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All Green Lights Ahead—Better Entry Point Likely

Highlights:

- The upbeat mood at the Citi Global Property Conference last week was in contrast to the doom and gloom atmosphere at November's NAREIT conference.
- With fears of a European meltdown and U.S. recession abating, CEO's are positive on the outlook.
- Apartments, cell towers, lodging and regional malls should see the strongest internal growth over the next 12 months.
- Suburban office and shopping centers continue to suffer as the small business sector struggles to grow.
- Better entry points in property shares are likely in the months ahead as reality tempers expectations.

The key theme from meeting with over 50 management teams at the Citi Global Property Conference last week was that real estate has all green lights ahead. Specifically the debt capital markets, equity capital markets, as well as supply and demand present a favorable backdrop for real estate. The mood at the conference was the exact opposite of November's NAREIT conference in Dallas when fears surrounding the European Financial Crisis, recession in the U.S. and a China hard landing had pushed property shares down over 25%. Coming out of the 2010 and 2011 Citi conferences, similar ebullience pervaded both property share prices and the equity markets generally. Better entry points into property shares were found in the months that followed as reality tempered expectations.

Transaction Activity Subdued But Steady

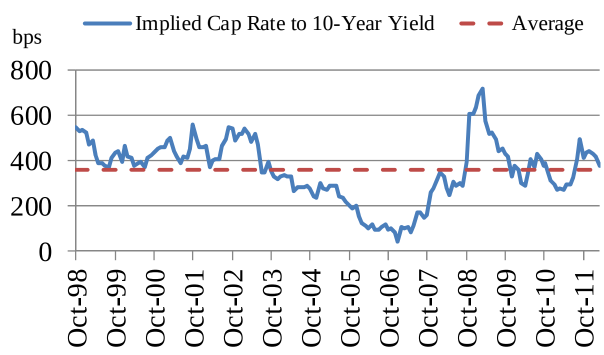
Private market real estate transactions and public market buying confirmed firmer pricing of real estate as debt capital markets continued to recover. CMBS has not recovered to the same degree as the equity markets. However, barring a major interruption, CMBS will likely continue to improve.

For example, Westfield Group (ASX: WDC) recently sold a minority stake in 12 of its U.S. mall assets to a Canadian Pension Fund in the mid-5% cap rate range and Boston Properties (NYSE: BXP) completed a $615 million acquisition of 100 Federal Street, a Class A office tower in Boston at a reported 4.4% cap rate, solidifying values for higher-quality retail and office assets.

The attractive relative valuation of REITs has fallen as the 10-year treasury yields rose and REIT implied cap rates fell, however, they continue to remain attractive when compared to BBB corporate bonds.

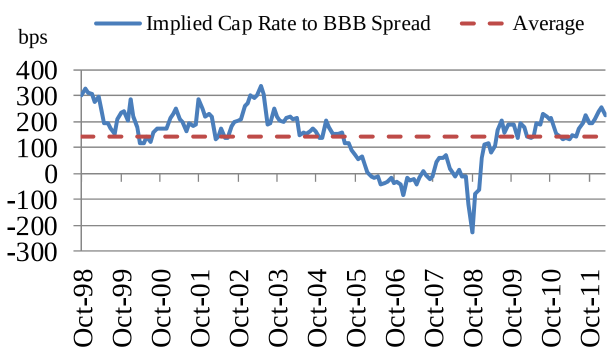
Absolute level of cap rates (yields) at 6.1% is approaching the lows seen in the Spring of 2011. (Figure 1 and 2)

Figure 1. Valuations Narrowed As 10-Year Rose



Source: Citi, Bloomberg.

Figure 2. Implied Cap Rates to BBB Spreads Taper



Source: Citi, Bloomberg.

Sector Commentary

Apartments: Consistent with the bullish view from our 2012 Outlook, 1Q12 rental growth is coming in above expectations, reversing the seasonal slowdown in the fall/winter that had previously spooked many investors. Numerous one-on-one meetings with apartment REIT CEOs confirmed this view and the consensus now among the public apartment REITs is that rent growth in 2012 will exceed that in 2011.

Apartment REITs are valued at a discount to the private market. The highest quality apartment REITs trade at implied cap rates in the mid 4s to lows 5s. Apartment transactions in the core gateway cities, such as New York City and San Francisco, are routinely at 4% cap rates and below and many Sunbelt markets are seeing Class A apartments trading sub 5%.

Cellular Towers: Early 2012 leasing results are coming in strong. AT&T and Verizon continue to accelerate their 4G network build-outs and incremental leasing demand from T-Mobile and Clearwire, which is mostly excluded from company guidance, is tracking above expectations. Many REIT investors are still unfamiliar with the cellular tower story as American Tower (NYSE: AMT), in January 2012, was the first of the three major public cell tower companies to convert to REIT status. Further upside is likely in the sector as interest from REIT investors increase.

SBA Communications (NASD: SBAC), a cell tower company that will likely convert to a REIT, is priced to generate a 25%+ total return over the next 6-12 months. The stock is trading at roughly 17.5x 2012 AFFO and we expect 20%+ AFFO growth for SBAC in 2012. The REIT sector overall is trading richer with half the growth: 21x 2012 AFFO with 10% AFFO growth in 2012. Catalysts exist for SBAC to close the valuation gap. The company will formerly disclose FFO/AFFO metrics in 1Q12, it has greater exposure than peers to new leasing demand from T-Mobile & Sprint, and SBAC's smaller size allows for faster growth through acquisitions. In February, SBAC announced a $1 billion acquisition which immediately increased full-year earnings.

Lodging: The fundamental outlook for lodging continues to be positive with low supply and EBITDA approximately 20% below prior peak levels. Management teams have confirmed that RevPAR is trending towards the higher end of 4%-6% full-year guidance, and further margin expansion seems likely as companies push rates ahead of near peak occupancy levels. Valuations are attractive given better growth prospects relative to historical levels. Key risk is economic growth coming in below expectations which has abated for the moment.

Regional Malls: Recent transactions are trading in the 4.5%-5.5% range suggesting high quality public malls are trading at a discount to private market valuations. Further, higher-productivity centers should be able to push robust leasing spreads and occupancy improvements given retailer sales growth of 10%-14% last year. Given the improvements in the debt markets, lower-quality mall owners have room for improvement from a valuation standpoint, though will likely lag on the fundamental front.

Shopping Centers: Small shop leasing continues to be challenging, though occupancy has improved as landlords backfill spaces with national franchisees or newer concepts (i.e. Medical Services) at flat to lower rents. For the most part, we expect the shopping centers to post relatively lackluster results, expecting flat occupancy improvements and slightly positive leasing spreads for 2012. Stocks are fully valued in the mid to high 6% cap rate range.

Suburban Office: Sluggish growth, a relative lack of financing and a weak private market continue to plague suburban office. Same store NOI growth in 2012 is likely to be negative due to rent roll downs and flattish occupancy. Cap rates in the 8's and 9's remain appropriate for much of the suburban office sector. The public REITs are primarily selling suburban office assets at 8-9% cap rates and the capital needs of these assets make the after cap-ex cap rates even less attractive. As the CMBS market continues to open up and the green lights for real estate remain, suburban office can see outsized cap rate compression, with or without meaningful NOI growth.

Data through 3/16/2012.

LANDandBUILDINGS Background:

Jonathan Litt is the Founder and CEO of LANDandBUILDINGS, a long/short investment firm that actively invests in securities of global real estate and real estate related companies. Prior to LANDandBUILDINGS, Jonathan Litt was Managing Director and Senior Global Real Estate Strategist at Citigroup where he was responsible for Global Property Investment Strategy from 2000 to March 2008. Jonathan Litt led the #1 Institutional Investor All American Real Estate Research Team for 8 years and was top ranked for 13 years while at Citigroup, PaineWebber and Salomon Brothers. Craig Melcher, Co-Founder and Principal at LANDandBUILDINGS, was a key member of the Citigroup team. Land & Buildings Investment Management is a Registered Investment Adviser with the SEC.