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Battening Down the Hatches

Highlights:

- With the risk of a full blown banking crisis in Europe, deteriorating credit and CMBS markets in the US, in all likelihood, the US will be in a recession in 2012.
- Barring a major financial crisis, a potential recession in 2012 would more likely be in line with the 2000-2002 recession when property stocks generated positive total returns.
- High quality companies with staggered debt maturities, low debt levels, long leases and strong markets will likely outperform best.
- Patience will likely prove to be a virtue for investing in distressed long opportunities as it will take time for an optimal entry point to be established.

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The current correction could be more sinister than we have seen since the bottom. In the prior corrections of 2010 and early 2011, the global growth story was questioned but in our view, remained intact. In addition, it appeared then, and as it does now, the European financial crisis would unlikely have a Lehman moment.

Today, with global growth already decelerating to stall speed, austerity measures in developed markets, and the European crisis coming to a boiling point, the current correction will likely develop into a bear market and a recession.

Figure 1. History Suggests More S&P Downside in a Recession and Bear Market

Period	Peak to Trough Real GDP %	Peak to Trough EPS %	Peak to Trough % Decline
1929 - 1932	-27%	-75%	-86%
1937 - 1938	-3%	-49%	-54%
1946 - 1949	-2%	-18%	-30%
1956 - 1957	-4%	-22%	-22%
1961 - 1962	-2%	-12%	-28%
1969 - 1970	-1%	-13%	-36%
1973 - 1974	-3%	-15%	-48%
1980 - 1982	-3%	-19%	-27%
1987	n/a	n/a	-34%
1990 - 1991	-1%	-28%	-20%
2000 - 2002	0%	-23%	-49%
2007 - 2009	-4%	-45%	-57%
Average	**-5%**	**-29%**	**-41%**
Median	**-3%**	**-22%**	**-35%**

Source: BAS-ML

In July 2009, we outlined the case for a cyclical bull stock market, within the context of a bear market that began in 2000. Our expectation was for the bear market to reassert itself in 2012 or 2013 focusing on three macro factors that could trigger the onset: 1) premature exiting of monetary and fiscal policy, 2) a decline in single family home prices and 3) a contraction in jobs.

Unfortunately, despite the experience with premature exiting of fiscal policy in the 1930's in the US and the 1990's in Japan, the austerity measures being undertaken by central governments in the developed world will likely to nudge these economies into recession. Complicating matters is the risk emanating from a full blown banking crisis in Europe.

There have been 12 bear markets since 1930, resulting in an average price decline in the S&P of 41%. All but one of the bear markets were associated with recessions; in these instances, EPS declined 29% and GDP declined by 4.5%. Valuations rarely mattered while earnings declined, but have created an excellent floor as the bottom has been made.

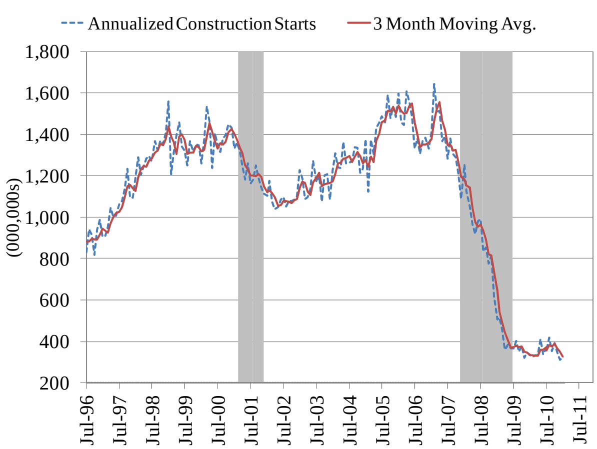
Technically, the US economy is not in a recession or a bear market, and barring the current correction turning into a bear market—20% or more declines—there is hope that politicians, central bankers and the US consumer can bail the economy out as we teeter on the edge. Furthermore, third quarter GDP will likely show a rebound on the heels of a recovery in car sales due to Japan's productivity returning after the earthquake, amongst other things, providing a catalyst for a market rally. However, history is not on the bulls' side as recessions have typically followed GDP growth slipping to current levels, premature exiting of fiscal policy amongst other things, and both a recession and a bear market are increasingly the most likely outcome.

Property Stocks Should Outperform

During the bear market of 2000-2002, REIT stocks generated 32% total returns while the S&P 500 sank 49%. REIT stocks today have several similar attractive characteristics to that period:

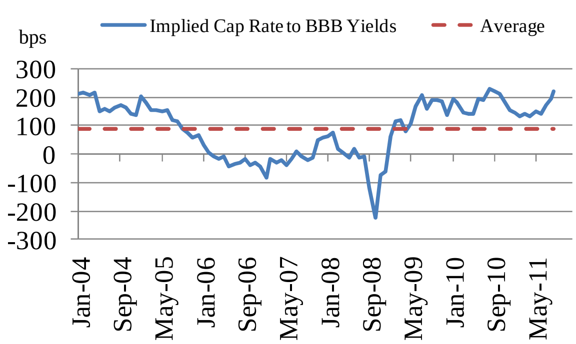
1. Lowest level of new supply since the early 1990's. (Figure 2)
2. Attractive valuations given high cap rate yields and historically wide spreads to 7-10 year BBB yields. (Figure 3)
3. Stable cash flows particularly when compared to the typical declines in S&P 500 earnings during recessions. (Figure 4)
4. Modest leverage, staggered debt maturity schedules, and high fixed charge coverage ratios. (Figure 5)

Figure 2. Construction Starts Remain Near Historic Lows at 0.5% of Stock



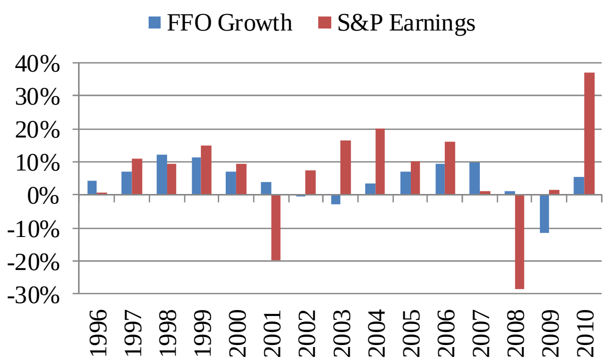
Source: Citi, McGraw-Hill Construction.

Figure 3. Implied Cap Rate to 7-10 Yr BBB Yield Spreads Are 130bps Above the Historical Average



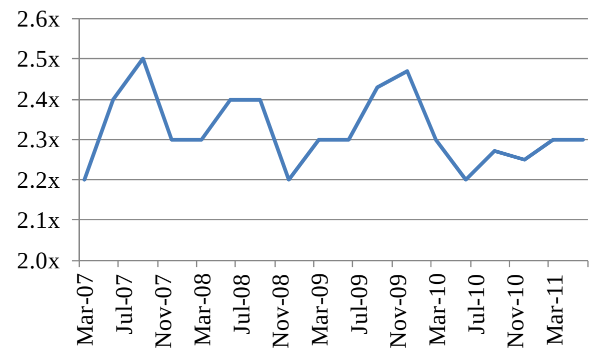
Source: Citi.

Figure 4. REIT FFO Growth Relatively Stable During Recessions



Source: Citi, Bloomberg.

Figure 5. Fixed Charge Coverage Ratios Stable



Source: JP Morgan, Company Reports.

Bear markets, in contrast to bull markets, are episodic with sharp sell-offs and bear market rallies. Certainly during bear market plunges, REIT shares will get sucked down with the market as we have seen in the past, but will likely rebound and generate positive returns.

Quality On The Long Side

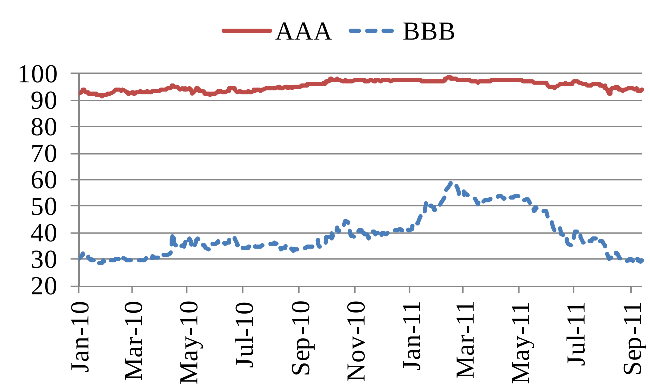
Not all REITs are created equal and in a bear market or a recession so it is critical to batten down the hatches and own the highest quality companies. High quality companies with staggered debt maturities, low debt levels, long leases and strong markets will likely outperform.

Short portfolios should be concentrated in cyclical companies with the greatest impact on earnings from a contracting economy, and low quality companies with poor balance sheets, markets and real estate. Patience will likely prove a virtue when considering more cyclical companies or those with less attractive capital structures, creating a shopping list to sit on.

European Banking Crisis Greatest Near-term Risk

In the last 20 years, there have been two bear markets in real estate, both induced by a freezing up of the mortgage market. The current banking crisis in Europe has the risk of morphing into a global financial crisis which could freeze the mortgage market. Since June, the CMBS market has been deteriorating with spreads widening on CMBS and other forms of mortgages, putting downward pressure on property prices. (Figure 6)

Figure 6. CMBS Market Continues to Deteriorate



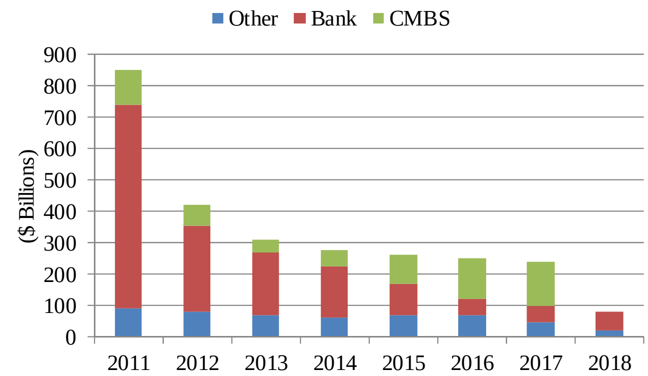
Note: Represents AAA and BBB CMBX, a synthetic pool of CMBS, and should approximate CMBS performance.
Source: JP Morgan, Bloomberg.

Fed Chairman Bernanke's strategy has been to reflate asset values to avoid insolvency from financial institutions—a sharp contrast to the solution in the early 90's where the assets were liquidated at market clearing prices. The reflation strategy was likely born out of the challenge that the financial institutions would not have otherwise been solvent had the assets been liquidated at market.

Further Loan Extensions Likely In US

Banks and other lenders have extended mortgages in the absence of alternative sources of mortgage financing. As recently as 2009, of the $3.1 trillion of commercial real estate loans outstanding, a manageable pace of $400+ billion needed to be refinanced annually. In the second half of 2011, nearly $800 billion matures as many loans extended in the prior three years come due. In all likelihood, banks will again have to extend these loans. (Figure 7)

Figure 7. Significant Debt Maturities in 2011



Source: CoStar.

Bank commercial real estate mortgages account for over 40% of the total CRE mortgages. At current property values, these loans are for the most part covered by the underlying asset value, although the loan-to-values are higher than can be achieved in a traditional arm's-length transaction. Low interest rates on CRE mortgages will likely limit defaults and keep asset values at or above the mortgage balance.

The corrosive impact of deflation could undermine the delicate balance Bernanke has achieved through low interest rates and reflated asset values. Material outright declines in property values and asset values could raise the specter of a banking crisis in the US which would exacerbate our defensive call on property shares.

The Bernanke Put

Bernanke has vowed to do whatever it takes to avoid deflation, however unorthodox and controversial (our editorial view). If he follows his script to date, it would not be surprising or far-fetched to see direct support of commercial real estate values through Fed purchases of CMBS or REIT shares given commercial real estate's importance to the solvency of the banking system. The Bernanke Put is likely alive and well in commercial real estate and is not without precedent. Consider the Bank of Japan announced in the fall of 2010 that they would buy J-REIT shares.

When the same or more time is taken to explain the risks to our bullish outlook for property stocks as the outlook itself, it suggests the bull case is not a slam dunk. In the current environment in which a full blown banking crisis in Europe is possible, battening down the hatches requires positioning a property portfolio defensively and keeping net exposures tight.

As the crisis works its way through, there should be an opportunity to be more aggressive and pick up the pieces from the fall out.

All data through 9/13/2011.

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. LANDandBUILDINGS was seeded by funds advised by Citi Alternative Investments in the summer of 2008, now SkyBridge Capital. Land & Buildings Investment Management is a Registered Investment Adviser with the SEC.