom, Storage
Sub-Sets	Heavy, Light Manufacturing	Bulk Warehouse, Cold/Refrigerator Storage, Freezer Storage, High-Cube	Overnight Delivery Services, Air Cargo	Heavy, Light Manufacturing		
Size (SF)	Any	Any	Any	Any	Any	Any
Clear Height (ft)	10+	16+	16+	12-16	10-24	Any
Loading Docks/Doors	Yes	Yes	Yes	Cross-dock	Yes	Yes
Door-to-Square-Foot Ratio	Varies	1:5k-15k	1:3k-10k	1:500k-5k	1:15k+	1:10k
Office Percentage	<20%	<15%	<20%	<10%	30-100%	30+%
Vehicle Parking Ratio	Varies	Low	Low	Varies	High	High
Truck Turning Radius (ft)	130	130	120-130	130	110	110

Source: NAIOP

Accessibility for 18-wheeler trucks, ceiling (clear) heights, ability to unload and load product, and how much office space vs warehouse space are just a few of the important aspects that prospective tenants consider. Figure 2 gives an overview of the different types of industrial buildings from the NAIOP, the Commercial Real Estate Development Association.

Prospective industrial tenants tend to be shy about agreeing to a lease until they can see and touch the building. Contracting with a developer for a "build to suit" can be complicated and requires a long lead time. As such, most industrial development is speculative, implying higher risk.

New Supply Increasing, but from a Low Base

The industrial sector's close ties to the economy created a 500 bp increase in industrial REIT vacancy during the recession. As a result, the need for new industrial buildings was close to zero for several years as the vacant space was re-leased. As the economy rebounded, demand slowly returned, and so has development. Due to the relatively quick construction time for warehouses (6-9 months), developers have the ability to capitalize on improving markets assuming they can assemble the financing and find attractive locations. In 2013, REIS, a commercial real estate research firm, estimates that the total square footage of industrial space increased by only 0.6%. Though this is up significantly from 2010 and 2011, it is still well under the 0.8% average since 1999. REIS expects annual new supply to revert to the mean over the next 4 years, which should hopefully be close to the increase in demand.

Capital has not been deaf to the lack of supply in the sector. With some high quality industrial parks selling for cap rates in the low 5%'s recently, developing a park to a 7-9% yield can be extremely profitable. Industrial REITs have been on the forefront of development. On their 4Q 2013 earnings call from January 30, ProLogis (NYSE: PLD) CEO Hamid Moghadam was overwhelmingly excited about the industrial business. In his opening statements, he said, "We are seeing strong improving market conditions pretty much around the world. The US markets in particular have been terrific with record absorption and very low levels of new construction. And, against this backdrop, our business has been firing on pretty much all cylinders." For PLD, that includes their profitable development and asset management business, along with strong same store growth via better occupancy and rising rental rates.

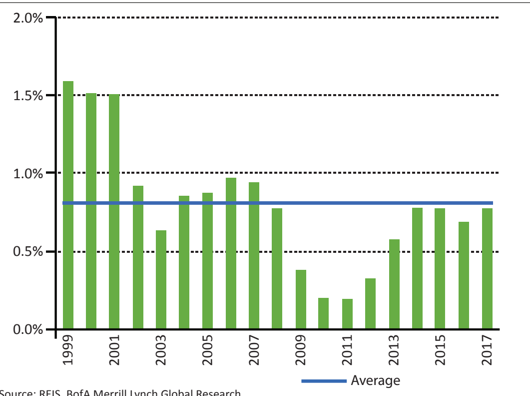
Eastgroup (NYSE: EGP) has an excellent reputation for disciplined development of multi-tenant warehouse space. EGP is a small cap industrial REIT that owns approximately 33.8 million sqft across the southern US, from Cali-

fornia to North Carolina. EGP has developed over a third of their current portfolio, and it derives almost 40% of its net operating income (NOI) from such properties.

In 2013, the company started 13 projects totaling 1.2 million sqft, and they project starting at least 17 projects encompassing 1.3 million sqft in 2014. Besides being multi-tenant, EGP-constructed buildings are LEED-certified distribution facilities with a moderate percentage of office space. Finding multiple 5,000 to 50,000 sqft tenants to fill a building may require a little more work on the leasing side than one big 200,000 sqft tenant, but it lowers the long term risk of having empty buildings.

EGP projects an average stabilized yield of 8.6% on its development pipeline today. With an average cap rate of 6% for high quality industrial properties, EGP is developing to a profit margin over 40%. EGP's pace of approximately $100 million in development stabilizing per year equates to over $40 million in value creation, or almost $1.40 per share per year. EGP's share price as of February 28 was $62.04.

Figure 3: New Industrial Supply as a % of Existing Inventory



Sources of Demand

Due to the risk associated with speculative development, REITs need to be highly confident there will be demand for the product they are providing. In general, industrial warehouses benefit from growing global consumption. The process of bringing goods to the end user requires warehouse space–everything from manufacturing, wholesale and retail inventories, logistics (trucking, rail, shipping), and importing.

Putting the "E" in Warehouse

In particular, the growth of e-commerce has had a significant influence on demand. Despite the headlines of the negative effects of online retail sales on retail REITs, the industrial REITs are direct beneficiaries of the shift toward online purchases. According to 'Area Development' Magazine, "…one third of all demand for big-box space in the US in 2012 was tied to multi-channel retail or E-Commerce." Retailers still need to keep inventory in a building and the ability to ship it to the consumer. In fact, the new trend to attempt to ship to the consumer within 2 days or sooner (like Amazon Prime) has dramatically increased the amount of space Amazon needs to fill orders on time. As of the end of 2012, Amazon had spent almost $14 billion on 89 new warehouse buildings, and anticipated building at least 5 more in 2013.

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In 2013, an estimated 9% of retail sales were done online; Deloitte projects this will increase to 24% by 2018, and Dematic, another research firm, projects online sales will reach 30% by 2025. Though the last minute Christmas deliveries didn't go too well for UPS this season, we suspect the growing market share by online purchases is inevitable, and industrial REITs will be a prime beneficiary of the switch.

Industrial Occupancy Up…More

In our REIT outlook from November 2012 titled "Industrial Occupancy up with Manufacturing", we discussed the hiring for construction and manufacturing that had reversed trend from the almost 15 years of declining job growth in these sectors. As of June 30, 2012, the weighted average industrial REIT occupancy was 92%. Since then, the manufacturing and construction trend has only gained steam adding over 1 million employees, and the weighted average industrial REIT occupancy was up to 95% as of December 31, 2013, which is within 100 bps of the 2007 peak. Not by coincidence, industrial production is now within 2% of the 2007 peak according to the NAICS.

Geographically, pockets of industrial strength are being driven by market-specific demand generators. Texas is benefiting from the domestic energy boom and population growth, which is fueling single family home building. Florida demand is being driven by a growing pharmaceutical sector due to the ageing demographics. The middle of the country is feeling the manufacturing renaissance, while the West Coast has remained strong thanks to the busy ports in Los Angeles and Long Beach. The widening of the Panama Canal will likely be a

factor for ports that are deep enough to handle the large ships, but it is unlikely to have any impact on broad demand. Rather, it could shift demand to different parts of the country. The completion of the expansion is at least 2 years away, so the effects are to be determined.

Multi-Prong Attack

The combination of the accelerating demand and measured supply growth has created an overwhelmingly positive environment for well located ('in-fill') high quality warehouse space. Cap rates on such stabilized properties have fallen to 6% and even 5% in hot markets like the Inland Empire in California, Houston, New Jersey, and Dallas. The low acquisition cap rates have driven most public industrial REITs to use development to grow their portfolios, generating stabilized yields of 8% and above, which drives higher cash flow growth and NAV accretion.

Figure 4: Industrial REIT Development Pipelines

Ticker	Pipeline ($mm)	As a % of Mkt Cap	Pipeline (000 sqft)	As a % of Portfolio sqft.	% Leased
DCT	200	8.5%	3,256	5.2%	53.0%
DRE	391	7.7%	2,253	1.5%	85.0%
EGP	91	4.9%	1,339	4.1%	55.0%
PLD	1,525	7.8%	16,774	5.1%	51.8%
STAG	0	0.0%	0	0.0%	0.0%
LRY	277	5.3%	4,644	4.5%	66.5%
PSB	0	0.0%	0	0.0%	0.0%
FR	129	6.6%	1,796	2.9%	0.0%

Source: BAML, Chilton Capital, Company Reports as of 9/30/2013

Multiples are currently well above the REIT average, reflecting the growth and positive sentiment around the sector. Within the sector, we prefer companies that have strong management teams and multiple prongs of growth, including redevelopment, development, and same store growth opportunities. Figure 4 depicts the development pipelines for each of the REITs as of September 30, 2013. However, managing the land bank size, picking quality locations, and timing the market can drastically affect long term returns. We invest with disciplined teams with proven capital allocation track records and experience through past real estate cycles.

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

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

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

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