

JULY 18, 2016

THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

**THE FOLLOWING REPORT IS EXCERPTED FROM
THE WALL STREET TRANSCRIPT**

ANALYST INTERVIEW

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Founded 1963
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Better Sentiment on the REIT Space as Macro Concerns Moderate

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SECTOR — REAL ESTATE

(AHI802) TWST: We spoke about a year ago, have there been any changes in your coverage universe?

Mr. Goldfarb: No, we cover close to 30 stocks across apartments, student housing, shopping centers, malls, office, industrial, and in the net lease space, one is a health care company and the other one is traditional net lease.

TWST: How would you describe overall investor sentiment on the REIT space today, and what's driving that?

Mr. Goldfarb: It's certainly better now than it was at the beginning of the year. Earlier in the year there was a lot of macro concern. If you go back to last summer, it was China, and then pick your favorite topic, such as oil. Even right now, Brexit at least doesn't have that much of a scare factor the way China did last summer. But still, earlier this year there were definitely some macro uncertainties, and it definitely manifested itself in the market performance. When you looked at where interest rates were and what the environment was and what you thought the impact on rates was going to be, we remained bullish because we didn't see any reason that interest rates would go up.

As you and I have spoken about in the past, about real estate being a derivative of credit and the economy, if the economy

is continuing to slowly grow and there is little if any reason why the long rates should rise, then real estate will continue to do well. And in fact, if you look on a year-to-date basis, REITs are up just over 7%, and the S&P is up only 2%. So REITs have definitely

performed well. They're delivering 6%, 7% earnings growth, 3%-plus dividend yield, and we've seen the 10-year go from starting the year at around 2.25% to now being around 1.6%, 1.7%. So clearly concerns about rates going up have given way to concerns of global concerns of negative sovereign yields, and in that sort of environment, a security like a REIT that's going to offer growth, and income is going to find a lot of happy homes.

TWST: You look at the whole spectrum of property types. Are there any particular areas of strength that you would point to?

Mr. Goldfarb: Certainly student housing has done well. ACC (NYSE:ACC) and EDR (NYSE:EDR) have done very well this year. Both are well-capitalized, and in times of uncertainty, there's a comfort knowing that kids are always going to school. It may not be fun for the parents paying ever-escalating tuition costs, but for an

investor, they know there's always going to be a new crop of kids living in the dorms, so they've done well.

When you look at triple net — our two names are **Community Health** (NYSE:CHCT) and **Spirit** (NYSE:SRC) —

Highlights

Alexander Goldfarb says sentiment on the REIT space is better now than the beginning of the year when there was a lot of macro concern. Year to date he says REITs are up 7%, so they have been performing well. He says student housing and triple net have done well, while apartments are seeing slower growth. He says a big net positive for the sector will be the new GICS code. Companies include: American Campus Communities (NYSE:ACC); Education Realty Trust (NYSE:EDR); Community Healthcare Trust (NYSE:CHCT); Spirit Realty Capital (NYSE:SRC); EastGroup Properties (NYSE:EGP); Equity Residential (NYSE:EQR); Camden Property Trust (NYSE:CPT); Essex Property Trust (NYSE:ESS); Federal Realty Investment Trust (NYSE:FRT); Vornado Realty Trust (NYSE:VNO); DDR Corp. (NYSE:DDR); TJX Companies (NYSE:TJX); Hudson Pacific Properties (NYSE:HPP); Boston Properties (NYSE:BPX); Simon Property Group (NYSE:SPG) and Terreno Realty Corporation (NYSE:TRNO),

again both have done well. They are simple stories. You're looking at good acquisition vehicles with good underwriting, not buying in bulk but buying asset by asset and having good income, good yield. That resonates with investors, and those stocks have done well. Industrial is another area. **EastGroup** (NYSE:EGP) was a name that at the beginning the year was in the low \$50s. Everyone's concerned about Houston. We looked at it and said, "Even with what's going on in Houston, the earnings trajectory and the valuation discount is just completely mismatched." That stock has done really well this year.

So there have been some areas that have done well, there have been some other areas that we've gotten a little bit more cautious about.

We had downgraded **EQR** (NYSE:EQR) late last year, but we still had "buys" on **Camden** (NYSE:CPT) and **Essex** (NYSE:ESS) going into this year. At the end of second quarter earnings, we had no more "buys" in apartments because the fundamentals are moderating there. There are now supply concerns in some of the coastal markets, where people think about supply constraint. In our view, we don't think about supply constraint, because if developers can figure out a way to make money by building, they'll build. It doesn't matter if they're cornfields or in the middle of a downtown, if the math is there and they think they can make it work, developers will build. So apartments are one area where they're still going to have good growth, but that rate of growth is slowing.

TWST: Did any themes stick out for you from the REITWeek conference earlier in June?

Mr. Goldfarb: I'd say the big one is the new GICS sector that is going to occur in September. Real estate is going to have its own group. We've just had two companies on the road recently, **Federal** (NYSE:FRT) and **Vornado** (NYSE:VNO), and met with a lot of generalists, and it's been really interesting. Over the past two months we've had more meetings with generalists as they take a look at the sector, as well as management meetings with generalists, where you hear the types of questions that they're asking, and it's interesting because they definitely, at least in our view, seem to be much more company-specific. Rather than saying, "We've been underweight REITs, give us X percent weighting in REITs so we can rightsize our exposure," they really want to understand company by company. I think that's going to benefit companies with good business models, good management teams, good cultures, where generalists can feel good that the earnings stream is repeatable.

That's in contrast to REIT-land; among the dedicated often it's more about relative valuation because they're playing within a sector, and it's often trying to figure out, "Well, where can I get similar geographic exposure but get it a bit cheaper than some of the other names there?" I think the generalists are approaching it and saying, "We want companies that have good earnings growth, cash flow growth, dividend growth, because we can compare those metrics across other companies that we would invest in." So it's not as though REITs are only competing within the REIT space, they're now competing against other equities that the generalists have to pick from.

"As long as REITs overall are doing well, then clearly the IPO market will follow suit."

I think it's going to be a big net positive. I think it's going to help provide differentiation between the companies, which is a good thing. But let's face it, it's going to take time. It's not like on September 17, when it becomes effective, that this magical \$100 billion that everyone talks about, that suddenly you have a \$100 billion buying program going on. It's going to take time, but it seems to be a net positive.

TWST: What's the current climate like for new IPOs, other capital markets activity and M&A activity?

Mr. Goldfarb: As long as REITs overall are doing well, then clearly the IPO market will follow suit. With a number of the companies that have gone public this cycle, some

of which clearly should not have, I think folks are much more discerning now. Good companies, good management teams will find a receptive audience, and companies that are questionable, it's going to be more challenging. M&A always depends on, one, having a willing seller, and, two, the certainty and the ability of the acquirer to perform. If you get a big private equity firm with a cash bid, that's pretty compelling. If you get a smaller shop that puts out a large number for a company but it's not really clear how they're going to finance it, it's less compelling. On the stock for stock, we haven't seen as many of those, and I think it's tougher because unless the companies neatly line up and the target's management team is willing to step down, it's harder to see those coming through. Certainly, with way too many REITs and still more REITs coming into existence, there's definitely a reason for consolidation. But like in any industry, it comes down to personalities.

1-Year Daily Chart of DDR Corp.



Chart provided by www.BigCharts.com

TWST: What are your top recommendations right now and why?

Mr. Goldfarb: Our top pick for the year is **DDR** (NYSE:DDR), the Cleveland-based shopping center company. I think that management has done a really good job of honing the portfolio and really focusing on value retail. If you think about the **TJXs** (NYSE:TJX) of the world, where people really want bargains but they want bargains of brand-name, first-run goods, **DDR** is at

the center of that.

A few other names are in office, which we didn't speak about earlier. One of the benefits of office right now is, even as the economy slows, as long as it doesn't go negative there's a pretty big mark to market between expiring rents and market rents. Companies like **Hudson Pacific** (NYSE:HPP) are printing 30%, 40%-plus releasing spreads out in California and Seattle as 10-year-old deals roll to market. And clearly they've been a beneficiary of the tech boom. Now, if you think that tech is about to roll, you're probably not going to be too enthusiastic about **Hudson Pacific**. But from our viewpoint, tech is definitely widespread. A few years ago all the focus was on some of the storage things and payment systems, and now all the focus is on autonomous cars. Tech has certainly shown an ability to not just be one area or dominated by one company, but it is a whole sort of creative class, creative way of thinking that's pervading the West Coast, and that's been great for companies like **Hudson Pacific**.

Boston Properties (NYSE:BXP) has certainly done a solid job of rolling out all the leasing that they're doing and have done. That's leasing is driving a lot of NOI in over the next few years. **Vornado** is another one that has outlined that. Another name that we always like is **Simon** (NYSE:SPG). David Simon has built a complete earnings machine, where earnings, cash flow and dividend just continue to increase. At the same time, it has really adapted well, incorporating a lot of the trend-setting retailing areas: online retailing, apps to focus on driving customers to stores, etc. Now a lot of the mall guys have done similar, but I think **Simon** has really taken advantage of the efficiency, size, breadth and scale of their platform, across malls, outlets, Mills and international, to really try to maximize as best they can all the different new technologies of retail. Also, just their ability to operate retail centers efficiently and continue to drive solid earnings growth through constant retailer demand to open at their centers.

TWST: Looking ahead to the next couple of quarters, what would you say investors should pay most attention to in the quarterly results and calls?

Mr. Goldfarb: I think it's going to be tenant sentiment. Clearly, everyone right now is focused even more so on the economic data following the weak jobs number a few weeks ago. I think what people are really going to look at is the demand from tenants, whether it's apartment renters, office tenants, retailers. Is it holding in there? Are people willing to continue to pay the increasing rents? I think that's where you're going to see a lot of the focus.

Certainly we saw pushback during NAREIT with the apartment guys like **EQR** and **Essex**. While **EQR** cut guidance, **Essex** commented that San Francisco still remains a bit of a challenge given the outfall of supply. I think those are areas where people are going to continue to focus, and then you look and say, "OK, if jobs numbers are weak, are we seeing that on the office side? What's going on on the retail side?" So I think the tenant demand is likely to remain at the forefront.

TWST: Any final thoughts to wrap up?

Mr. Goldfarb: Our view is that there's really no reason for rates to go up. I think the Fed waited too long to raise the short end. I don't think, whether they raise it or not, it's going to make a real difference. And even if they do raise it, I think you end up with more of a flatter curve than anything else, because again, from an economic perspective globally, domestically it's hard to see a reason why the 10-year is going to materially increase.

The supply picture remains relatively in check. Obviously you've had some overbuilding of apartments in some of the major urban areas, but when you look at retail, industrial, office, it's pretty much been in check this time, or if there has been building, it's away from some of the areas that our companies are exposed to. If you look at industrial, you've had a lot of building of larger warehouses, over 300,000 square feet, whereas companies that we cover like **EastGroup** or **Terreno** (NYSE:TRNO) focus on warehouses below that threshold. Even here in New York, where you are seeing a lot of office supply come on, it's like 1%, 2% of stock, it's not that much. And for all the tenants who have moved over to the Far West Side or some of the new buildings downtown, there have also been a lot of tenants who have renewed in place and stayed within the older stock buildings. So again, supply really hasn't been a factor of this cycle, with the exception of apartments, but if you look at what's going on in this cycle, we haven't had a move out to homes. We've had people increasingly want to rent, increasingly want to live in the urban areas, so it's not surprising that we've seen some more apartment construction there. And then we get to the fun of the election.

TWST: Yes, that's going to be interesting.

Mr. Goldfarb: It will be. You know, there's banter and there's reality. There's fear and there's reality. I just happened to be with some folks who own TV stations last week, and we started talking politics. I made my views known, and they said, "Listen, it doesn't matter, it's just great for TV to have the election." I think for a bunch of people it's entertainment, for others it's seriousness. But I think there's a general frustration that this year is definitely exemplifying. When you look at how that impacts REITs, again, if there's uncertainty, if there's frustration, does that mean that interest rates are going to go up or down? If anything, they're probably bound to stay low, and again, anything that's providing growth in income, which the REITs do, likely remains attractive to investors.

TWST: Thank you. (MN)

Note: Opinions and recommendations are as of 06/23/16.

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