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Must Own Real Estate Stocks for 2014

- Land and Buildings' "must own" real estate stocks for 2014 with expected returns of 25% or more are: BRE Properties (Essex Property Trust), DiamondRock Hospitality, First Industrial, Jones Lang LaSalle, Kilroy Realty, Las Vegas Sands and SBA Communications.
- Land and Buildings' 2013 "must own" stocks returned 20% since our initial report last January, significantly outperforming the 2% total return for REITs.
- Two of the companies Land and Buildings actively highlighted as undervalued performed well, with Las Vegas Sands generating a 55% return while BRE Properties generated a 15% return, outperforming apartments by 20% since the 2013 "must own" list was published a year ago.
- REITs appear well positioned to generate total returns in 2014 of 10-14% as valuations are attractive and underlying supply/demand dynamics remain supportive of high single digit cash flow growth.
- Historically, REIT stocks have delivered double digit returns, after an initial decline, as interest rates rise. REITs are trading at one of the sector's largest discounts to net asset value over the past 15 years following the 16% pull back in share prices since late May combined with little to no movement in private market values of real estate.

Bouncing Back — Real Estate Stocks Poised for Above Average Returns

Numerous REIT stocks appear well positioned to generate attractive returns in 2014 as valuations are at steep discounts to net asset value, underlying supply/demand dynamics remain supportive of high single digit cash flow growth and capital markets are open.

REITs have declined by 16% from their May highs on concerns about the Federal Reserve tapering quantitative easing and rising 10 year treasury yields. REITs have historically generated attractive total returns, after an initial weakness, following a rise in the ten year treasury yield. Our conversations with private market participants suggest private market values of real estate remain largely unchanged since May despite the public market volatility.

REITs at 15% Discount to Net Asset Value — M&A Could Pick Up

REITs are trading at a 15% discount to net asset value, one of the sector's largest discounts over the past 15 years; the declines in the stocks combined with little to no change in private market values has created a significant undervaluation. (Figure 1) Management teams are likely to act to attempt to

close the gap versus private market value through stock buybacks, asset sales and/or a full sale of the company. M&A heated up in 2013 with BRE Properties (NYSE: BRE), Colonial Properties Trust (NYSE: CLP; Apartments) and Brookfield Office Properties (NYSE: BPO; Office) all getting acquired and 2014 could bring more such activity if the current large discounts persist or grow. Among the major property types, apartments and regional malls trade at the widest discounts to NAV and could be ripe for further consolidation.

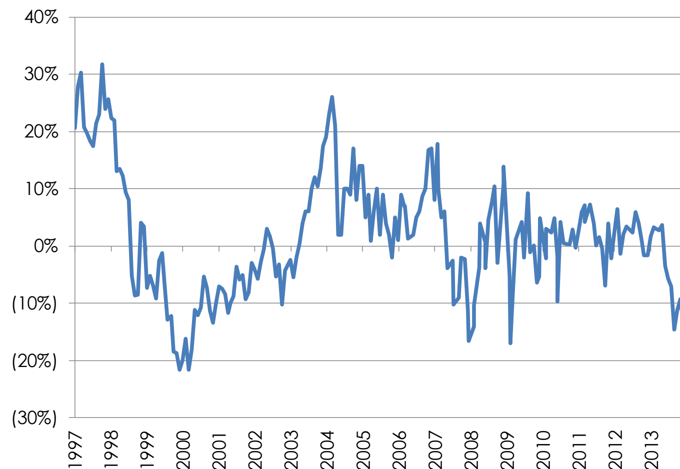
REITs at a Discount to Bonds

REITs are trading cheap to bonds as REIT implied cap rates are 180 bps above BBB corporate bond yields, 30 bps above the historical average. (Figure 2) Historically, this discount has been resolved at this point in the economic cycle with REIT shares appreciating given solid cash flow growth (unlike bonds) and valuations improving given increasingly open capital markets.

REITs have risen 12% on average since 1990 during 12 periods of 10 year treasury yield increases of at least 60 bps for a sustained period. REIT returns have been even stronger at 17% when the economy is in an early expansion as we believe we are in today.

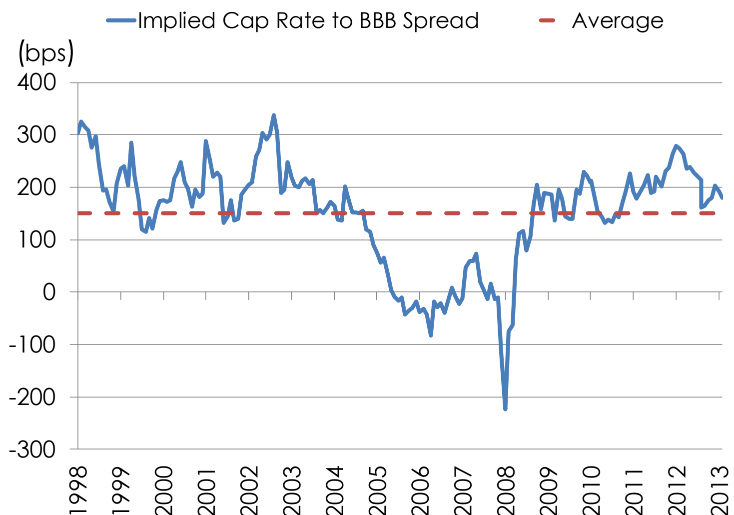
Often times the total rise in rates during these periods has been much more than 60 bps. From 2003 – 2007, the 10-year rose over 200 bps and REITs returned 141%. (Figure 3) From 2004 – 2006, REIT implied cap rates traded below the historical average spreads.

Figure 1: REITs are Trading at a 15% Discount to NAV, Near Historical Lows



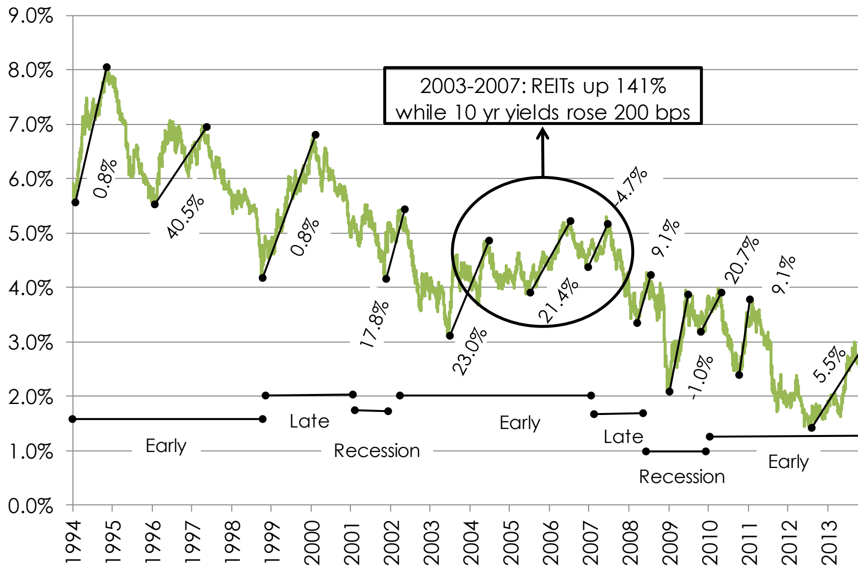
Source: Land and Buildings, ISI

Figure 2: REIT Implied Cap Rates Cheap to BBB Bond Yields



Source: Land and Buildings, Citi

Figure 3: REITs Have Generated Strong Returns as 10-Year Rates Rise During Early Economic Expansions

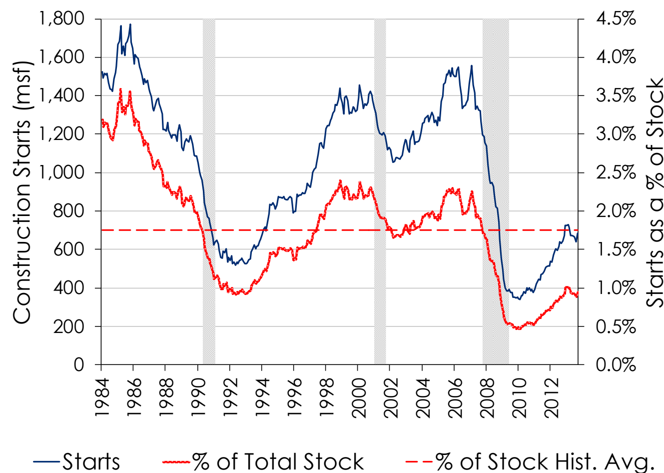


Note: Returns are REIT returns during the specified rate rising period
Source: Land and Buildings, Bloomberg

Real Estate Demand Greater Than New Supply

Modest commercial real estate construction activity combined with steady economic growth provide a favorable backdrop for real estate fundamentals, causing occupancy rates and rents to continue to rise. The current pace of new construction is only 0.9% of existing stock, well below the long run historical average of 1.8%. (Figure 4)

Figure 4: Commercial Real Estate Construction Activity Remains Low

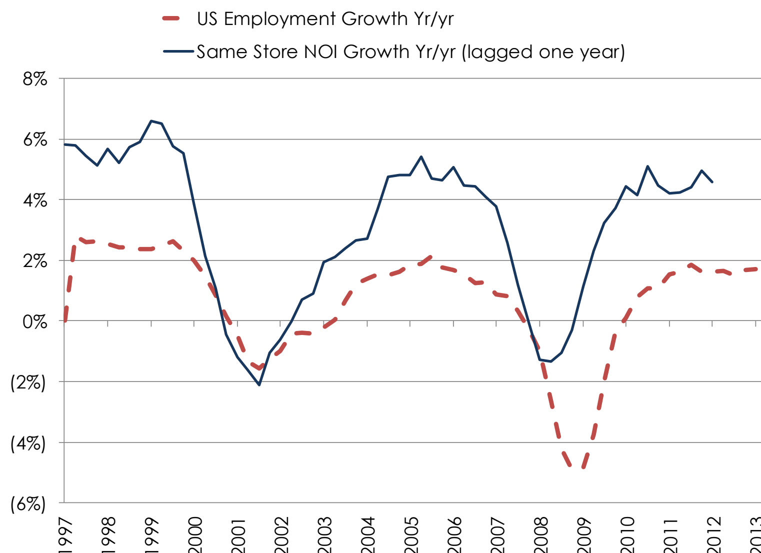


Source: Land and Buildings, Citi

Healthy underlying demand is supported by expectations of approximately 3% GDP growth with 2.5 million of job creation in 2014. Job growth is highly correlated with real estate net operating income growth. (Figure 5)

A higher pace of job gains in 2014 could provide a boost to real estate demand and should keep annual same store NOI growth for the sector above 4%.

Figure 5: Improving Job Market Supports Strong Real Estate Fundamentals



Source: Land and Buildings, ISI

2014's "Must Own" List

Land and Buildings' 2013 "must own" stock list, issued quarterly, returned a compounded 20% since our initial report last January, significantly outperforming a 2% total return for REIT stocks over the same time period. Each quarter, Land and Buildings' "must own" stocks met or exceeded the return of the REITs.

Figure 6: Land and Buildings "Must Own" Stocks in 2013 Generated 20% Return, 1,800 bps Above REITs

	1Q13	2Q13	3Q13	4Q13	Full Year 2013
L&B "Must own" stocks	10%	-1%	4%	6%	20%
REIT Index	10%	-4%	-3%	0%	2%
L&B Outperformance	**0%**	**3%**	**7%**	**6%**	**18%**

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 piece use a measure period of closing prices on July 10, 2013 to October 10, 2013. See Figure 7 for additional details.

2014 Must Own Stocks

Land and Buildings' 2014 must own stocks, that we expect will likely generate a 25% or more total return, are BRE Properties (Essex Property Trust), DiamondRock Hospitality, First Industrial, Jones Lang LaSalle, Kilroy Realty, Las Vegas Sands and SBA Communications.

BRE Properties (NYSE: BRE; Apartments) Up 11% in 2013—*BRE Properties is an owner, 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.*

- **Following BRE's merger with Essex, a second phase of shareholder value creation should occur as the combined entity is trading at a significant discount to underlying asset value with the best growth in the apartment sector and operating improvements likely.**

Land and Buildings worked with the management and Board of BRE for over a year in an attempt to maximize shareholder value, including nominating a control slate of directors. We are pleased that BRE announced in December 2013 that they have entered into an agreement to sell to Essex Property Trust (NYSE: ESS; Apartments) in a primarily stock deal.

BRE's chronic underperformance of net operating income growth, including 6% cumulative NOI growth underperformance versus Essex between 2011 and 2013, presents an opportunity for outsized future growth at the combined entity. Through ownership of Essex, BRE investors are getting the best-in-class West Coast apartment operator at a large discount to net asset value with significant upside to growth expectations.

Essex recently laid out a plan to generate 5-7% same store NOI growth annually for the next three years; the addition of the BRE assets into the portfolio will likely be additive to this core growth rate as incremental revenue and expense opportunities are realized. As of result of operating synergies and other balance sheet opportunities including joint ventures and asset sales, Essex likely set the bar low for FFO accretion at 1%.

BRE Properties is up 26% on a total return basis since October 2012 when we first highlighted the undervaluation and strong fundamentals in the company's markets. During that time, total returns of apartment REITs were negative 1% and REITs overall were up only 6%.

DiamondRock Hospitality (NYSE: DRH; Lodging) Up 33% in 2013—*DiamondRock Hospitality owns 27 hotels across major gateway and destination markets primarily in the United States.*

- **DiamondRock is poised to have a multi-year period of superior EBITDA growth versus peers as portfolio renovations boost profitability, which is not reflected in its discounted valuation.**

DiamondRock is positioned to generate several years of outsized EBITDA growth as the benefits of the company's recent $140 million renovation program and other asset management initiatives come to fruition. DiamondRock should generate at least high single digit RevPAR growth in 2014 and EBITDA growth in excess of 20% as the company is likely to see the $17 million (or 9% of EBITDA) renovation disruption headwind go away and realize a return on its investment.

The company's forward group bookings are strong, with the combination of higher rates and a higher number of rooms booked translating into a pace of over 10% RevPAR growth for the group segment in 2014. This high level of activity should allow the company to push even harder on nightly transient rates for the remainder of the hotel.

The company has prudently managed its balance sheet with low leverage, positioning the company to take advantage of accretive acquisition opportunities, including the pending below market pricing purchase of the Hilton Garden Inn Times Square that should close in mid-2014. But given the discounted valuation the company may also utilize the stock buyback authorization in put in place in 2013. The stock is trading at 14x 2014 EBITDA, a discount to peers and the private market despite further renovation tailwinds that will boost growth beyond next year.

First Industrial (NYSE: FR; Industrial) Up 27% in 2013*— First Industrial is an owner, operator and developer of industrial warehouses in the United States, with a current portfolio of over 60 million square feet.*

- **First Industrial's portfolio lease-up opportunity, balance sheet improvements and development pipeline create a compelling opportunity to get mid-teens cash flow growth at a discounted valuation.**

First Industrial has undergone a significant transformation with Bruce Duncan at the helm for the past five years, improving the quality of the portfolio and the balance sheet, putting the company in position to deliver strong results going forward. The company has set out a plan to grow cash flow in the mid-teens annually between 2014 and 2017, superior to its peers and the REIT universe, primarily through a combination of occupancy and rent increases. Development opportunities and interest savings from debt refinancing will enhance core operating growth.

The company's portfolio should benefit from strong trends in the company's markets with tenant demand outpacing new construction, leading to further occupancy gains. Portfolio occupancy stood at 91.2% as of the end of the third quarter and the company has outlined lease-up opportunities to reach a 95% goal by the end of 2015. Higher occupancies for First Industrial and the industry overall should allow for increases in market rents and drive at least 3% same store NOI growth for the portfolio the next few years.

The company appears on the cusp of getting its investment grade credit rating back, which will result in accretive debt refinance opportunities. The company has $125 million of debt maturing in 2014 at 6.6% and nearly $400 million of debt maturing in total between 2014 and 2016 at 6.25%.

The stock is trading at 7% implied cap rate, nearly 100 bps above its peer average, but with superior growth prospects the next few years. FR is also trading at a discount to net asset value given the high demand for industrial real estate in the private market.

Jones Lang LaSalle (NYSE: JLL; Real Estate Brokerage) Up 23% in 2013*—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.*

- **JLL has a significant valuation expansion opportunity (currently at 14x P/E) combined with 20%+ annual earnings growth in 2014 and 2015.**

Jones Lang LaSalle stands to be among the largest beneficiary of a global real estate recovery that continues to gain momentum. This best in class real estate broker is well positioned to deliver strong top-line growth the next several years as increased business confidence translates into accelerated leasing volumes and investment sales transactions growth.

JLL is gaining market share in leasing and investment sales through increased headcount and exceptional execution. Market share gains, accretive acquisitions and outsized growth in the high margin leasing and sales business segments should cause company margins to expand, likely leading to annual earnings growth of 20%+ in 2014 and 2015, above street estimates.

As the growth outlook continues to improve at JLL, we anticipate both robust earnings growth and valuation improvement. JLL trades at an attractive 14x P/E multiple as the stock saw almost no multiple expansion in 2013 due to misplaced fears about rising interest rates, which had no material impact on any of JLL's business lines. The stock is trading cheap relative to its own historical average multiple over the past decade of over 16x P/E and with significant recurring revenues and much faster growth than the broad market, JLL is discounted on an absolute basis as well.

Kilroy Realty Trust (NYSE: KRC; Office) Up 9% in 2013*—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 see a large NAV increase in 2014.**

Northern California remains the hottest office leasing market in the country with office asking rents up 3% from 3Q13 to 4Q13 in San Francisco and likely much more than that in Kilroy's highly sought after space. Southern California continues to turn the corner and Kilroy should benefit from 4.5–6.0% annualized market rent growth in San Diego over the next 5 years. Continued occupancy and rental rates increases should cause KRC to deliver annual same store NOI growth of at least 4% for the next several years.

Kilroy has been relatively quiet on the external growth front the past several months, but the savvy KRC management team should continue to unearth attractive acquisition and development opportunities across its core markets and that additional value creation appears imminent.

The company is currently underway on over $800 million of fully leased developments with over $1 billion of additional developments either in the pipeline or currently being evaluated, driving NAV increases of 20%-plus.

Development is a compelling investment, with yields in the 7-9% range and market cap rates of sub-5%. A rumored 3 cap transaction at $765/sf in San Francisco reported in the first week of January shows that office cap rates may still be compressing in the Bay Area.

Las Vegas Sands (NYSE: LVS; Gaming) Up 75% in 2013*—Las Vegas Sands is the pre-eminent operator and developer of integrated casino resorts predominantly located in Macao and Singapore, featuring a combination of gaming, lodging, entertainment and retail facilities.*

- **Las Vegas Sands' EBITDA will likely grow 25% in 2014, significantly above current consensus, and current valuation underappreciates the best in class malls and hotels owned.**

Las Vegas Sands owns a portfolio of integrated resorts in Macao that is located in the right submarket (Cotai) and is focused on the right segment (mass) that is driving substantial growth for the company.

In 2013, Macao gross gaming revenues once again beat expectations, up 19%. Infrastructure improvements in China and the opening of a $3 billion theme park on nearby Hengqin Island (along with additional hotel capacity on the Island) should drive further increases in 2014 in visitation from mainland China. Average bet amounts are also growing and the high margin mass business is posting year-over-year growth in excess of 30%.

Earnings estimates for Las Vegas Sands, in our view, are significantly below what the company's assets will generate in 2014 and as such EBITDA estimates should rise from the current expectations of 14% growth in 2014. In 2013, 2013 EBITDA estimates rose by 18% during the year as gaming revenues in Macao exceeded expectations, Las Vegas Sands gained market share and the company increased margins.

Las Vegas Sands owns some of the best retail and hotel assets in the world, with the mall portfolio generating annual sales in excess of $1,800 per square foot, more than double that of the highest quality mall company in the U.S., and a portfolio of luxury hotel rooms with occupancy of near 90%, well in excess of industry norms. The stock is trading at ~15x consensus 2014 EBITDA estimates, which will likely prove conservative. The mall and hotel assets of the company are likely worth well in excess of this multiple and at the current share price investors are still getting the casino business on the cheap.

For Land and Buildings' 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)***.

SBA Communications (NASDAQ: SBAC; Cellular Towers) Up 27% in 2013*—SBA Communications owns and leases 17,500 multi-tenant cellular towers across North and South America.*

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

SBAC should beat their initial 2013 AFFO guidance by nearly 15% as robust organic leasing and a high level of accretive acquisitions powered results above analyst expectations. This phenomenon is primed to repeat in 2014 as well with accelerated tower leasing activity from Sprint & T-Mobile and increased high growth international exposure. Additional catalysts for increased growth include a potential build-out of DISH Network spectrum as well as early work on FirstNet, the dedicated national public safety network.

Industry contacts continue to describe current tower leasing fundamentals as the "strongest ever" with strong prospects for 2014 and 2015 underappreciated by the market. SBAC is likely to grow same store EBITDA above market expectations at 10-12%+ annually over the next 3 years.

SBAC's significant outperformance relative to REITs should continue as the stock trades at a comparable cash flow multiple as REITs despite SBAC growing cash flow per share more than twice as fast as traditional real estate.

Figure 7: 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	

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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