REIT Research
US Real Estate Investment Trusts
Industry Commentary

Our View on Fed Lift-Off and the US REITs

Summary

The Fed's decision to raise short-term interest rates this week came too early, according to MSUSA Chief Economist Steve Ricchiuto, and it could prompt increased risk that the US economy will eventually fall into deflation. While it may take time for this thesis to fully sink in, the consequences for the US REIT market could be quite positive based purely on the idea that lower (not higher) longer-term interest rates will showcase the REIT dividend yield in an incrementally more positive light. Longer-term, we expect positive commercial real estate fundamentals to begin steering the ship.

Key Points

- **Questionable Economy:** At-trend US GDP growth in the 2.0% to 2.5% was doing so at zero interest rates, while declining oil prices and a strong dollar are keeping a wide distance between current inflation and the 2% target. It is hard for us to see how raising rates now helps either of these metrics. It is true labor markets are firming, but the quality of jobs remains a question, as do several other economic indicators such as retail sales and the housing market.

- **Curve Flattens?** If we are right about the weight that lift-off will have on the economy, then a flattening of the interest rate curve would be a likely consequence -- a declining 10-year Treasury yield based on deflation fears and continued appetite for yield from foreign investors. This should resonate positively with the income orientation of the US REITs (average dividend yield of 3.8%, or about 160bps above the 10-year Treasury).

- **Transition to Fundamentals as the Key Driver to REIT Performance:** While day-to-day volatility will likely enter into the equation, we see this interest rate trade relative to the REITs playing out over the next 2 to 3 months. Afterwards, we believe generally positive real estate fundamentals (i.e., manageable supply growth) across the continuum of the commercial real estate sectors, will become the main determining factor in REIT stock performance. All of this assumes any negative implications on the US economy are within a reasonable band, and don't overwhelm the positive demand trends that are currently in place. As with any external force, the scale of the change is the main risk from the US REITs perspective.

Company	Symbol	Price (12/17)	Rating Prior	Rating Curr	PT
Alexandria Real Estate Equities	ARE	$90.86	–	Buy	$104.00
Apartment Investment & Management Company	AIV	$39.53	–	Neutral	$37.00
AvalonBay Communities, Inc.	AVB	$178.98	–	Neutral	$182.00
BioMed Realty Trust, Inc.	BMR	$23.59	–	Neutral	$21.00
Boston Properties, Inc.	BXP	$130.02	–	Neutral	$128.00
Brandywine Realty Trust	BDN	$13.04	–	Buy	$16.00
Camden Property Trust	CPT	$75.33	–	Neutral	$78.00
Corporate Office Properties Trust	OFC	$22.16	–	Neutral	$23.00
Douglas Emmett, Inc	DEI	$30.30	–	Buy	$36.00
Equity Residential	EQR	$80.58	–	Buy	$88.00
Essex Property Trust, Inc.	ESS	$238.63	–	Neutral	$230.00
HCP, Inc.	HCP	$37.24	–	Neutral	$37.00
Healthcare Realty Trust Incorporated	HR	$27.71	–	Buy	$29.00
Healthcare Trust of America	HTA	$26.82	–	Neutral	$26.00
Home Properties, Inc.	HME	NA	–	Neutral	$75.00
Hudson Pacific Properties, Inc.	HPP	$28.16	–	Neutral	$30.00
LTC Properties	LTC	$42.31	–	Buy	$49.00
Mid-America Apartment Communities, Inc.	MAA	$90.35	–	Buy	$95.00
National Health Investors, Inc.	NHI	$60.87	–	Neutral	$63.00
Paramount Group, Inc.	PGRE	$18.03	–	Neutral	$18.00
Parkway Properties, Inc.	PKY	$15.94	–	Buy	$19.00
Post Properties, Inc.	PPS	$58.67	–	Neutral	$58.00
Sabra Health Care REIT, Inc.	SBRA	$19.73	–	Buy	$23.00
UDR, Inc.	UDR	$36.57	–	Buy	$41.00
Ventas, Inc.	VTR	$54.81	–	Neutral	$54.00
Welltower, Inc.	HCN	$66.01	–	Neutral	$66.00

Source: Bloomberg and Mizuho Securities USA

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Our View on Interest Rates and the REITs

The Fed's decision to raise short-term interest rates this week came too early, according to MSUSA Chief Economist Steve Ricchiuto, and it could prompt increased risk that the US economy will eventually fall into deflation or worse. At-trend US GDP growth in the 2.0% to 2.5% was doing so at zero interest rates, while declining oil prices and a strong dollar are keeping a wide distance between current inflation and the 2% target. It is hard for us to see how raising rates now helps either of these metrics. It is true labor markets are firming, but the quality of jobs remains a question, as do several other economic indicators such as retail sales and the housing market.

While it may take time for this thesis to sink in, the intermediate-term consequences for the US REIT market could be quite positive based purely on the idea that lower longer-term interest rates will showcase the average REIT dividend yield in an incrementally more positive light. Here is the roadmap to our thinking:

- **Initial Reaction:** We think the universally positive stock market reaction in the moments following the announced 25bps increase to the Fed Funds rate was a function of carefully-chosen language pertaining to future policy changes (e.g., "gradual", etc.) and a small reigning in of the dots versus September. That fully reversed itself during Thursday’s trading session, which did not surprise us. Often the contrarian, economist Ricchiuto read the message as more hawkish than dovish, taking the stance that the market ultimately wanted a clearer message that future interest rate increases would be more subdued than what was communicated in the Fed's message. In the interest of maintaining credibility, we think the Fed's options are somewhat limited going forward, with "one and done" appearing to be off the table except in the most extreme of circumstances.

- **Curve Flattens:** If we are right about the weight that lift-off will have on the economy, then a flattening of the interest rate curve would be a likely consequence **--** a declining 10-year Treasury yield based on deflation fears and continued appetite for yield from foreign investors. This should resonate positively with the income orientation of the US REITs (average dividend yield of 3.8%, or about 160bps above the 10-year Treasury). While day-to-day volatility will likely require some anxiety medication, we see this interest rate trade relative to the REITs playing out over the next 2 to 3 months. As a general rule of thumb, the higher the dividend yield currently, the more likely the stock will outperform.

- **Operating Fundamentals Takeover:** Afterwards, we believe generally positive real estate fundamentals (i.e., manageable supply growth) across the continuum of the commercial real estate sectors, will become the main determining factor in REIT stock performance. At this point, investors will be faced with a menu of considerations when choosing sectors and stocks once the interest rate trade has run its course.

All of this assumes any negative implications on the US economy are modest, and don't overwhelm the positive demand trends that are currently in place. Should the Fed's move result in substantially worse economic consequences during 2016, we may have to reassess our thesis.

Price Target Calculation and Key Risks

Alexandria Real Estate Equities

Our price target is based on a 5% range around 21x our 2016 AFFO estimate. Should consolidation in the biotech and pharmaceuticals industries create a declining need for space, our price target may not be achieved.

Apartment Investment & Management Company

Our price target is based on a 5% range around 18.5x our 2016 AFFO estimate. Should the company's redevelopment platform experience further cost overruns and delays, our price target may not be achieved.

AvalonBay Communities, Inc.

Our price target is based on a 5% range around 23.5x our 2016 AFFO estimate. Should the company's extensive development pipeline produce returns below current expectations, our price target may not be achieved.

BioMed Realty Trust, Inc.

Our price target is based on a 5% range around 17x our 2016 AFFO estimate. To the extent consolidation in the biotech and pharmaceutical industries reduce space needs, our price target may not be achieved.

Boston Properties, Inc.

Our price target reflects a 14% to 17% discount range relative to our NAV estimate. Should the technology industry begin to slow resulting in reduced demand for office space in San Francisco, Boston and New York City, our price target may not be achieved.

Brandywine Realty Trust

Our price target is based on a 5% range around 17x our 2016 AFFO estimate. To the extent the city of Philadelphia is unable to produce incremental organic growth to support the company's portfolio, our price target may not be achieved.

Camden Property Trust

Our price target is based on a 5% range around 18.5x our 2016 AFFO estimate. Should CPT's DC and Houston exposure weigh on growth to a degree greater than we expect, our price target may not be achieved.

Corporate Office Properties Trust

Our price target is based on a 5% range around 14.5x our 2016 AFFO estimate. Should the US government continue to negatively impact the demand for office space in the Washington DC metro area to a degree greater than expected, our price target may not be achieved.

Douglas Emmett, Inc

Our price target is based on a 5% range around 25x our 2016 AFFO estimate. Should the economy of the state of California negatively impact business development, our price target may not be achieved.

Equity Residential

Our price target is based on a 5% range around 25.5x our 2016 AFFO estimate. If the company's same store growth prospects decline in the face of increased competition from new supply, our price target may not be achieved.

Essex Property Trust, Inc.

Our price target is based on a 5% range around 23.5x our 2016 AFFO estimate. Should the performance of its West Coast markets be negatively impacted by supply, primarily in Seattle and San Jose, our price target may not be achieved.

HCP, Inc.

Our price target is based on a 5% range around 14x our 2016 AFFO estimate. To the extent the company's increasing exposure to operating leases, including the planned investment in CCRCs, falls short of growth expectations, our price target may not be achieved.

Healthcare Realty Trust Incorporated

Our price target is based on a 5% range around 20x our 2016 AFFO estimate. Should the company's same store growth fail to maintain its historic pace of performance, our price target may not be achieved.

Healthcare Trust of America

Our price target is based on a 5% range around 18x our 2016 AFFO estimate. If the company's active investment platform result in weaker than expected performance in future periods, our price target may not be achieved.

Home Properties, Inc.

Our final price target is based on 17.2x our 2016 AFFO estimate. Our final risk statement was: Should HME's low turnover property type underperform to a degree greater than we anticipate, or should the deal not be consummated, our price target may not be achieved.

Hudson Pacific Properties, Inc.

Our price target reflects a 14% to 17% discount range relative to our NAV estimate. To the extent the technology industry in San Francisco and Seattle begin to slow resulting in a reduced pace of office space needs, our price target may not be achieved.

LTC Properties

Our price target is based on a 5% range around 17x our 2016 AFFO estimate. To the extent the regulatory environment negatively impacts rent coverages in the company's skilled nursing portfolio, our price target may not be received.

Mid-America Apartment Communities, Inc.

Our price target is based on a 5% range around 18.5x our 2016 AFFO estimate. Should MAA's secondary markets experience further job growth deceleration, our price target may not be achieved.

National Health Investors, Inc.

Our price target is based on a 5% range around 15x our 2016 AFFO estimate. Should senior housing development negatively impact the company's RIDEA growth prospects, our price target may not be achieved.

Paramount Group, Inc.

Our price target reflects a 14% to 17% discount range relative to our NAV estimate. Should the company find some difficulty producing rent growth from its portfolio from this leasing effort, our price target may not be achieved.

Parkway Properties, Inc.

Our price target reflects a 5% to 10% discount range relative to our NAV estimate. To the extent PKY's active investment platform results in pockets of underperformance relative to expectations, our price target may not be achieved.

Post Properties, Inc.

Given the elevated industry chatter regarding consolidation, and with PPS being a direct part of that conversation, our price target is based on a 5% range around 21.5x our 2016 AFFO estimate -- above its nearest peers. In the absence of a transaction, and/or if supply pressures continue to mute same store performance to a degree greater than expected, our price target may not be achieved.

Sabra Health Care REIT, Inc.

Our price target is based on a 5% range around our current NAV estimate. If the company encounters difficulty finding investments that meet its quality and growth criteria, our price target may not be achieved.

UDR, Inc.

Our price target is based on a 5% range around 23.5x our 2016 AFFO estimate. Should UDR experience revenue growth deceleration to a degree greater than our expectations, our price target may not be achieved.

Ventas, Inc.

Our price target is based on a 5% range around 15x our 2016 AFFO estimate. Should the company's fast pace of investment activity result in some missteps given the numerous moving parts, our price target may not be achieved.

Welltower, Inc.

Our price target is based on a 5% range around 16x our 2016 AFFO estimate. If the company's significant exposure to the RIDEA structure results in declining same store prospects in the face of new supply growth, our price target may not be achieved.

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(As of 9/30/2015)	**% of coverage**	**IB service past 12 mo**
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Hold (Neutral)	52.9%	44.8 %
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