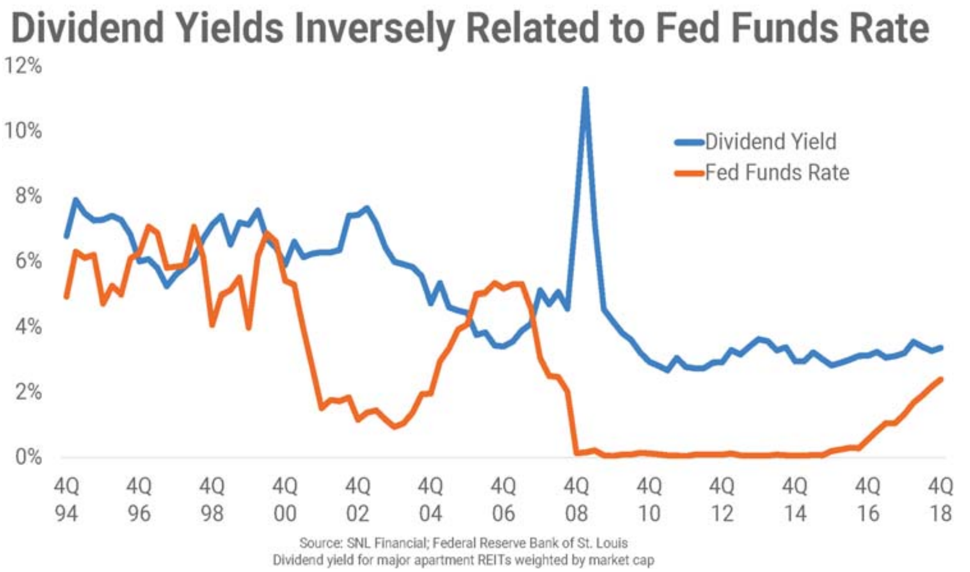
APARTMENT ADVISORY

MARCH 2019

Apartment real estate investment trusts (REITs) provide a defensive, dividend-paying counterweight to traditional non-dividend-paying securities. REIT dividends are not directly tied to interest rate adjustments like bonds or changes to capital appreciation like stocks. So, whether interest rates move up or down, apartment REITs can bring upside in both scenarios; providing a hedge against inflation during expansionary times, and consistent income growth when rates are tightening.

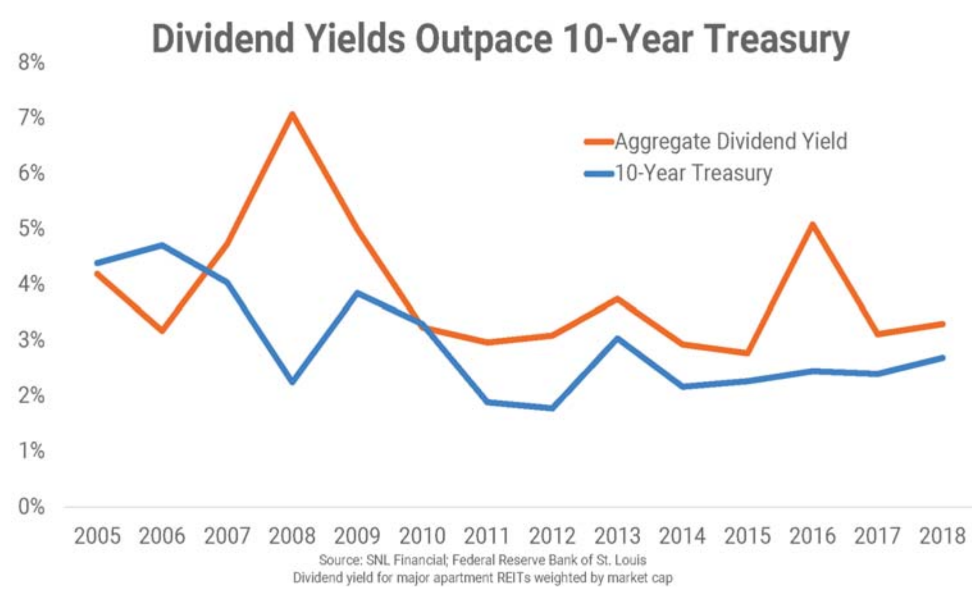


When interest rates rise, so does the cost of capital. One of the most appealing attributes of apartments among other real estate classes, particularly for the risk averse, is the short lease exposure and steady cashflow. The apartment sector is nimble enough to react to a changing economic climate while still maintaining steady income streams.

Real estate valuations and returns are closely tied to interest rate movement and broad investor sentiment. Dividend yields are negatively correlated with changes to the federal funds rate (FFR). When the FFR goes up, divided yields have a tendency to move in the opposite direction. When interest rates go up, so does the cost of debt, which tightens the flow of capital. As it relates to real estate, contractionary monetary policy triggers broad deleveraging and depressed property values. There is less capital available to deploy. But while appreciation slows, rising interest rates can stimulate income returns and dividend growth to help offset the sluggish capital slows upstream.

That relationship is especially noticeable from 2000 to 2008 when the trajectory of the FFR and dividend yields oscillated in opposite directions. In fact, during that time there was a 40% negative correlation between the two. As uncertainty around the FFR looms the dividend yield spread is likely to remain compressed into the near future. The dividend yield spread has historically tightened during periods of rising inflation and economic expansion. But dividend yields will almost certainly accelerate during an economic downturn as investors seek to diversify their portfolios into dividend paying stocks.

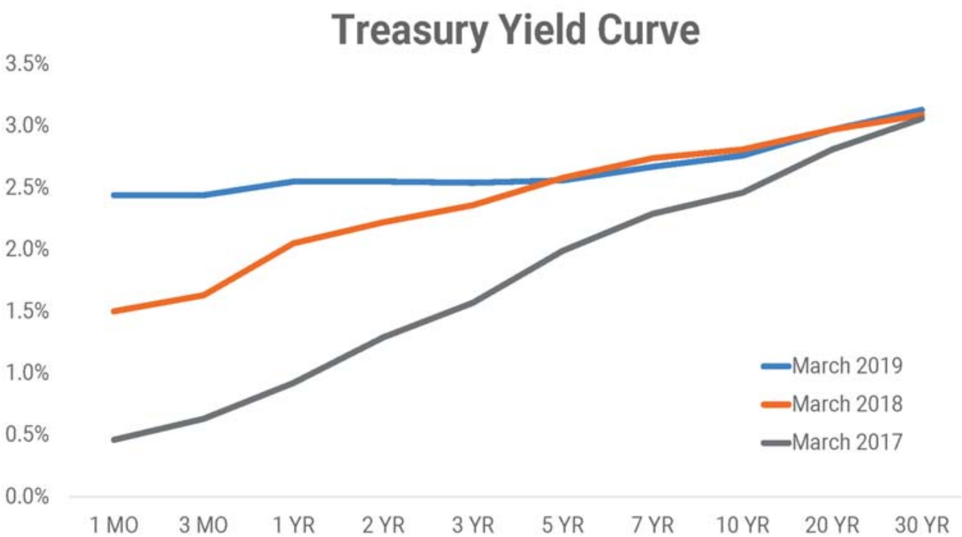
Dividend yields have carried a premium to the 10-year Treasury for nearly 11 years, which coincidentally is the same number of years as the economic expansion. Meanwhile, the average spread between the aggregated dividend yield and the 10-YRT from 2005 to 2018 was positive by about 95 basis points (bps) annually. That means an investor would have earned a dividend yield premium roughly one point higher than holding an equivalent amount in 10-YRTs. And that doesn't even capture the equity growth. An investor holding a price-weighted index of this REIT portfolio would have additionally realized a nearly



three-fold increase in share price between 2008 and 2018.

SLOWING ECONOMY COULD BOOST APPEAL OF STABLE INVESTMENT CHOICES

The Treasury yield curve is one of the best indicators of sentiment for U.S. debt. It shows investor expectations for future interest rate movement. The yield curve is upward sloping, which indicates longer hold periods receive a higher payout than shorter ones. That makes sense. Investors expect to be paid a higher premium when their liquidity is locked up over a longer period of time. By the same logic, investors who only lose access to their liquidity for a short time can expect a much lower return. In fact, when the Fed raises and lowers overnight rates, those changes take more time to impact the longer-term end of the yield curve. Most of the time the relationship between hold period, interest rates - with respect to the total return - holds true. But the spread between short- and long-term interest rates can vary by a lot.



Source: Federal Reserve Bank of St. Louis

One of the most common signals used to gauge investor sentiment and perception is the spread between the two-year and 10-year Treasuries. A narrower delta can indicate a peaking business cycle. It can also suggest that investors are pessimistic about near-term growth. The flatter the curve becomes, the closer we get to economic stagnation.

An inverted yield curve indicates bearish investor sentiment. It means that long-term investors are trying to lock-in rates because their perception is that interest rates will soon be on the decline. When the yield curve becomes inverted – when short-term rates rise above long-term rates – there is cause for concern. While inversion doesn't consistently predict forthcoming economic recessions, it almost always indicates a peak in the business cycle.

Notice the trend over the last few years. Three consecutive March readings show that the slope of the yield curve continues to flatten. More specifically, the spread between the 10-year and two-year Treasuries has gone from nearly 120 bps in 2016 to roughly 20 bps today. Meanwhile, interest rates at long-end of the curve have held steady. Notice the slight change in the 30-year rate over the last three years, which has held steady around 3.0%.

Moving forward, there isn't much room for dividend yield spreads to compress. The most recent spread came in at just 20 bps. Much like cap rates this late in the cycle, yield premiums have become so thin that even the most scrupulous and creative real estate investors need to prudently underwrite potential acquisitions or possibly adjust their hold period expectations to meet internal rate of return (IRR) hurdles.

But apartment fundamentals should remain strong and provide long-term tailwinds to investors. While there has been a building spree of conventional market-rate apartments in this cycle, tightening employment opportunities for Millennials and iGen have been equally pervasive, particularly in most large markets across the country. This coupled with rising occupancy, accelerating single-family pricing and greater economic activity will continue to provide strength to apartment fundamentals in the future.

Apartment REITs Analyzed

Apartment Investment and Management Company
AvalonBay Communities, Inc.
Camden Property Trust
Equity Residential
Essex Property Trust, Inc.
Mid-America Apartment Communities, Inc.
UDR, Inc.