

Collaborations and Comparisons Drive our 2016 REIT Ideas

Summary

When we launched REIT coverage at MSUSA in July 2014, we were asked how we plan to differentiate ourselves. As has always been our way, we have attempted to consider issues with a second derivative mindset, in this case by comparing similar REITs head-to-head while regularly collaborating with our MSUSA colleagues on the economy, healthcare and technology. These serve as the basis to our investment theses for 2016, with a possible "kicker" from increased foreign investment (click [here](#) for our FIRPTA report).

Key Points

- The Economy:** We have worked regularly with MSUSA Chief Economist Steve Ricchiuto to gauge the potential impact from Fed policy on the economy and interest rates. Steve has gone against the grain in his view that the Fed should have waited longer before raising short-term rates, and we provide some of his latest comments in this report. The bottom line is the December increase has turned out to be the policy error he expected, and Steve continues to forecast a flattening of the interest rate curve. While consensus might have anticipated a commensurate rise in the ten-year Treasury yield, Steve has stuck to his 1.75%-2.25% range. We think further downward pressure on long-term rates could be the story during 2016, and that should be positive for US REITs. As such, we do not fear higher-yielding REITs, and this has been one consideration in our bend into the out-of-favor suburban office sector where direct investment is catching a bid in many second-tier markets. We maintain a handful of Buy ratings in that corner of the office sector: BDN, OFC, DEI, and PKY.
- Healthcare:** We have also collaborated with our Healthcare Services group, Sheryl Skolnick and Ann Hynes, providing us with unique insights into the Medicare bundling initiatives introduced by CMS (most notably [here](#)) that are starting to impact post-acute operators -- including publicly-traded GEN and KND. This has caused us to take a pause on most healthcare REITs, and is having a piling-on effect considering the supply issues in the senior housing segment (which we discussed [here](#)). We suggest investors look to smaller cap and pure-play triple net REITs like LTC or medical office player HR (both Buy-rated). We also have an event-driven Buy rating on SBRA.
- Technology:** Last week, we worked with our technology team to produce [this](#) note on the state of the private tech market. While sentiment (at least) has weighed on some REITs heavily invested in the Bay Area, we did take note that the casino mentality of 2000 was not apparent in office rents today.

Company	Symbol	Price (1/25)	Rating			PT
			Prior	Curr	PT	
Alexandria Real Estate Equities	ARE	\$77.47	-	Buy	\$104.00	
Brandywine Realty Trust	BDN	\$12.32	-	Buy	\$16.00	
Corporate Office Properties Trust	OFC	\$21.36	-	Buy	\$25.00	
Douglas Emmett, Inc	DEI	\$28.47	-	Buy	\$36.00	
Equity Residential	EQR	\$78.20	-	Buy	\$88.00	
Healthcare Realty Trust Incorporated	HR	\$29.04	-	Buy	\$29.00	
LTC Properties	LTC	\$44.23	-	Buy	\$49.00	
Parkway Properties, Inc.	PKY	\$13.36	-	Buy	\$19.00	
Sabra Health Care REIT, Inc.	SBRA	\$19.63	-	Buy	\$23.00	
UDR, Inc.	UDR	\$35.41	-	Buy	\$41.00	

Source: Bloomberg and Mizuho Securities USA

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Below we expand on our individual sector and stock calls first, and follow that up with the latest comments from MSUSA Chief US Economist, Steve Ricchiuto, in advance of the next Fed decision this week.

Property Sector Commentary

Office

We continue to think investors have to choose carefully in the office sector, with no clear “broad-brush” investment thesis that encompasses the overall property sector. We believe it is about geographies and how to play them. For example, we raised our rating to Buy on **PKY** on 11/23/15 on the view that Houston was priced in and every other market was basically up for sale – not literally, but the company has been getting great pricing on one-off asset sales, and we expect that to continue. So the thesis was targeting the ~80% non-Houston portfolio, but since then oil has continued to fall. Sentiment and real influences related to increases to subleased space are still negatively impacting our call. But the stock is cheap and management is strong, so we are sticking with it for now.

Separately, **HPP** stock has also been impacted by negative sentiment related to the risks that technology sectors are showing signs of weakness – particularly in the private side where venture capital (VC) funding has re-approached peak conditions. HPP is a “poster-REIT” for technology, in our view, with ~80% of the total portfolio located in the Bay Area, including the Blackstone (BX, not rated) deal, and another 6% in Seattle. Since the closing of the BX transaction on April 1, 2015, HPP stock has produced a negative 24% total return versus negative 7% for the REIT industry. So it can be argued that the market has already dialed in the tech risk, and we view HPP as a very knowledgeable organization that is acutely familiar with California real estate. Furthermore, we noted in our “Bubble” report (the link to that document is provided above) that Bay Area office rents have not had the hysteria element they displayed 16 years ago. So we are watching HPP, but remain on the sideline for now. Perception can be a powerful force.

Office: Where to Invest

Where we feel most confident is in pockets within suburban office. **DEI** emerges as our favorite office REIT given the positive trajectory of office rents. However, we acknowledge the risk of a possible major transaction on the horizon that could be worrying investors given the company’s elevated leverage level. We think that will get resolved either way in the near-term, with DEI putting up a fraction of the equity (if it happens at all), and then the stock should roll from there. Other office names that register as opportunities include **BDN** and the recently upgraded **OFC** – both of which appear extremely cheap and at the tail end of a transition. And finally on Buy-rated **ARE**, the lone remaining life science REIT is the way we are playing the “VC risk” in California. Given the geographic diversification and visible growth platform that we see improving as 2016 plays out, we have high conviction that ARE will reverse course from a tough January and again produced above average total return this year.

Healthcare

Most of what needs to be said we covered above or in the provided links to past research. However, the staggering stock price declines in the post-acute space bear mentioning, in our view. For example, GEN (not rated) is down 53% year-to-date after issuing a major “whiff” this week related to its 2016 outlook, while KND (Neutral rated by Sheryl Skolnick) is having its own share of headwinds, down ~20% year-to-date. We worry about a “guilty-by-association” mindset toward Neutral-rated **HCN** and **VTR**, which are still major landlords to GEN and KND, respectively. At some point, the weak stock performance of each may become an issue for the landlords (i.e., the REITs) down the road. Meanwhile, the other large-cap healthcare REIT, **HCP**, continues to be faced with a plethora of tenant-related issues (most notably, HCRMC), and we think some progress has to be made there before reconsidering that stock.

Healthcare: Where to Invest

So we are basically seeking safe haven in healthcare, including Buy ratings on **LTC** and **HR** – LTC being the triple-net story with a strong balance sheet, and HR being once removed from all the CMS noise given its thoughtful approach to its pure-play medical office building (MOB) platform. *We note our price target for HR is currently out of synch with the MSUSA rating system. As we expect a strong quarterly result from HR during 4Q15, we will revisit this issue upon having the most current information on the company’s earnings.* Meanwhile, **SBRA** is the high risk/high return potential, and is mostly dependent on how quickly and effectively management resolves its Forest Park issues – a chain of events we wrote about extensively in 2015, including [here](#), [here](#), [here](#) and [here](#). We note that SBRA calls GEN its largest tenant at over 40% of the company, potentially adding to the risk profile. But we think the oversold condition is mainly a Forest Park issue. We can see 10%+ upside to the stock if management gets that right.

Multifamily

The multifamily sector collectively had a strong year in 2015 (weighted average total return of 15%) and expectations are high that solid growth will continue in 2016. The question becomes what level of performance will be acceptable to continue the strong stock performance. Our call is to remain on a holding pattern for the next week or two as we await early signals on 2016 guidance. First up is Neutral-rated **CPT** this Thursday night, which will have the noise of Houston in the numbers given 12% of the portfolio is located there. We would also reference Neutral-rated **ESS**, which is the natural name to focus on relative to our “Bubble Jeopardy” report on the private tech market referenced earlier. ESS is a fantastic organization on many fronts, but we think any hint of a slowdown from its enormous internal growth could (unfairly or not) disrupt the stock’s performance.

Multifamily: Where to Invest

Our three Buy-rated multifamily REITs are intentionally chosen because they are a) high quality organizations and b) tend to cycle out of synch with one another – **EQR**, **MAA** and **UDR**. As 4Q15 earnings season plays out, we will revisit our multifamily

call in greater detail. However, we think the debate is fairly simply – if you believe same store will accelerate versus 2015, that will likely be enough to maintain the sector’s solid performance (on the “*where else are you going to find growth?*” thesis). That is, we think it matters more to investors where a company is headed rather than where it is currently. To provide a primer, we wrote [this](#) note on UDR following our non-deal roadshow in Tokyo in December. While a company-specific note, we think it topical enough to be broadly interpreted. We would point out that UDR’s body language indicated to us that internal growth might be a hair better than 2015 (that’s good), but other factors may make bottom line earnings growth a hair worse. Overall, we would characterize the business of multifamily in the US as being in great shape. Although sometimes markets are quick to over-judge even the slightest change. That is the risk to multifamily, in our view.

Latest Economic Commentary from Steve Ricchiuto

What will the Fed Say? (January 26, 2016)

The markets are probably correct in assuming that the makers of domestic monetary policy will hold short rates unchanged at the conclusion of their ongoing deliberations (on Wednesday). However, it deserves to be mentioned that the Committee hiked rates in December, in part, because of the strength of the November jobs report and with the December report having come in even stronger there should be a few members who will argue to a further tightening at this meeting. The more hawkish composition of the voting members this year also suggests there is likely to be a dissention noted in favor of another rate hike. With an unchanged interest rate decision, the markets focus will be on the tone and substance of the post-meeting policy statement. The financial market dislocations that have followed on the heels of the December rate hike have convinced most consensus forecasters that the language used in the post meeting statement will be more dovish.

The increase in market volatility, the decline in the equity markets, the steady downward pressure on the Chinese currency, and the downward bias in crude oil prices have led to speculation that the Committee will spread out the pace of rate hikes from that anticipated by the FOMC in the “Dot Plots” released just a month ago. My read of the Chair’s December post-meeting press conference and the public comments made by a number of policy makers since is that policy makers are less apt to be swayed by market movements than the Street assumes. For the majority of the Committee, they still see policy as highly accommodative, especially now that they have decided to delay tapering re-investment their portfolio of marketable securities. I still believe the FOMC would like to hike rates again, either in March or April. Make no mistake, I believe the December rate hike was a policy mistake but now that they lowered the bar to justify the December rate hike, they are committed to follow through with at least one more hike.

***Lowered Expectations Suggest a Defensive Asset Allocation
(January 25, 2016)***

Global growth expectations continue to be cut despite the apparent willingness of central bankers to maintain a dovish bias. The consensus forecast has been cut back to 3.5% from 3.7% as developments in both the developed and the emerging economies disappoint the experts. The downward adjustment in growth expectations has been broad-based with reductions in both the developed and emerging markets. A steady downward trajectory in growth expectation continues despite the apparent dovish stance of most central bankers. Both the ECB and the BOJ are expected to provide additional stimulus measures in the weeks ahead. Chinese policy makers appear tossed between stemming the slide in the currency while also providing additional policy support for its battered manufacturing sector. Global equity market volatility and declining crude oil prices exacerbate the excess supply situation confronting most economies. As such, deflation risks are real and in the absence of a policy prescription that shows promise of reversing the trend, we continue to advocate an overweight in bonds relative to stocks.

Valuation Concerns (January 22, 2016)

The equity markets were supposed to do better once the Fed hiked rates! Remember that refrain from late 2015? The growth and equity bulls were sure that all the Fed needed to do was hike rates and the economy would accelerate and equities would climb to a new record high because the economy historically accelerates after the first rate hike of a cycle and accelerated growth boosts earnings which lifts stocks. Well, what happened? The Fed hiked rates for the first time in seven years in December and the equity market has had its worst start to a New Year in decades. The answer is simple if you are willing to look at the post-war period as being divided into two periods.

The first period stretches from the end of the war into the late-1980's. This was the period of excess demand, when inflation dominated the business cycle. In an inflation cycle, the Fed's responsibility is to lean against the wind and, as a result, the first rate hike was typically behind the curve so momentum had been building. The 1990-forward period, in contrast, is the period of excess supply. Excess supply means the business cycle is driven by credit quality not inflation. The Fed's responsibility and effect on the economy are very different in a credit cycle than in an inflation cycle. The key difference is that in an inflation cycle there is nothing fundamentally wrong with the economy, it is just running too hot. This implies when the central bank takes its foot off the brakes, the economy quickly rebuilds momentum. In a credit cycle, balance sheets take time to heal and the recovery process is more drawn out. The pent-up demand accumulated during the contraction phase is used up during the later stage of the balance sheet restructuring which dampens the economy's ability to build upside momentum. This explains why the December rate hike has had such a negative effect on both growth expectations and equity valuations.

The Fed essentially stated that it is capping growth at 2% with its decision to increase short rates. A cap on real growth is not good for companies which are already confronted with a lack of pricing power and a slowing global economy. The widening in global short rate spreads that resulted from the Fed rate hike also increased the upward pressure on the dollar and increased the downward pressure on commodity prices denominated in dollars. The fact that the debt markets have also begun to penalize companies that exploit their balance sheet to undertake share buybacks also increased investor valuation concerns. The net result has been an economy what is confronting increased headwinds in the wake of the Fed hike and an equity market that was clearly overvalued and remains so, despite the correction already underway.

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.

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.

Corporate Office Properties Trust

Our price target is based on a 5% range around 16x 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.

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.

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.

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.

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.

Companies Mentioned (prices as of 1/25)

Camden Property Trust (CPT- Neutral \$71.65)
 HCP, Inc. (HCP- Neutral \$36.64)
 Kindred Healthcare, Inc. (KND- Neutral \$8.94)
 Welltower, Inc. (HCN- Neutral \$66.75)

Essex Property Trust, Inc. (ESS- Neutral \$223.11)
 Hudson Pacific Properties, Inc. (HPP- Neutral \$24.70)
 Ventas, Inc. (VTR- Neutral \$54.98)

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(As of 1/25)	% of coverage	IB service past 12 mo
Buy (Buy)	49.72%	35.56%
Hold (Neutral)	49.72%	25.56%
Sell (Underperform)	0.55%	0.00%

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