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## Must Own Property Names to Buy During Interest Rate Fears

- REITs have sold off 9.5% since their peak in mid-May on fears of rising interest rates. Historically, sell-offs related to interest rate fears have created excellent buying opportunities.
- In the 30, 90 and 365 days following interest rate induced fears, property stocks have outperformed the S&P, delivering 6.8%, 9.2% and 28.7% total returns.
- To take advantage of the acute sell-off in REITs, buy General Growth Properties (NYSE: GGP), BRE Properties (NYSE: BRE) and CoreSite (NYSE: COR).
- Real estate today enjoys an excellent outlook given the dearth of new construction, modest but improving demand and attractive valuations relative to bonds.

### Buy REITs on Dislocation: Rising Interest Rates Creates Buying Opportunity

Historically, rising interest rates have created a favorable backdrop for property stocks to post attractive returns during the first half of the business cycle. Specifically, REITs have risen 12.4% on average since 1994 during 12 periods when the 10-year treasury yield rose 60 basis points or more for a sustained period.

Breaking the 12 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 18.1% on average (Figure 1). During periods of late economic expansions, property shares delivered poor performance due to the end of the tightening cycle choking off demand and capital.

The economy is in the first half of an economic expansion; as such REITs will likely deliver attractive total returns. Furthermore, given the unprecedented Federal Reserve Quantitative Easing, a sustained rise in interest rates that would threaten the fragile recovery without an appreciable improvement in the labor market or economic growth would be met with additional quantitative easing measures to keep rates low for an extended period.

### Peeling the Onion – Interest Rate Induced Sell-Offs Are Attractive Entry Points

Looking more closely at the short but intense periods when property stocks sold off due to fears of rising interest rates reveals a historically attractive buying opportunity. Since 1994 there have been 7 instances, including the last 10 days, of acute fears of rising interest rates that caused the REITs to decline an average of ~12%.

The current time period, May 21st through May 31st, has seen REITs decline 9.5%, consistent in magnitude with prior declines. Returns subsequent to these declines over the next 30 days, 90 days and 1 year were 6.8%, 9.2%, and 28.7% respectively, and nearly doubling the returns of the S&P 500 (Figure 2).

The rationale for the strong returns of property stocks during these periods is driven by the inflation hedge characteristics real estate offers. Specifically, modest inflation, coupled with rising rents and occupancies as well as solid demand has historically generated attractive growth in earnings and dividends, resulting in a low correlation between bonds and property stocks. REITs are attractively valued to bonds today, trading at historically wide spreads to BBB corporate bond at 220 bps vs. a historical average of 150 bps (Figure 3).

Buying the interest rate fear-inspired sell off in property stocks has historically been attractive and will likely be in the current environment. However, if the 10 year moved above 3% and was headed higher due to inflation concerns, much stronger economic growth, and the US economy was in the clear to come off life support of the Fed's quantitative easing, the re-pricing of real estate may detract from the historical attractiveness of real estate during the adjustment period. It does not appear that moment has arrived just yet.

**Taking Advantage of the Sell-Off—Buy GGP, BRE and COR**

**General Growth (NYSE: GGP; Regional Malls) Up 4% YTD** – *General Growth owns and operates 125 high-quality regional malls across the United States as well as 18 malls in Brazil*.

- GGP has sold off 12% from its early May peak, should generate stronger NOI growth then its peers over the next several years, and has 30% upside to the underlying value of its real estate. Strong NOI growth of 4-5% is likely the next few years as 1) in place rents are significantly below market and be re-priced as leases expire, 2) further occupancy gains as the company closes the gap to its other high quality peers following a period of underperformance following its bankruptcy during the financial crisis. The stock is trading at an implied cap rate of 5.8% while the highly productive malls the company owns are likely worth 5% or less based on recent market transactions.

**BRE Properties (NYSE: BRE; Apartments) Down 1% 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 has sold off 7% the last 10 days of May, should generate NOI growth in the mid to high single digits the next several years, has over 35% upside to the underlying value of its real estate, and trades at a discount to its peers. Our channel checks continue to indicate that west coast apartment fundamentals are robust, peak leasing season has appeared to meet or exceed expectations, and apartment cap rates continue to be in the mid to low 4% range. The recent pull-back in BRE shares will further pressure management to execute on their stated objectives or seek strategic alternatives.

**CoreSite (NYSE: COR; Datacenters) Up 17% YTD** – *CoreSite is a national provider of datacenter products and interconnection services with 14 datacenters across nine major U.S. markets including Los* Angeles, San Francisco, Chicago, Washington DC and New York City.

- COR sold off 16% from its high in May, should generate double digit growth over the next several years, is well-positioned to benefit from the strongest growth segment in the data center business (interconnection), and has external growth opportunities that could double the size of the company in a few years' time. At an implied cap rate of nearly 8%, there is significant valuation upside. COR will likely generate 25% plus total return over the next 12 months.

## Figure 1: REITs Have Generated Strong Returns in Prior Sustained Interest Rate Increases

| | | Period of Rising Interest Rates | | | | | Subsequent REIT Returns | | | Subsequent S&P Returns | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Period | | Days | Rate Rise (bp) | REITs | S&P | REITs vs. S&P | 30 Days | 90 Days | 1 Year | 30 Days | 90 Days | 1 Year |
| Jan-94 - | Nov-94 | 299 | 247 | 0.8% | 0.0% | 0.8% | -1.6% | 4.7% | 20.5% | -2.3% | 4.0% | 30.0% |
| Jan-96 - | Apr-97 | 451 | 145 | 40.5% | 24.8% | 15.7% | 2.0% | 10.5% | 24.1% | 12.6% | 23.8% | 52.6% |
| Nov-01 - | Apr-02 | 145 | 123 | 17.8% | 3.3% | 14.5% | 1.1% | 3.4% | -4.1% | -5.2% | -13.3% | -23.8% |
| Jun-03 - | Jun-04 | 367 | 177 | 23.0% | 15.8% | 7.2% | 6.9% | 13.4% | 39.0% | -1.1% | 0.3% | 8.9% |
| Jun-05 - | Jun-06 | 391 | 136 | 21.4% | 5.5% | 15.8% | 7.4% | 12.7% | 17.3% | 2.7% | 7.7% | 23.1% |
| Nov-09 - | Apr-10 | 126 | 79 | 20.7% | 9.1% | 11.7% | 3.3% | -9.1% | 20.6% | -1.7% | -13.5% | 14.5% |
| Oct-10 - | Feb-11 | 123 | 134 | 9.1% | 14.4% | -5.2% | -1.1% | 5.7% | 12.4% | -2.0% | 2.1% | 4.1% |
| Jul-12 - | May-13 | 311 | 76 | 11.7% | 24.3% | -12.6% | n/a | n/a | n/a | n/a | n/a | n/a |
| **Early Recovery** | | **277** | **140** | **18.1%** | **12.2%** | **6.0%** | **2.6%** | **5.9%** | **18.5%** | **0.4%** | **1.6%** | **15.6%** |
| Oct-98 - | Jan-00 | 473 | 263 | 0.8% | 48.2% | -47.4% | -5.7% | 2.8% | 27.2% | -6.5% | -0.2% | -5.8% |
| Dec-06 - | Jun-07 | 193 | 82 | -4.7% | 7.9% | -12.6% | -0.6% | -8.0% | -12.6% | 3.8% | -2.3% | -8.7% |
| **Late Stage Expansion** | | **333** | **173** | **-1.9%** | **28.1%** | **-30.0%** | **-3.2%** | **-2.6%** | **7.3%** | **-1.3%** | **-1.2%** | **-7.2%** |
| Mar-08 - | Jun-08 | 88 | 95 | 9.1% | 7.1% | 2.0% | -11.0% | -2.1% | -46.2% | -8.7% | -7.6% | -28.5% |
| Dec-08 - | Jun-09 | 174 | 186 | -1.0% | 7.6% | -8.5% | -12.5% | 19.5% | 55.9% | -6.2% | 9.8% | 18.1% |
| **Recession** | | **131** | **140** | **4.1%** | **7.3%** | **-3.3%** | **-11.7%** | **8.7%** | **4.8%** | **-7.5%** | **1.1%** | **-5.2%** |
| **Total** | | **262** | **145** | **12.4%** | **14.0%** | **-1.6%** | **-1.1%** | **4.9%** | **14.0%** | **-1.3%** | **1.0%** | **7.7%** |

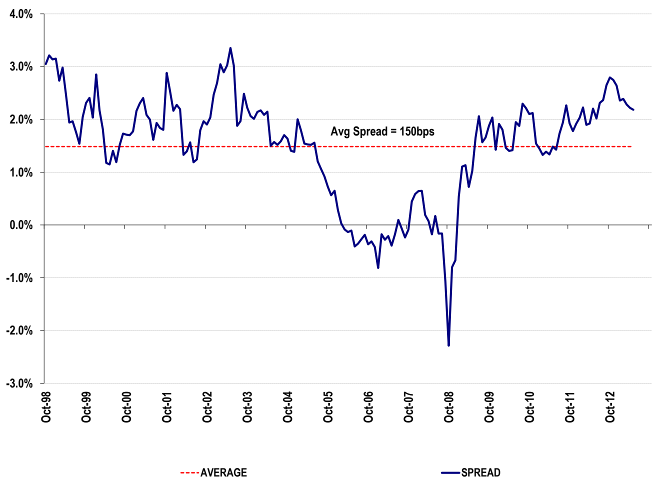
Source: Land & Buildings, Bloomberg, EPRA/NAREIT

## Figure 2: REITs Initially Had Steep Declines in Acute Interest Rate Fears, But Rebounded Sharply

| | | Acute Period of Interest Rate Fears | | | | | | Subsequent REIT Returns | | | Subsequent S&P Returns | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Period | | Days | Rate Rise in Fear Period (bp) | Total Rise | REITs | S&P | REITs vs. S&P | 30 Days | 90 Days | 1 Year | 30 Days | 90 Days | 1 Year |
| Jun-94 - | Nov-94 | 159 | 93 | 247 | -11.1% | -1.4% | -9.8% | 7.3% | 8.8% | 24.1% | 2.4% | 7.8% | 36.5% |
| May-99 - | Dec-99 | 217 | 68 | 263 | -21.0% | 4.4% | -25.4% | 12.1% | 6.0% | 38.0% | 3.8% | -3.6% | -4.0% |
| Apr-04 - | May-04 | 39 | 88 | 119 | -17.7% | -3.8% | -13.9% | 11.0% | 15.1% | 42.4% | 4.3% | -1.7% | 9.2% |
| Mar-06 - | May-06 | 67 | 39 | 91 | -9.3% | -3.6% | -5.7% | 3.5% | 13.4% | 28.0% | -0.7% | 3.7% | 23.4% |
| Nov-10 - | Nov-10 | 11 | 31 | 134 | -9.2% | -3.8% | -5.4% | 2.3% | 13.8% | 11.1% | 5.7% | 13.6% | 7.2% |
| Jul-12 - | Aug-12 | 28 | 23 | 47 | -3.0% | 3.2% | -6.1% | 4.5% | -2.0% | n/a | 4.2% | -1.2% | n/a |
| May-13 - | May-13 | 10 | 22 | 53 | -9.5% | -2.2% | -7.2% | n/a | n/a | n/a | n/a | n/a | n/a |
| **Interest Rate Fears** | | **76** | **52** | **136** | **-11.5%** | **-1.0%** | **-10.5%** | **6.8%** | **9.2%** | **28.7%** | **3.3%** | **3.1%** | **14.5%** |

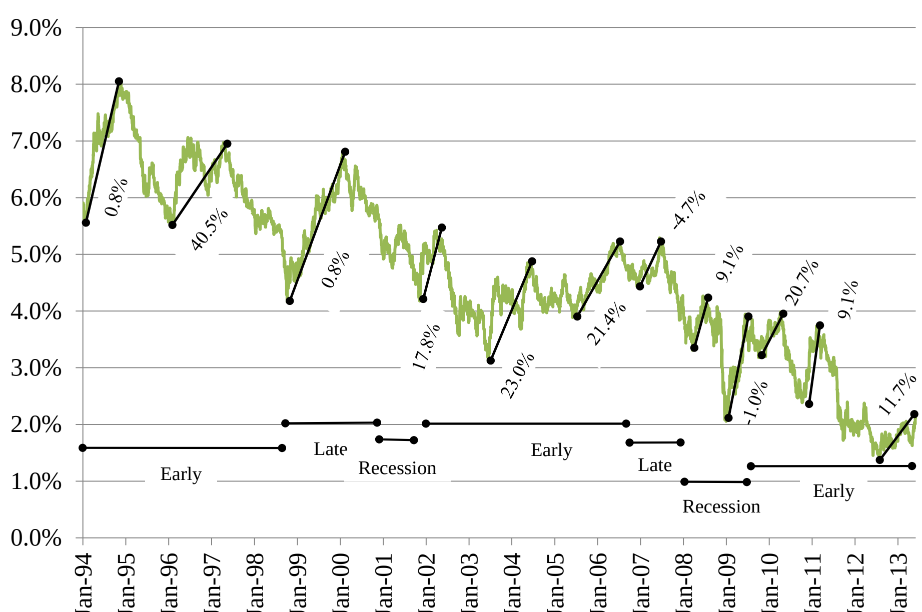
Source: Land & Buildings, Bloomberg, EPRA/NAREIT

## Figure 3: REITs Are Attractively Priced Relative to BBB Bonds Today




Note: Data represents the spread between REIT implied cap rates and BBB corporate bond yields.
Source: Land & Buildings, Citi

## Figure 4: REITs Returns Are Strong in Early Economic Recoveries as Rates Rise




Note: Percentages represent returns of REITs in periods of sustained interest rate increases.
Source: Land & Buildings, Bloomberg, EPRA/NAREIT

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