US equities

REITs in the sweet spot | 23 February 2016

CIO WM Research
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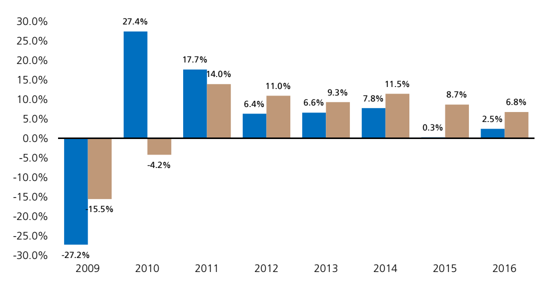
- We believe REITs are well positioned for solid performance in 2016.
- The operating fundamentals for a majority of the REIT sub-sectors remain solid.
- Since 2010 REIT dividends have grown at an average annual rate of 11.4% We believe rising dividends are a trend that is likely to continue for the foreseeable future.
- We believe REITs are trading at attractive valuations, particularly relative the broader market.
- Capital remains abundant and attractively priced for a majority of REITs.
- Recent legislative and index construction actions should boost longer-term demand for REITs and commercial real estate in our view.

We believe REITs are well positioned for solid performance in 2016 based on several factors including a solid fundamental and funds from operation (FFO) growth outlook, continued access to attractively priced capital, rising dividends, attractive valuation, limited currency risk, favorable legislation action and the Impending establishment of REITs as a stand-alone economic sector. In addition, the UBS CIO House View for modest GDP growth and a reduced number of interest rate increases from the Federal Reserve provides a very favorable economic environment for REITs and commercial real estate, in our view.

Operating fundamentals

The operating fundamentals for a majority of the REIT sub-sectors remain solid. Based on consensus estimates REITs are poised to deliver strong FFO growth in 2016 (Figure 1). This would represent the fifth consecutive year of REIT FFO growth outpacing the broader market.

Figure 1: REIT Forward FFO Growth and S&P 500 EPS Growth



Note: 2016 UBS estimate. Source: SNL, FactSet, UBS CIO as of 19 Feb 2016

Rising dividends

Since 2010 REIT dividends have grown at an average annual rate of 11.4% (Figure 2). Following the 2009/2009 global recession many REIT management teams focused on regular dividend increases as a means of returning capital to shareholders. We believe this is a trend that is likely to continue for the foreseeable future.

Attractive valuation

Since 2009 REITs have traded at an 11% premium to the broad market based on forward FFO and EPS multiples. The recent sell-off in the shares of financial sector companies (including REITs) has effectively eliminated that premium (Figure 3). In our view, the combination of faster relative earnings growth, solid operating fundamentals and rising dividends should allow REITs to trade closer to their longer-term average multiple premium.

Access to capital

Access to capital has been one of the key drivers of the REIT sector (and overall commercial real estate industry) strength. Since 2010 more than USD 1 trillion of capital has been raised by REITs and commercial real estate. Augmenting this strong access to capital is a resurgent CMBS market, more than USD 220 billion in uncalled capital in the private equity market and the growth of crowd funding as a viable source of capital for commercial real estate transactions.

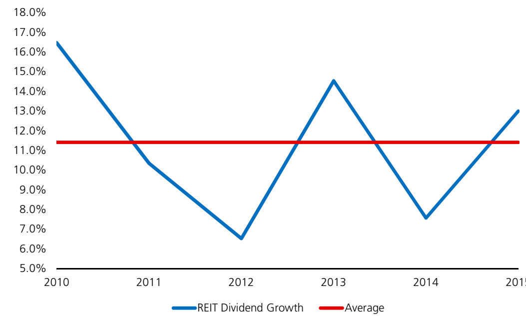
REITs as a stand-alone GICS sector

On 11 November 2014 Standard & Poor's and MSCI announced that REITs would become a stand-alone sector under the Global Industry Classification Standard (GICS). Currently REITs are a part of the Financials sector. It is anticipated that the new sector will be effective 31 August 2016. Recently, State Street Global Advisors (SSGA), manager of the Financial Select Sector SPDR ETF (XLF), the largest financials exchange traded fund (ETF), announced that it will continue to include S&P 500 real estate stocks when the new REIT GICS sector is created. This decision was a result of the fact that S&P is not changing the underlying index that the XLF tracks. In our view this is a significant positive for the REIT sector. As the XLF has more than USD 19bn in assets (with REITs more than USD 3bn of that), significant downside pressure could have been exerted pursuant to re-balancing trades. Although it is possible that some active Financials sector managers will re-balance upon the effective date, we would make two observations: 1) it is unlikely that these managers had significant exposure to REITs in the first place; 2) any re-balancing would be optional as REITs remain part of the XLF. In addition creation of both the separate GICS sector and SSGA's new ETF could lead to additional inflows into the sector, particularly from non REIT-dedicated investors seeking greater exposure to the group.

Recent legislative actions

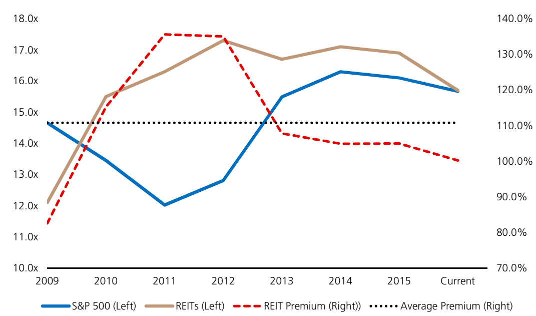
One of the provisions of the 2015 Omnibus spending bill contains changes to the Foreign Investment Real Property Tax Act (FIRPTA). The bill calls for, among other things, an increase from 5% to 10% the maximum stock ownership a shareholder may have held in a publicly traded corporation to avoid having that stock treated as a US real

Figure 2: REIT Dividend Growth



Source: SNL Financial as of 19 Feb 2016

Figure 3: REIT Forward FFO Multiples vs Forward S&P 500 EPS Multiples



Source: SNL, FactSet, UBS CIO as of 19 Feb 2016 property interest on disposition. In addition, the provision allows certain publicly traded entities to own and dispose of any amount of stock treated as a US real property interest, including stock in a REIT, without triggering FIRPTA withholding. A companion bill addressed certain "tax extenders" as part of the budget negotiations. A key provision of the companion bill positions the US commercial real estate sector for significant additional investment from non-US-based investors, in our view. The magnitude and importance of this should not be underestimated by investors. Non-US investors have been an increasingly important component of the CRE transaction market, accounting for more than USD 80 billion in US-based transactions in 2015 alone. Foreign pension funds remain under-allocated to CRE relative to their US peers. The research we have done points toward foreign pension funds substantially growing their CRE allocations over time. Given the strength and stability of our capital markets, our system of strong property rights and rule of law, and our relatively consistent political system makes the US a natural market for a significant portion of that future investment capital. We believe the elimination of the FIRPTA withholding requirements further enhances the attractiveness of the US CRE market and by extension, the REIT market.

Appendix

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