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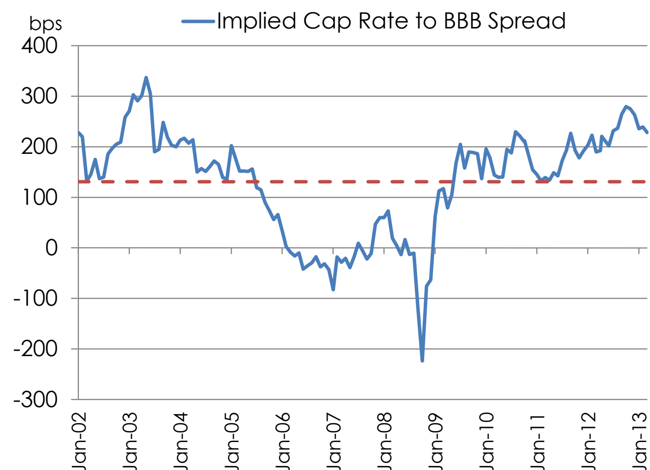
Blue Chips are on Sale

- It remains easy to like real estate given limited new supply, steadily increasing demand, cheap debt and attractive property valuations.
- Blue chip property companies are rarely on sale and with ~15% discounts to private market value—blue chips Taubman Centers, Boston Properties and AvalonBay should all be bought.
- Historically, rising interest rates have been associated with strong REIT returns in the first half of an economic recovery.
- LANDandBUILDING's "must own" property stocks for 2013 were up 11.3% in the first quarter outperforming the REIT index and are positioned to continue their outperformance: BRE Properties, CoreSite, Extra Space Storage, General Growth Properties, Host Hotels, Kilroy Realty, and Las Vegas Sands.

Real estate fundamentals continue to be strong. Core property net operating income should grow 4-5% in 2013 causing real estate values to rise further. Despite the strong 8.1% gain in the first quarter of the year for the REITs, property stock valuations remain exceptionally attractive as the REIT sector implied cap rate of 5.8% is 230 basis points above BBB corporate bond yields, well above the 130 basis point average since 2002 (Figure 1). This wide spread to debt costs is a strong positive signal for future stock performance.

It is easy to like real estate today, with limited new supply, steadily increasing demand, cheap debt and attractive valuations. What is unusual is the ability to buy the stock of the companies with the best real estate, the best management teams and the best balance sheets at discounts to private market valuations. There have been a handful of periods in the past 20 years when this phenomenon has presented itself; it did not last long and it was profitable.

Figure 1. Implied Cap Rate Spreads Wide to BBB Yields



Source: LANDandBUILDINGS, Citi

Specifically, Taubman Centers (NYSE: TCO; Regional Malls), AvalonBay (NYSE: AVB; Apartments), and Boston Properties (NYSE: BXP; Office), as of quarter-end, were all

trading at approximately 15% discounts to underlying asset value, have strong fundamentals and attractive growth prospects.

- Taubman Centers owns the highest quality regional mall portfolio in the U.S. and was down 1% in the first quarter. Taubman's malls are the most productive as they are well tenanted and cater to the top income categories in the country. Internal growth potential of the portfolio is significant, evidenced by the same store NOI growth of over 6% over the last 2 years, with strong runway ahead as below market rents move to market and market rents move up. Private capital would likely bid 4.5% cap rates or lower for the company's malls, much richer than the stocks' quarter-end implied cap rate of 5.5%.
- AvalonBay owns the highest-quality public apartment portfolio, should grow same store NOI 5.5% in 2013, see growth reaccelerate in 2014 and will likely continue to have the most productive, value-creating development platform in the multifamily space. Yet the stock was down 6% in the first quarter, underperforming the REITs by about 1400bps. Two overhangs are in the process of being resolved as Lehman Brothers is likely to liquidate their remaining stake near term and Washington DC is proving more resilient than expected as rental growth remains positive. At quarter-end, AVB traded at a 5.3% implied cap rate, a meaningful discount to the private market value of the real estate.
- Boston Properties, the best-in-class office REIT that owns Class A trophy assets across major coastal markets such as New York, Boston Washington DC, and San Francisco, was unloved as well in the first quarter, posting a -4% return. The company should achieve 7%-plus same store cash NOI growth in 2013 while the New York City office market is gaining traction and the Washington DC office market is stabilizing, likely leading to upward estimate revisions in 2014/2015 as well increasing NAVs. Transaction activity is also picking up in BXP's markets with sub-5 cap rate asset sales highlighting the discount BXP is trading at given a 5.6% quarter-end implied cap rate.

Since the beginning of the second quarter, these stocks have begun to rebound and move closer to NAV and will likely continue to do so as the wide discount is anomalous in history.

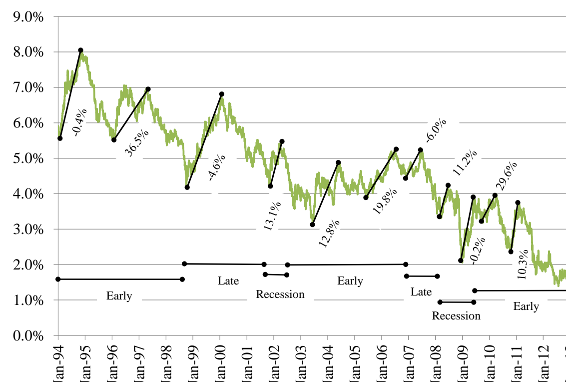
Rising Interest Rates Not a Concern

Historically, rising interest rates have created a favorable back drop for property stocks to post attractive returns during the first half of the business cycle. Specifically, REITs have risen 11.1% on average since 1990 during 11 periods when the 10 year treasury yield rose 60 basis points or more for a sustained period. Breaking the 11 periods of rising interest rates into early and late periods of economic expansion, the strongest periods of performance were during early economic expansions when REITs rose 17.4% on average, while shares were weak during periods of late economic expansions (Figure 2). The economy is in the first half of an economic expansion; as such REITs will likely deliver attractive total returns.

2013 "Must Own" Property Stocks Outperforming

An equal weighted portfolio of LANDandBUILDING's "must own" 2013 property stocks returned 11.3% in the first quarter, outperforming the REITs which returned 8.1%. See below for an update on each of the seven "must own" stocks and why we remain bullish on each name (all returns as of 3/31/2013):

Figure 2: REITs Have Generated Strong Returns as 10-Year Rates Rise During Early Economic Expansions



Source: LANDandBUILDINGS, Bloomberg.

Note: Returns are REIT returns during the specified rate rising period

- **BRE Properties (NYSE: BRE; Apartments) Down 3% YTD.** *BRE Properties is an owner, operator and developer of 82 apartment communities throughout the supply-constrained markets on the West Coast, including San Francisco, Los Angeles, Orange County, San Diego and Seattle.*

  BRE Properties trades at a 30% discount to the private market value of its assets. This discount is likely to narrow one of two ways: the company's operating fundamentals will improve and come in well ahead of expectations or BRE will seek strategic alternatives, including selling the entire company. Meetings with CEO Connie Moore suggest a fair offer would be seriously considered.

  BRE's 4Q12 same store NOI was a solid 6.2%, but BRE curiously guided same store NOI to 4.5% in 2013. The majority of BRE's apartments are located in the top 9 rental growth markets in the country which will likely result in actual results coming in ahead of guidance. Connie is on a short leash as shareholders are dissatisfied with the company's performance suggesting she wants 2013 to be a beat and raise year, hence the low guidance. Our channel checks in BRE markets suggest a strong first quarter, including strength in the lagging San Diego market.

  BRE management's missteps are creating an M&A opportunity for a public or private buyer to purchase the company. Class A apartment acquisitions in California confirm strong valuations for these assets with assets selling in the mid 4% cap rates and some below 4%. Ms. Moore likely has less than one year to right the ship and we will continue to advocate for BRE to seek strategic alternatives and put the company up for sale.

- **CoreSite (NYSE: COR; Datacenters) Up 27% YTD**. *CoreSite is a national provider of datacenter products and interconnection services with 14 datacenter across nine major U.S. markets including Los Angeles, San Francisco, Chicago, Washington DC and New York City.*

  We expect COR to be a $40+ stock before the years end, representing an additional 15%+ upside from here. With an implied cap rate still in the 7's, double-digit same-store NOI and enough land and buildings currently on the balance sheet to double the size of the company in a few years' time, CoreSite's story is just beginning.

Trends in the network-dense datacenter segment remain very strong and drove COR's material outperformance in the first quarter of 2013. Fourth quarter 2012 results, reported in late February, showed bookings more than doubled the average of the previous four quarters, releasing spreads returned to double-digits, and interconnection revenue (over 10% of COR's business) grew 88% year-over-year as the company committed themselves to driving both the price and volume of cross-connects.

A March meeting with CoreSite management and proprietary channel checks indicate that 1Q13 trends are even stronger than 4Q12. External growth through development will drive outsized NAV growth as low-teens yields are a low bogey for COR. The company even insinuated they would need to be "stupid" to not hit a 12% yield on the company's $65M Secaucus, New Jersey development, showing just how divorced COR's niche is from the wholesale datacenter segment troubles in that same region.

- **Extra Space Storage (NYSE: EXR; Storage) Up 9% YTD**. *Extra Space Storage is the second largest owner and operator of self storage properties in the United States. The Company's properties comprise approximately 550,000 units and over 59 million square feet.*

  The fundamental story for Extra Space Storage outlined 3 months ago is ahead of plan, propelling the stock to outperform the REITs by 150bps in the first quarter. We continue to expect 20%-plus return in 2013 from EXR.

  After finishing 2012 with same store NOI growth of 10.2%, Extra Space's operations are off to equally strong start in 2013. In the first two months of the year, move-ins on the same store portfolio are approximately 10% above their long-term average, while vacates remain subdued as tenants are becoming stickier. Street rates are currently being driven up 3 – 4% on new move-ins, discounts are down 20%, rent increases on renewals remain at 8 – 9% and occupancy going into March is over 200bps higher year-over-year.

  2013 same-store NOI guidance of 4.5–6.5% is impressive given EXR's well-known conservatism. At the beginning of 2012, the company guided to SS NOI of 3.0–6.0% and finished in double-digit territory. Solid initial guidance clearly illustrates EXR's high conviction in storage fundamentals as the company continues to benefit from little new supply, accelerating demand and market share gains. Continued accretive, smart external growth through acquisitions, the company's potential acquisition pipeline is in the billions of dollars, will further drive returns.

- **General Growth (NYSE: GGP; Regional Malls) Flat YTD**. *General Growth Properties owns and operates 125 high-quality regional malls across the United States and 18 malls in Brazil.*

  General Growth's operational turnaround is progressing ahead of expectations and accelerating net operating income growth is evident in results, which should drive double digit FFO growth and strong performance for the stock this year. The company generated 5% same store NOI growth during the fourth quarter, its best quarter of the year, and simplified its capital structure by purchasing warrants held by two shareholders that were issued upon its emergence from bankruptcy.

Recent meetings with management confirmed that GGP remains on target to achieve or exceed the key drivers to strong performance: 1) driving permanent tenant occupancy up to 93% by year-end 2014 from 90% at the end of 2012, 2) continuing to improve asset quality through redevelopment of existing assets with $1.6 billion of projects already identified and 3) capitalizing on debt refinancing opportunities to further reduce debt costs.

General Growth should generate same store NOI growth of at least 4% the next few years, ahead of peers as it makes up for the ground lost during the recession and bankruptcy when operating results suffered. The valuation is attractive at a 5.8% implied cap rate, a discount to private market values and its public peers.

- **Host Hotels (NYSE: HST; Lodging) Up 12% *YTD*** *Host Hotels owns high quality lodging assets in prime urban, airport and resort/convention locations across the United States.*

  Host is off to a strong start this year with RevPAR growth up over 9% through the first six weeks of the year and likely up over 7% for the first quarter, well ahead of its full year guidance of 5%-7%. Consistent with our thesis, upside to 2013 guidance is likely. Host is enjoying the benefits of several large hotel renovations it undertook in 2012, an additional driver of above-peer RevPAR growth.

  The lodging recovery continues to be on solid footing with new construction activity less than 1% of total inventory and demand outpacing new supply as the economy accelerates. Group business, which represents 40% of Host's demand, should rebound further this year as business spending improves. 2013 group RevPAR is on pace to grow 6.5%, with approximately two-thirds of this growth from higher occupancy. High booking volumes on group business, which is a higher rate/margin customer for the hotel, is allowing for the company to push rates on other more transient customers. Valuations of lodging assets in the private market should rise in concert with growing profitability of the assets, supporting further upside for shares of HST.

- **Kilroy Realty (NYSE: KRC; Office) Up 11% YTD**. *Kilroy owns, operates and develops high quality office properties that span top coastal market locations from Seattle to San Diego. The Company's portfolio totals more than 12.5 million square feet.*

  Kilroy remains poised for further outperformance as robust west coast office fundamentals have not slowed. Shares of KRC had a strong start to 2013, up 11%, benefitting from the strong momentum the company has had on its value-creating development investments and strong leasing activity in its west coast office portfolio.

  Kilroy now has four fully pre-leased development projects in the Bay Area with total spending of over $800 million at attractive yields of 7.0%-7.5%, versus market cap rates at completion around 5%. The value creation on these four projects is 10% likely of the company's market cap. The company continues to seek out additional opportunities, with $600 million of additional opportunities already identified.

  Strong job growth in Kilroy's markets is translating into occupancy gains and higher market rents, as Kilroy's occupancy improved to near 93% at year-end 2012, up over 250 bps for the year. With job growth off to a strong start so far this year, further upside in rents and occupancy appears likely. Market strength is showing up in Kilroy's leasing activity, with cash

rents on leasing activity currently under letter of intent at the time of its last earnings call 15% above expiring rents. Same store NOI growth guidance of 3.5% in 2013 is likely conservative.

- **Las Vegas Sands (NYSE: LVS; Gaming) Up 23% YTD**. *Las Vegas Sands is the pre-eminent operator and developer of integrated casino resorts predominantly located in Macao and Singapore, and feature a combination of gaming, lodging, entertainment and retail facilities.*

  Las Vegas Sands' underlying real estate is worth $85 per share, providing over 50% upside from current levels. The malls and hotels are worth over $40/share alone. As an integrated resort company, it suffers from a conglomerate discount. To maximize shareholder value, spinning out the mall and lodging entities into separately traded REITs would unlock the true value of the real estate. Discussions with management confirm that a spin-out is compelling, but at least 3 - 5 years out.

  Macao gross gaming revenue reached an all-time monthly record in March, up over 25% year-over-year. 1Q13 GGR growth came in at 15%, ahead of street estimates, and should continue to beat expectations as comps get easier throughout most of 2013. Over 50% of LVS EBITDA comes from Macao and the company's resorts are the best positioned in the region with the highest exposures to the fast-growing mass segment, the most hotel rooms located on the Cotai Strip and have limited new supply to contend with the next several years. For LANDandBUILDINGS full analysis, please see our September 2012 presentation, *Las Vegas Sands: Unleashing The Best Mall and Lodging REITs in the World (And Why the Stock Can DOUBLE)*.

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