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Mexican Standoff

Highlights:

- Property executives remain positive despite tightening capital markets and deteriorating growth.
- Some property companies with rich valuations will miss expectations on the heels of weak economy.
- Property valuations will be constrained until capital markets open up.
- CMBS market deterioration corroborates our concerns about the sustainability of the rally last month.
- Lodging, commercial real estate brokers and shopping centers will likely see expectations decline.
- Cell towers, data centers and student housing should continue to experience attractive growth.

A Classic Mexican Standoff

A classic Mexican standoff has emerged as U.S. equity markets defy the tightening of credit and recession in Europe as well as recession-like GDP growth in the U.S. Our base case assumes recession-like GDP growth in 2012 and a bear market.

Last week, we met with the management teams of 40 property companies with the chief takeaway being that the 2012 outlook was bright, with the occasional caveat that presumes GDP growth remains positive. U.S. economic data over the past 9 weeks has come in stronger than expected. Last week also saw Spanish and Italian bond yields around 7%, as lenders/investors to European sovereigns and European banks liquidated their investments. Europe is widely forecasted to be in a recession, the severity of which is hotly debated. Most major stock markets around the world are in bear markets and down for the year, while US equities are roughly flat.

Debt Markets Have Not Recovered With the Equity Markets

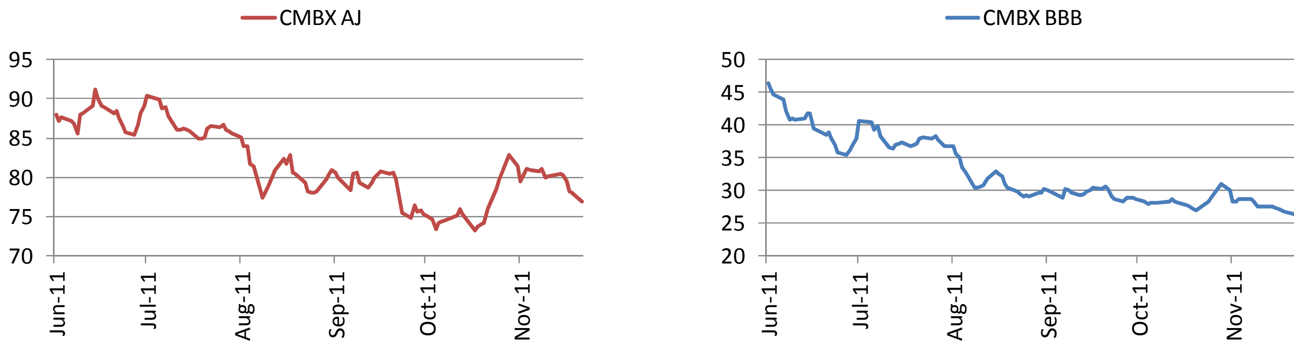
The Commercial Mortgage Backed Securities ("CMBS") market has historically been the canary in the coal mine for early warnings about weakness in real estate valuations. In June and July, as illustrated in Figure 1, the weakness in the CMBS markets was concerning and proved to be a good leading indicator of weakness in property valuations. The equity market rally in October came without a comparable rally in CMBS, which was disconcerting. Over the past few weeks as the crisis in Europe continued to unfold and the debt debate in the U.S. heated up, the CMBS market once again began to deteriorate. Until the CMBS market specifically, and debt markets generally stabilize, a sustainable rally in property shares is unlikely.

In the current yield constrained environment, the attractive yield offered by the CMBS market will likely result in improved pricing. An initial catalyst will likely be the ECB embarking on quantitative easing, and/or the Federal Reserve pursuing QE3.

Base Case Assumes U.S. Recession like Growth in 2012

Our base case for 2012 has been recession like growth in the U.S. and that the financial crisis in Europe will fade, leaving property shares well positioned to deliver superior total returns. However, before the European Financial Crisis fades, it will likely get worse, leaving property shares and the equity markets generally held hostage with material downside.

Figure 1: The CMBS Markets as Measured by the CMBX AJ and BBB Continue to Languish



Source: Bloomberg

A recession in the U.S. and Europe will likely render company guidance and consensus estimates in certain industries well above actual results in 2012. Take for example, the lodging industry: historically, in recessions, RevPAR falls, but currently companies are forecasting 4-6% growth in 2012. In an environment where RevPAR falls 2%, EBITDA could decline by 10%. At current valuations, 12.1x 2012 EBITDA, shares are pricing in an acceleration in earnings not a decline. Lodging companies have historically traded at 10.7x forward EBITDA, making current valuations rich.

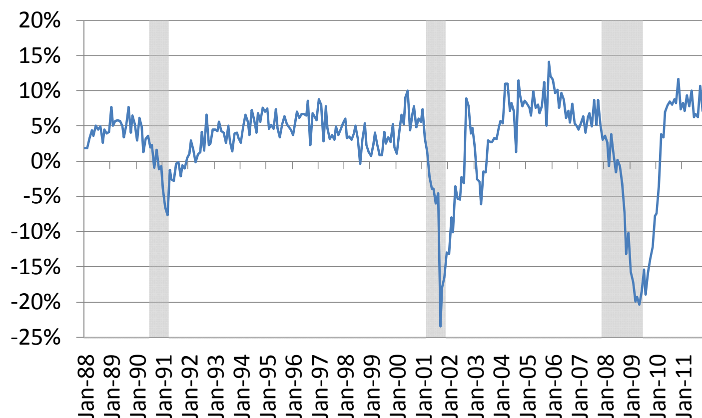
Sectors Likely to Have Downside to Guidance/Consensus Estimates

Commercial Real Estate Brokers will likely face a more challenging year as businesses hunker down and the debt markets remain under pressure. Current consensus expectations for growth in leasing and transaction volumes, around 10% for 2012, appear too robust. With tight credit markets, transaction volume may well fall for a period of time.

Lodging Companies could face headwinds as leisure and business demand slows in the face of weakening consumer and business confidence. Current street expectations suggest the sector remains in the early phases of a multi-year expansion, but if economic activity declines, RevPAR and valuations are at risk (Figure 2).

Shopping Centers will likely have slower than anticipated lease up in small shop space as potential tenants continue to struggle with a lack small business financing. Though national franchisees continue to take up space in this category, rents will likely roll down. Continued pressure on the US economic outlook could further lower tenant demand and increase tenant move-outs.

Figure 2: RevPAR Rapidly Deteriorates During Recessions



Source: Citi, Smith Travel Research

Sectors Likely to Meet or Exceed Guidance/Consensus Estimates

Cell Towers have robust core trends with high single digit same tower revenue growth based on highly visible drivers of contractual rent increases, lease amendments and occupancy growth. The build out of carrier networks to support greater smartphone penetration and greater device data usage, as well as technology upgrades to 4G technology, point to accelerating antenna demand. Tower valuations are attractive at 16x 2012 cash flow multiples, versus 18x for the traditional real estate sectors. For 2012, towers should generate in excess of 15% cash flow growth, relative to the REIT sector growth of 10%.

Data Centers should continue to see robust demand to keep up with rising data traffic and data storage needs. This should provide strong leasing volumes for existing portfolios and development pipelines. Data center owners should be a beneficiary from increased corporate data center outsourcing; corporate belt tightening should expedite this trend.

Student Housing Operators have attractive internal and external growth profiles that should hold up well in a weaker economic environment. For example, American Campus (NYSE: ACC) achieved annual rental rate increases on legacy assets in excess of 2.5% in 2008 and 2009. The academic year lease structure provides significant earnings visibility into next year.

Apartment Peak Revenue Growth Nearing, but Growth Should Remain Solid

Some apartment landlords are seeing deceleration in new and renewal rent increases in recent months, likely due to a combination of seasonality and economic weakness. The decline in home prices and lower mortgage rates has pushed the cost of owning to be more on par and in some cases, now cheaper to own rather than rent. AvalonBay (NYSE: AVB), an apartment landlord in coastal markets, noted that in more than half of its markets, it is now cheaper to own than rent. The psychological hurdle of not wanting to buy a depreciating asset along with tight lending standards and higher downpayment requirements provide a counterbalance. If the economy weakens further, consistent with our base case, consumer confidence will come under further pressure, further delaying any rise in the homeownership rate, thus keeping apartment demand relatively solid.

Data through 11/21/2011.

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.

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