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Equity REITs: A Yield-Oriented Investment with Potential for Price Appreciation | September 2011

August was anything but a boring month for REITs. Driven primarily by macroeconomic concerns surrounding domestic and European recession fears, the MSCI REIT Index (RMS) finished the month down 5.5% amid widespread volatility. After starting the month with YTD performance of +12.1%, the YTD performance as of August 31 was +5.9% for the RMS. The broad market was not immune to the pain either, dropping 5.4% as measured by the S&P 500 Index (now -1.8% YTD). Despite S&P's downgrade of US government debt, treasury bonds were still viewed as a safe investment and the 10 year US Treasury yield dropped to a low of 2.1% during the month. The yield on the 10 year Treasury note finished the month at 2.2%, and the Federal Reserve has stated that it will keep rates low until 2013. In this low yield environment, the search for higher yielding investments can sometimes lure investors out further on the risk curve than they may want. For this reason, we would like to draw attention to the yield on the REIT portfolios we are constructing for clients and the earnings cushion behind these dividend payments.

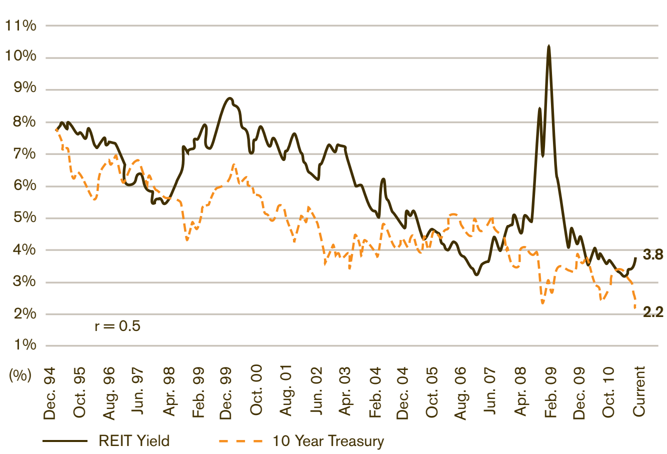
REIT Current Yield vs Historical Averages

As of August 26th, 2011, the yield on the MSCI REIT Index was 3.8%. When compared to the 20 year average yield of 6.1%, REITs may appear to be overvalued. However, when compared to the yield on the 10 year US Treasury note, REIT valuations look more attractive. The historical spread between the REIT dividend yield and the 10 year US Treasury yield is 100 basis points. Thanks to the recent pullback in REIT equity prices and the flight to safety driving down the 10 year treasury yield, the spread as of August 26th, 2011 stood at 160 basis points, indicating that REIT valuations are attractive when compared to the historical average spread (see Figure 1).

Dividend Yield Cushion

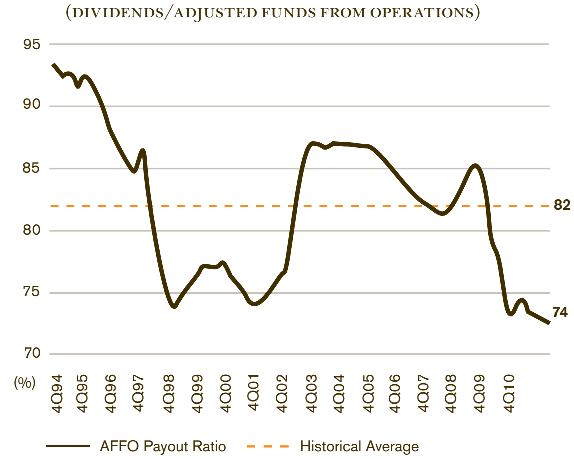
Adding to the attractiveness of the yield spread valuation signal is the security of the REIT dividends. Behind those dividends lies a diversified stream of cash flows that should give investors confidence for dividend increases as earnings grow coming out of the trough of the real estate cycle. A popular benchmark for the sustainability of REIT dividend yields is the ratio of the dividends paid to cash flows available for distribution, or AFFO. Since 1994, this ratio has averaged 82%. As of August 26th, this ratio stood at 74%, the lowest on record (see Figure 2). As REIT earnings climb out of the trough in the real estate cycle, AFFO will grow and support growth in dividends. Additionally, the

FIG. 1: REIT DIVIDEND YIELD VS. US 10 YEAR TREASURY YIELD



Source: Company reports, FactSet, Reuters and Citi Investment Research and Analysis

FIG. 2: REIT AFFO PAYOUT RATIO (DIVIDENDS/ADJUSTED FUNDS FROM OPERATIONS)



Source: Citi Investment Research & Analysis

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long term nature of tenant leases, benign supply of new commercial real estate, and strength of REIT balance sheets bolster the predictability of REIT earnings for the next 3-5 years. Based on conservative assumptions for modest economic growth and the positive trends mentioned above, we estimate that REIT dividends will increase 40% over the next 5 years.

Preferred REITs

Investors willing to take on the risk of rising interest rates in the future and who need income today should consider perpetual preferred REIT stocks. Unlike bonds, there is no maturity date. Accordingly, the price of preferred REITs (most have a par value of $25 per share) will tend to move down in price in a rising interest rate environment. Improving credit quality can often dampen downward moves in such periods.

The combined market capitalization of all REIT preferred equity outstanding only totals about $23 billion and are sold in series typically of $100 million each. The small size means liquidity can be an additional risk when large amounts are sold at one time.

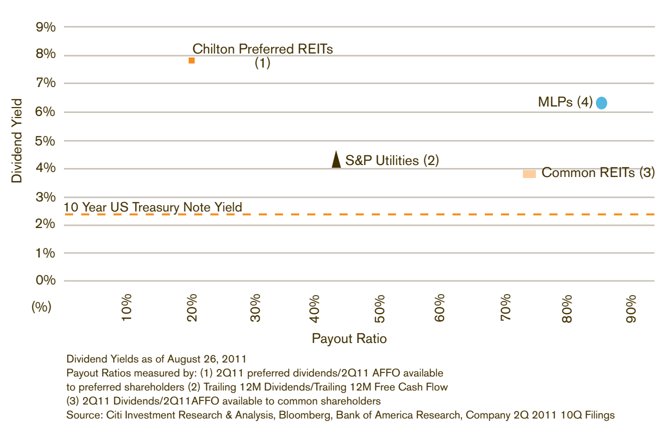
The main benefit is the high yield. Our portfolios contain approximately 10-15 issues producing a blended yield in the range of 7.5%-7.75%. Virtually all property types are represented and investors also enjoy geographic dispersion comparable to our portfolios with common stocks. Preferred dividends have priority over common dividends and when one looks at the implied payout ratio on AFFO of only 20%, investors have considerable protection. In addition, REIT preferred dividends are cumulative, meaning the obligation remains if the dividend is temporarily suspended. In the recent recessionary period beginning 2008, only a few REITs suspended dividends. Most culprits were found with the lodging REITs, the sector hardest hit by declining occupancy and room rates. Patient investors were rewarded as most of these have resumed dividend payments and taken care of the accruals.

REITs vs Other Yield Investments

Compared to other yield investments, REITs are attractive based on the yield and relevant payout ratio. Figure 3 shows the cushion and yield provided by several types of yield investments. Note that the preferred REITs are higher in the capital structure and trade more like bonds, so they are less susceptible to price volatility, and therefore have less appreciation upside. Due to the current predictability of cash flows for the REITs, we believe that both common and preferred stock of these companies are attractive for investors.

Given the low yield on the 10 year US Treasury note, our analysis indicates that REITs provide an attractive yield for the amount of risk behind the dividend payments. For investors that are willing to sacrifice the long term price appreciation that we see in the common stock of REITs for a higher yield, we would recommend the preferred REITs. For investors willing to take some price risk, we would recommend the common stock of equity REITs, which we believe will be able to raise dividends 40% over the next 5 years. We can also construct portfolios with a blend of common and preferred REITs. In all scenarios, we remain committed to putting our clients in the best possible position to achieve their total return goals within their risk tolerance range and stated time horizon.

Fig. 3: DIVIDEND YIELDS AND PAYOUT RATIOS OF YIELD INVESTMENTS



Dividend Yields as of August 26, 2011
Payout Ratios measured by: (1) 2Q11 preferred dividends/2Q11 AFFO available to preferred shareholders (2) Trailing 12M Dividends/Trailing 12M Free Cash Flow (3) 2Q11 Dividends/2Q11AFFO available to common shareholders
Source: Citi Investment Research & Analysis, Bloomberg, Bank of America Research, Company 2Q 2011 10Q Filings

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RMS: 1059 (8.31.2011) vs. 1000 (12.31.2010) vs. 792 (12.29.2009) vs. 993 (9.30.2008) and 1330 (2.7.2007)