

REITs: Poised for Dividend Growth

Lowell Bolken, CFA
Associate Portfolio Manager
Real Estate Securities

Joseph Betlej, CFA
Vice President & Portfolio Manager
Real Estate Securities

A Real Estate Investment Trust (REIT) is a tax-advantaged structure originated in the 1960's intended to allow the small investor access to income-producing commercial real estate investments. A qualifying REIT may not have to pay tax on income it distributes to its shareholders in the form of a dividend. This condition positions REITs as a high current income equity investment. Though investors enjoy the benefit of this current income model, conversely, a REIT is also limited to the amount of cash it can retain at any one time.

Though this potential liquidity risk has been tested in the past when capital markets close down (such as in the 1998 Asian market disruption), the 2008-09 time period was the most severe test to date for the sector. REITs survived this recent market challenge – largely by cutting dividends down to the lowest allowable level, and by issuing dividends in a combined form of cash and common stock to reserve liquidity.

Having weathered the short-term liquidity crisis and an 18-month recession, REITs are now catching up to pre-2008 dividend distribution levels, with yields far below

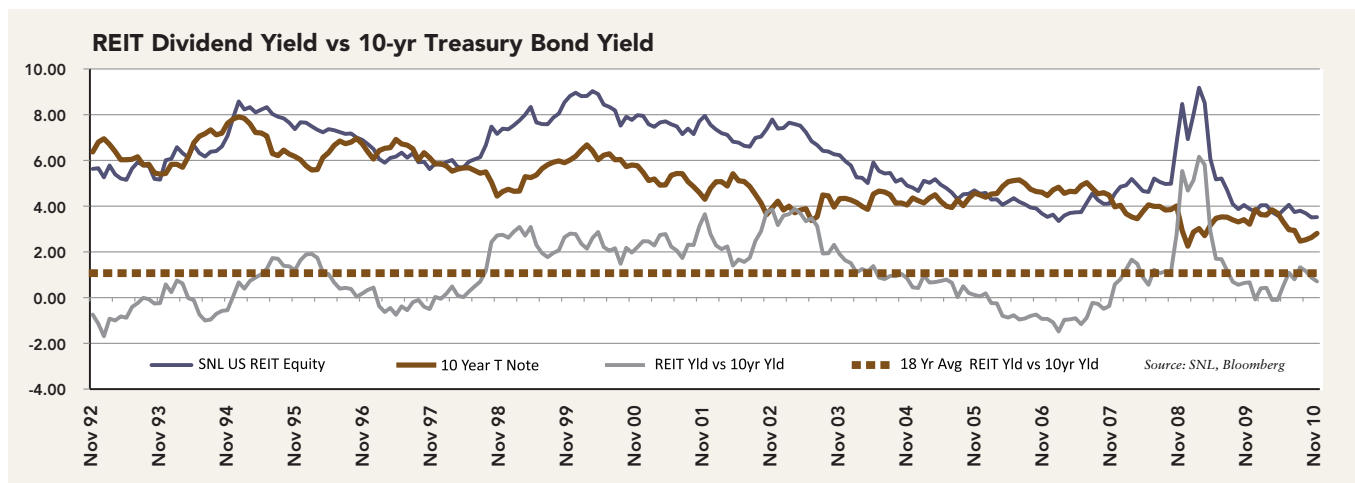
Advantus Insights

- REIT yields are back to historical levels relative to high-yield corporate bonds and 10-year Treasuries, and are poised for further increases.
- REITs are striving to rebuild investor confidence in dividend growth after slashing dividends to minimum levels in the financial crisis.
- Macro- and micro-economic trends could make the year ahead very favorable for REITs.
- Adding REITs to a portfolio may increase income while also reducing risk over the long term.

historical levels (see chart below). Increasing cash flow growth should fuel an increase in dividend levels.

REIT structure background

The REIT structure has been in existence in the U.S. since President Eisenhower signed the REIT Act into law in 1960. The intent behind the legislation was to allow the small investor the ability to diversify into income-producing real estate. The structure has since caught on internationally, with 19 countries now having enacted a similar form of REIT legislation.



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REIT law follows mutual fund laws closely, where the entity is not taxed as long as it distributes its earnings to investors. The primary requirements specify that a prospective REIT must:

- Distribute at least 90% of taxable income as dividends
- Derive at least 75% of gross income from real estate income
- Have at least 75% of assets in real estate (real property or loans secured by property)
- Have a minimum of 100 shareholders
- Have no more than 50% of shares held by 5 or fewer individuals

The REIT Modernization Act of 1998 amended and refined the qualifications for retaining tax-free status (income taxed at the investor level), allowing more flexibility in business operations within the parameters of REIT eligibility. Though the 90 percent taxable income distribution rule may seem rigid, in reality REITs have a certain amount of latitude within the accounting guidelines. In practice, REITs can govern their distribution levels through cash flow management. There is often a meaningful amount of cash flow that REITs can retain in their business. A large component of the difference between REIT operating income and its taxable income is a non-cash depreciation expense. That is why the industry uses a cash flow metric dubbed Funds From Operations (FFO), which in short hand is the net income before the depreciation charge.

Funds From Operations (FFO)
GAAP Net Income
+/- Plus losses (minus gains) from sales of property
+ Plus real estate depreciation & amortization*
= FFO
Adjusted Funds From Operations (AFFO)
Reported FFO
- Minus recurring capital expenditures
+/- Adjust for straight-line rent
+/- Adjust for intangible income items
= AFFO
*includes share of joint venture net income & depreciation
AFFO Payout % = Dividend/AFFO

Though helpful, FFO may still overestimate actual economic cash generated by the REIT businesses. That is why more sophisticated REIT investors calculate an Adjusted Funds From Operations (AFFO).

Structure of cash flow

The REIT structure has worked so well historically in part due to the emphasis on recurring cash flow. The underlying revenue source, rents, are collected as prescribed by contracted lease structures, whose duration can range from daily expirations (in the case of hotels) to 30 years (long-term credit or operator leases, the latter prevalent in the health care sector). Lease duration convention is largely driven by property type. Regional malls and offices tend towards longer-term leases, averaging 7 to 10 years, while apartment and self-storage leases generally extend for a year or less. The longer the term of the lease, the more durable the income stream and the more emphasis the landlord places on underwriting the credit strength of a potential rental tenant.

The fact that REITs emerged relatively unscathed after the last downturn (as measured by bankruptcies and bad debt expense) is a testament to how refined the practice of lease underwriting has become. Public REITs are subject to greater scrutiny than the private commercial real estate owners, to the point where an industry standard of transparent disclosure has evolved, often times down to tenant detail. We feel this disclosure, as well as refined and time-proven lease structures, have provided REITs a fair amount of protection on the downside. A good example of a beneficial lease structure is early cancellation fees, which were a material source of revenue in the downturn. These fees, negotiated at the front end of the lease transaction, came at an opportune time for REITs, smoothing the revenue stream as they partially offset occupancy rent losses.

Given the recurring nature of contracted revenue, enhanced by disciplined underwriting and time-tested lease structures, the other primary elements of REIT cash flow to consider are the negative offsets: operating expenses and capital investment.

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Once again, lease structure plays a vital role in this regard. Many commercial leases have some form of expense pass-through shifting the burden of expenses (and the increases thereon) to the tenant. Retail, office and industrial convention is a “triple-net” structure, where the tenant is responsible for repairs and maintenance, insurance and real estate taxes. Though apartment REITs technically shoulder the burden of some of these expenses, the short-term nature of the leases allow adjustment in rents to at least partially recapture increasing expenses over the longer term. Whatever the property type, the lease language as it has evolved not only serves to stabilize net income, it also provides a partial inflation hedge.

Capital expenditures (or “capex”), usually divided between “maintenance” or “revenue enhancement” spending, reduces cash flow and is a critical analytical component to determining AFFO. Maintenance capex typically refers to expenditures that are required to maintain the levels of current operating income. A REIT with new and/or well-maintained property may require a lower absolute level of maintenance capex. If the capex is revenue enhancement, that spending would result in a return on investment and theoretically would increase future cash flow. Investors need to become acquainted with the individual management team’s practices, the quality of the underlying real estate, and the nature of the tenancy when estimating future AFFO levels.

Why is AFFO projection critical? It all has to do with dividend coverage. A consistent dividend stream is appropriate with a recurring revenue model, but it is also important that the REIT sets the level of AFFO dividend payout (see chart on page 2) such that it creates a long-term history of growing income for the investor.

Setting the dividend level

It is necessary to understand the nature of the underlying components influencing cash flow generation, as explained above, in order to appreciate the stability of cash flow going forward. This understanding is crucial when doing forward-looking analysis for projecting dividend distribution capacity. REIT management teams take this analysis very

seriously in preparation for recommending a dividend level to its Board of Directors for approval.

Past, current and future investors are very cognizant of the value of a steady, growing dividend history in assessing the value of the enterprise. Errantly setting a dividend level that eventually proves too high to be supported by the business can be a destructive exercise for the long term franchise value of the REIT. Often the REIT management teams, and perhaps many of the Directors, are significant shareholders themselves, thus participating in the dividend benefit.

In the 2008-09 environment, REITs were tested in the most extreme conditions – a freeze-up of both the equity and debt capital markets. If prolonged, the REITs’ ability to refinance and/or repay maturing debt obligations was threatened. Since REITs distribute a large portion of income in order to maintain their tax-advantaged structure, they are reliant on open capital markets to rollover their debt. In preparation for extreme circumstances, most REITs typically maintain what is considered to be conservative leverage (approximately 50% total debt/total capital with 2x fixed charge coverage), with debt maturities spread evenly over long periods of time.

During 2008-09, however, the lending community froze, imperiling shorter-term maturities. Even the most credit worthy borrowers with superior collateral were locked out. The ability to sell assets was also dramatically affected due to lack of project financing. To weather this storm, a majority of REITs slashed their dividend levels to the minimum requirement, and/or partially substituted common equity share distributions for cash. The result for some REITs was an unprecedented disruption in what had been a stellar history of uninterrupted dividend growth.

Most readers now know that the story is evolving positively. The public REITs were eventually able to access the public debt and equity markets, and the traditional commercial real estate lenders followed by refinancing existing obligations and even sourcing new secured debt. The public REIT model survived due to access to the public debt and equity markets, the quality

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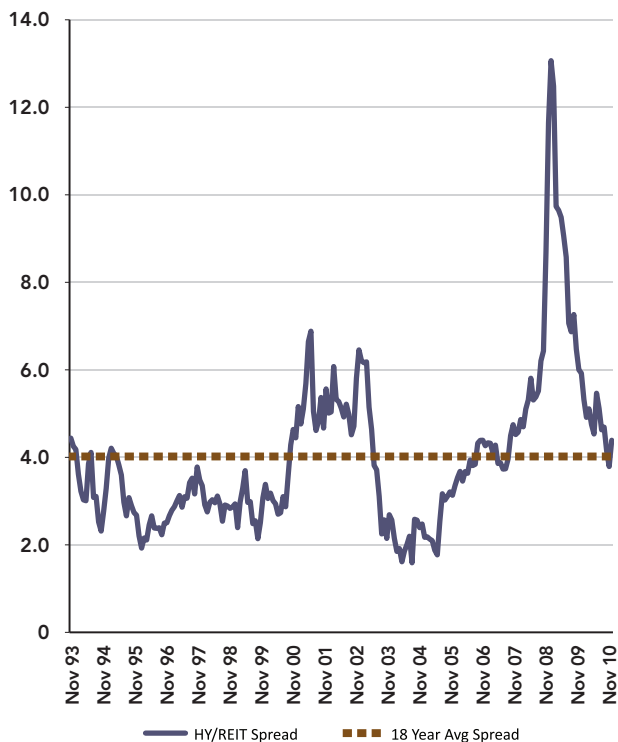
of assets used as collateral, and the high percentage of unencumbered assets that could be used as collateral for newly secured debt.

Nonetheless, a rebuilding of investor confidence had to begin on the dividend side. This recovery began to recur during a time in which the underlying economic fundamentals were in the nascent stages of recovery. The rebuilding process began in 2010, the first stage of which was a reversion back to an all-cash dividend distribution. Coincident with this, underlying fundamentals in the form of rental rates and occupancies began their troughing process, and eventual slow but tangible turnaround. Set those two dynamics together and you have the green shoots of dividend growth that should reflect the operating earnings growth of REITs.

Implications

With this backdrop, the public REITs are now primed for renewed dividend growth as the dual forces of dividend retracement and cash flow growth are poised to create an accelerated line of progression.

Yield Differential: High-yield bonds minus REIT dividend yield



Source: SNL, Barclay's Live

So far, the results have been dramatic. In 2010 alone, 46 U.S. REITs have increased their dividends, at a market capitalization weighted average of 33 percent. As you can see from the yield graphs, REIT yields have already closed the gap that historically exists between their dividend yield level, and those of the 10-year Treasury bond and high yield corporate bonds, respectively.

This gap has closed even as we are early into the recovery. Due to earnings growth projections, we feel prospects for further dividend increases are still intact. We can gauge this because the reaction of commercial real estate fundamentals tends to lag the underlying U.S. economy. If the U.S. economy shifts into a greater job creation mode, we will become even more confident that the recovery for REITs will strengthen. That is because employment growth drives occupancy, which positively influences rental rates, which eventually works its way into distributable cash flow.

According to the National Association of Real Estate Investment Trusts (NAREIT), REITs yielded a consistent annual income component of 7.4 percent over the period of 1986 to 2008. This comprised nearly 70 percent of the industry's average annual total return of 10.9 percent over the same time period. This compares to a current average yield in the 3.5 percent range.

According to our estimates, REITs (as represented by the Wilshire Real Estate Securities Index) are only paying out 70 percent of AFFO to fund quarterly dividends, based on 2010 AFFO (but calculated on the most recent dividend increases). Assuming AFFO growth into 2011, this payout ratio could drift even lower, all else being equal. Looking back into our archive of AFFO performance for the Wilshire constituents that were public between 2005 and 2007, AFFO payout ratio exceeded 80 percent of AFFO. Even if one assumes that REITs will be more subdued in dividend payout this time around, there is still room for greater payout percentages absent cash flow growth. Combining higher payouts with cash flow growth will provide the fuel for consistent dividend growth going forward.

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What about the long term?

Although REITs came into existence in 1960, it wasn't until the 1990s that the industry began to truly mature. It was during this time that REITs began to significantly exploit the capital markets to fund growth through acquisitions and development, while at the same time expanding their investor base.

This process continued into the 2000s as REITs began to find favor among institutional investors, complementing its traditional retail base. As they grew, REITs established more sophisticated and efficient corporate structures (see below).

Though significant growth potential still remains in the U.S., many REIT platforms invest in and operate property types that are in the mature stage. For instance, a large regional mall in a mature, infill neighborhood might generate tremendous cash flow, yet growth may be limited to annual rent escalations, expansions, and value-added re-tenanting.

This is the prototypical mature REIT asset: large cash flow generation; high barriers to entry for competition; recurring cash flow structure, and scale economy benefits driving a lower relative cost structure. These attributes create the consistent nature of cash flow that underlies a steadily growing dividend distribution.

Although investors may be accustomed to assigning a higher level of risk to a "high yielding" investment, REITs, particularly those managed with a long track record, provide a more complex story. A mature REIT that generates a high degree of defensible cash flow, such as in the mall example, is capable of distributing a large percentage of cash flow economically without applying excess leverage in its capital structure. This is why we assert that, over long periods of time, a portfolio that diversifies into REITs can add current income while at the same time reducing overall portfolio risk. The tremendous growth of REITs both in asset size and abroad is likely testimony to the benefit that the REIT structure provides investors.

The REIT Life Cycle

Introductory	Growth	Maturity	Longevity or Decline
<ul style="list-style-type: none"> • High cost of capital • Costs to grow portfolio • High public overhead costs • Little impediment to growth 	<ul style="list-style-type: none"> • Develop economies of scale • Operational efficiencies grow • Cost of capital decrease begins • Cash flow growth driven by acquisition & development • Addition of new markets • Increase in management quality 	<ul style="list-style-type: none"> • Access to newer & cheaper capital • Process & overhead improvement • Overhead costs are optimal • High but stable profitability • Larger share of growth driven by property operations • Market dominance continues 	<p>REITs begin a new growth cycle</p> <ul style="list-style-type: none"> • Capital recycling into higher cash flow growth • Right-size overhead • Focus on return on capital <p>OR</p> <p>REITs decline, liquidate, or merge</p> <ul style="list-style-type: none"> • Cost structure overwhelms • Cash flow returns decrease due to capital needs • Recycling capital into growth assets is necessary • Growth and stability below peers

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REITs in 2011: The financial winds at their backs

Conditions are very favorable for REITs going into 2011. The table is set for REIT dividend growth. The economy continues to recover, fundamentals support strong, sustainable cash flow growth, payouts are low and leading companies are at the stage in their lifecycle when they are best positioned to take advantage of precisely these conditions.

For more information, contact:

John Messing, Relationship Manager – Institutional Accounts
651-665-5097
john.messing@advantuscapital.com

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