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4Q14 Update: "Must Own" Real Estate Stocks

- Real estate stocks had a volatile third quarter, but real estate values and cash flows should continue to rise.
- Land and Buildings' "must own" real estate stocks for the next 12 months with expected returns of 25% or more are: Associated Estates, DiamondRock Hospitality, Essex Property Trust, Jones Lang LaSalle, Kilroy Realty Trust, MGM Resorts, Pennsylvania REIT and SBA Communications.
- Land and Buildings' "must own" portfolio of stocks has returned 38% since being established in January 2013, outperforming REITs which returned 23%. Since the last report in July 2014, the "must own" stocks have returned -1%.

Go figure. In September, the market feared higher interest rates and REITs traded down 8% during the month, while in October the markets feared deflation, interest rates went down and the REITs rallied 7%. During that time absolutely nothing changed on the ground at the malls, offices, apartments, hotels, etc. that the REITs own other than the continued improvement in fundamentals.

So, where do we think real estate goes from here?

Real estate supply is largely in check, demand continues to build, albeit modestly, and capital markets are wide open. Barring a significant shock to the economy, real estate values and cash flows should continue to grind higher.

Savvy Managements Lightening Up On Most Sought After Real Estate

Ok, I admit it, I am a huge fan of Mort Zuckerman, Executive Chairman of Boston Properties (NYSE: BXP; Office). Last month he sold a minority interest in 3 office buildings in Manhattan and Boston for $1.5 billion at a sub-4% cap rate or $1,075 per square foot. Despite this great valuation mark the shares of Boston Properties trade at a 5% implied cap rate. What differentiates the "Mort Man", as he has become affectionately known, is his impeccable timing. He has bought and sold well over the decades catching the cycles largely just right.

Chris Nassetta, CEO of Hilton Worldwide (NYSE: HLT; Lodging), a rock star in the lodging space, pulled a rabbit out of the hat when he sold Waldorf Astoria New York to a Chinese buyer for $1.95 billion, or $1.4 million per room. Yet the shares of Hilton trade at a discount to the peers and the private market value of their real estate.

These examples demonstrate how valuable the real estate owned by public real estate companies is. For all those who have crowed that private markets valuations are full, in the public markets discounts can still be had.

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Current "Must Own" Stocks

Land and Buildings' 2014 must own stocks, that we expect will likely generate a 25% or more total return, are Associated Estates, Essex Property Trust, DiamondRock Hospitality, Jones Lang LaSalle, Kilroy Realty Trust, MGM Resorts, Pennsylvania REIT and SBA Communications.

Associated Estates (NYSE: AEC; Apartments) Down 2% in 2Q14—*AEC own and operates over 50 high quality apartment communities containing over 13,000 units across 9 states. AEC is the smallest of the major public apartment REITs with ~$2 billion in total assets.*

- **Associated Estates trades at a significant discount to NAV which we believe can be closed through a sale of the company.**

Land and Buildings believes AEC has substantial upside to the private market value of its assets. This discounted valuation is due to several factors, including a misunderstanding by the public markets of the company's high quality assets as well as capital allocation missteps by management. Wide-open capital markets, historically low interest rates, and expectations for continued strong apartment net operating income growth are creating a robust, liquid private market with institutional appetite for apartment assets. This environment is both conducive to an outright sale of the company as well as improved capital allocation through asset sales and buying back stock.

Following repeated failed attempts to establish a dialogue with Chairman and CEO Jeff Friedman regarding maximizing shareholder value, Land and Buildings issued a public letter on June 3, 2014 encouraging a sale of the company and a potential board or management refresh (Land and Building Sends Letter to the Board of Associated Estates). Land and Buildings continues to actively pursue numerous pathways to close the valuation gap at AEC.

DiamondRock Hospitality (NYSE: DRH; Lodging) Flat in 3Q14—*DiamondRock Hospitality owns 27 hotels across major gateway and destination markets primarily in the United States.*

- **DiamondRock's consensus earnings estimates appear too low due to Wall Street underappreciating the company's asset renovation uplift.**

The tailwinds from DiamondRock's renovation program should continue to propel outsized results next year, which should lead to upwardly revised 2015 consensus EBITDA estimates. The company held an investor event in early October, preannouncing third quarter RevPAR would be in excess of 17%, well ahead of expectations. DRH also more clearly outlined 2015 growth drivers and this guidance does not appear to be fully appreciated by the investment community. 2015 consensus EBITDA estimates likely have at least 5% upside and 2014 earnings guidance is should be revised upward when the company reports earnings next month.

Successful hotel renovations are now ramping and strong RevPAR growth in the lodging industry should drive top-line growth and margin expansion. Group business, which has lagged in the recovery this cycle, is recovering with DRH's portfolio seeing forward group bookings for the second half of 2014 up 13%.

DiamondRock's small asset base of 27 hotels allows for the 5 key renovations to have a significant positive affect on growth. The initial recovery of lost RevPAR and EBITDA during the renovation periods should occur in 2014 and the incremental RevPAR beyond the in-place revenue pre-renovation will show up in numbers later in 2014 and beyond as the assets gain recognition in the marketplace from corporate planners and leisure travelers.

Essex Property Trust (NYSE: ESS; Apartments) Down 3% in 3Q14—*Essex Property Trust is an owner and operator and developer of apartment communities throughout the supply-constrained markets on the West Coast, including San Francisco, Los Angeles, Orange County, San Diego and Seattle. ESS merged with BRE Properties as of April 2014.*

- **Following Essex's merger with BRE, a second phase of shareholder value creation should occur as the combined entity should have the best growth in the public apartment sector.**

Essex CEO Michael Schall is the real deal when it comes to executives to invest alongside who can generate superior returns. The strong tailwinds in the west coast submarkets in which he operates, together with superior operating skills has led Essex to be a frontrunner in the multifamily industry.

The $6 billion acquisition of BRE Properties in the spring is already bearing fruit as his team is driving outsized growth from the portfolio, which had long been undermanaged. Continued strong job growth, high cost of home ownership on the west coast and high barriers to entry for new apartment development combined with the robust growth at the BRE apartments should drive double-digit earnings growth. Still, the shares trade at a discount to the private market value of their assets. With Michael at the helm, we expect to see continued strong returns.

Jones Lang LaSalle (NYSE: JLL; Real Estate Brokerage) Flat in 2Q14*—Jones Lang LaSalle specializes in commercial real estate services across 70 countries globally. Business lines include leasing brokerage, investment sales brokerage, property management outsourcing, and investment management.*

- **Commercial real estate investment sales momentum is building as credit eases and a wall of capital looks to acquire global real estate; leasing volumes are accelerating as well.**

Jones Lang LaSalle stands to be among the largest beneficiary of the continuing global real estate recovery. Commercial real estate investment sales transaction and leasing brokerage make up well over half of the company's earnings and JLL's fundamentals remain relatively insulated by changing interest rate expectations.

2014 global commercial real estate transaction volumes are projected to be up 20% industry-wide, hitting $700 billion, with further strong growth anticipated in 2015. Institutional investors remain under-allocated to real estate, the search for yield remains a consistent theme and CRE credit is likely to ease further, all driving robust growth in investment sales.

Office leasing volumes and rental rates are seeing solid growth globally, particularly in the Americas, as a modestly growing global economy, continued job growth, new business formations and pent-up demand from previously delayed decision-making all provide a tailwind. JLL management is increasingly bullish on leasing growth and believes we are early in the global up-cycle.

Market share gains, accretive acquisitions utilizing free cash flow, outsized growth in the high margin leasing and sales business segments and a renewed focus by management on company efficiency should cause company margins to expand and lead to annual earnings growth of 20%+ in 2014 and 2015, above street estimates.

Kilroy Realty Trust (NYSE: KRC; Office) Down 4% in 3Q14—*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 approximately 13.5 million square feet.*

- **Rapidly rising rents are compressing cap rates in Kilroy's markets and combined with a significant value-creating development pipeline, KRC should continue to see large NAV increases over the next 12 months.**

Kilroy Realty offers investors the opportunity to invest in the hottest office market in the country, Northern California, and a best-in-class management team that is creating significant value beyond what the market is already giving them, all at a discount to net asset value.

San Francisco, over half of Kilroy's asset value on pro forma basis, has seen an acceleration in leasing from the already very strong volumes in 2013. According to Cushman and Wakefield, San Francisco has seen 7.7 million square feet of leasing year-to-date through the third quarter, easily surpassing the 7.2 million square feet signed in 2013. Rents are poised to continue rising rapidly as San Francisco has only 13 Class A blocks of office space available of at least 50,000 square feet while there are over 33 tenants looking for at least 50,000 square feet.

The company is currently underway on over $1 billion of fully leased developments with well over $1 billion of additional developments either in the pipeline or currently being evaluated, driving likely NAV increases of 25%-plus. Development continues to be a compelling investment for Kilroy, with yields routinely in the 7-9% range and market cap rates of sub-5% across the west coast for Class A product. Transactions with cap rates in the 3% range are now occurring routinely in the Bay Area, further enhancing and highlighting the value Kilroy is creating.

MGM Resorts (NYSE: MGM; Gaming) Down 14% in 3Q14—*MGM Resorts is an operator and developer of casino resorts including lodging, retail and entertainment facilities located in Las Vegas and Macao as well as other regional destinations in the United States.*

- **MGM Resorts should benefit from an improving Las Vegas Market, a new project opening in Macao in 2016 and potential significant value creation on a project in Japan.**

MGM is set to benefit from a Las Vegas market recovery that is taking hold, continued growth in the Macao market and development value creation in Macao, Maryland and potentially Japan or other new international markets.

MGM generates over 60% of EBITDA from Las Vegas, a market that is rebounding strongly. In the third quarter, based on Land and Buildings channel checks, results are likely to beat guidance of 5% RevPAR growth and forward bookings for the fourth quarter are also robust. In addition, international player visitation to Las Vegas is rising, driving baccarat table volumes up 11% year-to-date.

MGM currently operates one asset in Macao and construction is underway on a new asset on the Cotai Strip that is expected to open in early 2016. The company's Cotai asset should be materially additive to the company's valuation as the asset stabilizes; if the new asset can generate EBITDA similar to its existing asset, that would translate to an approximately 30% return on the project's $3 billion cost.

Development value creation potential is significant beyond Macao, with a project in Maryland and the company actively pursuing numerous other projects, including Japan and Korea opportunities. A Japan development could represent in excess of 20-30% of additional value beyond the current share price. Legislation to legalize casinos in Japan may pass this fall and MGM would be a leading candidate to be awarded a license to build a new casino, most likely in Osaka.

Pennsylvania REIT (NYSE: PEI; Regional Malls) Up 7% in 3Q14*— Owner and operator of 33 regional malls and 7 other retail properties across 12 states in the eastern half of the United States with concentration in the Mid-Atlantic and Greater Philadelphia region.*

- **Pennsylvania REIT has an estimated 55% upside to the private market value of its assets, based on Land and Buildings analysis, which we believe can be unlocked through a liquidation of the lowest productivity retail assets.**

Pennsylvania REIT has an estimated 55% upside to the $30 per share net asset value of the company's real estate. Land and Buildings has been in discussions with management on various ways to close the gap to net asset value. The portfolio has been substantially upgraded over the past several years with 80% of estimated asset value derived from malls generating an average sales productivity of $480 per square foot. Land and Buildings believes these 16 high quality "Keeper" malls are worth $24 per share alone, or more than 20% above the current stock price. We believe the current stock price reflects less than zero equity value for the bottom 17 malls in the portfolio despite our estimate that these malls are with $6 per share.

Land and Buildings, earlier in this month, outlined in a presentation (available here) what we believe is the clearest path to maximize shareholder value and drive the share price closer to NAV: 1) PREIT should liquidate its lowest productivity retail assets in a timely manner, transforming the "Keeper" company into a high quality $480 sales per square foot mall REIT and 2) Management should communicate a strategic plan to narrow the discount to NAV, including a liquidation of lowest quality assets, and state that if the valuation gap is not closed within a finite timeframe that PREIT will explore strategic alternatives, including a sale of the entire company.

SBA Communications (NASDAQ: SBAC; Cellular Towers) Up 8% in 3Q14*—SBA Communications owns and leases 17,500 multi-tenant cellular towers across North and South America.*

- **Cash flow growth estimates continue to be too low for this cell tower company that should grow AFFO at more than 25% again in 2014; 3Q14 should exceed street estimates.**

SBA is benefitting from strong occupancy gains leading to increased pricing power as the wireless carriers are seeking to improve network quality by adding more antennas to their networks and upgrading to the latest technology. Cell tower leasing fundamentals continue to be described as the "strongest ever" and on July 25th, the company released robust second quarter earnings coupled with an increasingly bullish outlook by management.

The failed Sprint/T-Mobile merger removes an overhang on the stock and potential near-term catalysts are numerous, such as additional spectrum auctions, the build-out of DISH Network spectrum and the build-out of FirstNet, the United States government's new public safety network.

We expect cash flow growth will continue to be in the 15-20%+ range. SBAC still trades at a multiple discount to other high quality, high growth traditional real estate companies and we anticipate further valuation upside.

"Must Own" List Historical Performance

Land and Buildings' "must own" stock list, issued quarterly, returned a compounded 38% since our initial report in January 2013, significantly outperforming a 23% total return for REIT stocks over the same time period. The annualized return of the "must own" stocks is 20% since inception.

Figure 1: Land and Buildings "Must Own" Stocks Generated a 38% Since Inception, 1,500 bps Above REITs

	1Q13	2Q13	3Q13	4Q13	1Q14	2Q14	3Q14	Cumulative
L&B "Must own" stocks	10%	-1%	4%	6%	9%	7%	-1%	38%
REIT Index	10%	-4%	-3%	0%	9%	8%	3%	23%
L&B Outperformance	**0%**	**3%**	**7%**	**6%**	**1%**	**-1%**	**-4%**	**15%**

Note: Performance of the "must own" list is measured by calculating the total returns of each stock/index from the day prior to the release of the each respective quarter's "must own" list through the day prior to the release of the next quarter's report. For example, the measurement period for the "must own" stocks in the July 11, 2013 ("3Q13") piece use a measure period of closing prices on July 10, 2013 to October 10, 2013. See Figure 2 for additional details.

Figure 2: Land and Buildings "Must Own" Stocks Historical Detail and Performance

1Q13 Must Own List		2Q13 Must Own List		3Q13 Must Own List		4Q13 Must Own List	
BRE	1%	BRE	0%	BRE	1%	BRE	13%
COR	22%	COR	-8%	COR	5%	COR	-4%
EXR	11%	EXR	6%	GGP	-1%	DRH	6%
GGP	8%	GGP	-2%	HST	0%	GGP	3%
HST	7%	HST	0%	KRC	-5%	KRC	0%
KRC	12%	KRC	2%	LVS	25%	LVS	20%
LVS	7%	LVS	-4%			PLD	-4%
						SBAC	14%
L&B "Must own" stocks	**10%**	**L&B "Must own" stocks**	**-1%**	**L&B "Must own" stocks**	**4%**	**L&B "Must own" stocks**	**6%**
REIT Index	10%	REIT Index	-4%	REIT Index	-3%	REIT Index	0%
L&B Outperformance	0%	**L&B Outperformance**	3%	**L&B Outperformance**	7%	**L&B Outperformance**	6%
Dates: 1/9/13 to 4/10/13		Dates: 4/10/13 to 7/9/13		Dates: 7/9/13 to 10/10/13		Dates: 10/10/13 to 1/13/13	

1Q14 Must Own List		2Q14 Must Own List		3Q14 Must Own List	
ESS	12%	ESS	15%	AEC	8%
DRH	6%	DRH	8%	CBSO	-12%
FR	16%	FR	0%	ESS	3%
JLL	16%	JLL	8%	DRH	7%
KRC	17%	LVS	-3%	JLL	-1%
LVS	-3%	SBAC	14%	MGM	-13%
SBAC	2%			SBAC	8%
L&B "Must own" stocks	**9%**	**L&B "Must own" stocks**	**7%**	**L&B "Must own" stocks**	**-1%**
REIT Index	9%	REIT Index	8%	REIT Index	3%
L&B Outperformance	1%	**L&B Outperformance**	-1%	**L&B Outperformance**	-4%
Dates: 1/13/2014 to 4/17/2014		Dates: 4/17/2014 to 7/22/2014		Dates: 7/22/2014 to 10/27/2014	

Note: Performance of the "must own" list is measured by calculating the total returns of each stock/index from the day prior to the release of the each respective quarter's "must own" list through the day prior to the release of the next quarter's report.

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