Prudential

GLOBAL REAL ESTATE SECURITIES

A Perspective on Interest Rates & the U.S. REIT Market – May 2015

Despite the noise in the market, global REIT valuations are attractive today. Many of the major global markets are in the midst of some type of Quantitative Easing that will be around for the next few years. In Continental Europe, Japan, and China, look for rates to be steady to lower as these government policy measures and asset purchase programs will put a ceiling on rates and financing costs. In Europe, Basel III will continue to be a limiting factor on the availability of financing for new development. So, we have markets where net supply is projected to be negligible, demand is slowly increasing, and values should be rising.

We are at an interesting cross road where there is a significant arbitrage opportunity in the U.S. REIT market. The U.S. is the most expensive of the three major geographic regions; however, there is still a lot of value in a number of the stocks. Market sentiment is low for the U.S. real estate market based on "hearsay" as opposed to fundamentals. The conventional wisdom (the herd) approach to rising rates is to "shoot first, ask questions later". We expect that the mass media will advocate that investors should sell all income producing assets when the Fed "surprises" the market with a rate increase (will anyone really be shocked at this point?). However, this is counter to the direct real estate fundamentals of the market: 1) supply is still limited and increasing rates will serve to further diminish new supply; 2) there is abundant capital in queues and on the sidelines to invest from both domestic institutions and foreign capital sources to purchase real estate assets in the U.S. (as evidenced by recent purchases by European and Mid East sovereign wealth funds and Chinese insurance companies); 3) real estate returns are very competitive and look attractive versus equities and bonds.

Many of the public REITs are in an excellent position to increase dividends and grow asset values given 1) low payout ratios; 2) stellar balance sheets; 3) improving economic fundamentals (restrained inflation); 4) lack of major new supply pipelines in most institutional markets coupled with increasing demand. Additionally, many of the industry analysts and investors have already priced in rising interest rates into their valuation models. Granted, we do not expect to continue a period of excess returns due to cap rate compression, but values in the REIT market seem evident. While rates are projected to increase at a "measured" pace, the Street has been primed by the Federal Reserve that these bumps will be "data dependent" and nominal in nature. We are not in the era where we anticipate a series of future increases.

There is very little fundamental support for the negative sentiment around the U.S. REIT market. In fact, the evidence of the arbitrage opportunity and market data points are clearly on the other side of the market sentiment. Many U.S. REITs are trading at compelling values relative to both their NAV (break up value) and cost of financing. On average, almost half of the REITs in our coverage trade at significant discounts to their liquidation value. We project that we are at the beginning of the M&A cycle due to the confluence of a number of variables: 1) some REITs are cheap relative to private market valuations; 2) bifurcation in the REIT market between "Haves" and "Have Nots" - the latter group are companies ripe for consolidation or privatization; 3) abundance of debt and equity capital; 4) low cost of debt and equity capital.

We have just seen two REIT LBOs in the past few weeks from the Blackstone Group LP (Excel Trust Inc.) and Brookfield Associates Inc. (Associated Estates Realty Corp.). Now Macerich Real Estate Company is rumored to be in the hunt and facing shareholder pressure. Lone Star Funds is reportedly pursuing a privatization of another multifamily REIT. Fitch recently speculated that there could be 30-40 LBOs in the next few years. While magnitude of these projections may be a bit optimistic, we anticipate that when deals are announced, they are typically at premiums of 15%-20% above current stock levels.

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