

BofAML REIT Primer, 4th Ed. A Peek Into the Industry



Jeffrey Spector
Research Analyst
MLPF&S

James Feldman
Research Analyst
MLPF&S

Craig Schmidt
Research Analyst
MLPF&S

Jana Galan
Research Analyst
MLPF&S

Jane Wong
Research Analyst
MLPF&S

Katharine Hutchins
Research Analyst
MLPF&S

Stephen J.H. Sihelnik
Research Analyst
MLPF&S

Overview of REITs

This BofAML REIT primer provides an overview of the REIT industry and includes a discussion of the sector's unique quarterly reporting standards and methods of valuation. This primer is divided into separate sections for easy referencing: (1) the basic structure of a REIT and the growth of the industry; (2) REIT earnings and valuation; (3) dividends; and (4) frequently asked questions. We also include an appendix that contains definitions of REIT-specific terms and commonly used acronyms.

Providing access to commercial real estate

A REIT, or a real estate investment trust, is a company that owns income-producing real estate. REITs were formed in 1960 by Congress as a way for small investors to obtain an ownership in commercial real estate. REITs are required to derive at least 75% of their income from real estate and distribute 90% of their taxable net income as dividends. Similar to a direct real estate holding, REITs are taxed at the investor level (not the corporate level).

Evolution of REITs

The REIT industry has changed dramatically over the decades. Two cycles in the 1970s and 1980s slightly increased the number of REITs, but it was not until the early 1990s that the sector experienced explosive growth and wide acceptance among investors. Today, most REITs follow an active, hands-on, owner-and-operators model rather than simply owning a collection of assets, as was common in the early years. Collecting rent continues to be the main source of revenue for REITs. REITs grow internally through occupancy and rent increases, tenant upgrades, and redevelopment of existing properties. REITs generate external growth through accretive acquisitions and ground-up development. REITs only own about 15% of institutionally-owned US commercial real estate.

Valuation of REITs

A REIT's return profile has characteristics of both bonds and equities. The long-term nature of REIT leases provides income visibility (like bonds), while the mark-to-market of leases allows REITs to take part in the economic cycle (like equities). In valuing REITs, we use a number of metrics, including: price-to-fund from operations (FFO), a key earnings metric for REITs; price-to-net asset value, which values REITs based on their underlying assets; relative yield analysis, which compares yields across different asset classes; and implied cap rates, to determine where the market is valuing a company or sector. We provide an explanation of these valuation methods inside and list the pros and cons of each.

New sections inside

- Organizational structure
- Non-traded and private REITs
- Student housing
- Manufactured housing
- Single-family rentals
- Retail freestanding / triple-nets
- Infrastructure/Towers
- Other potential REIT conversions
- Alternative FFO measures

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Refer to important disclosures on page 50 to 51. Link to Definitions on page 49.

Contents

What is a REIT?	3
Evolution of the REIT industry	15
REIT returns	21
Funds from operations (FFO)	23
Net asset value (NAV)	29
Capitalization rates	31
Valuation	33
Pros & cons of valuation metrics	38
REIT dividends	40
Frequently asked questions	41
Appendix: acronyms & definitions	43

Real estate investment trusts, or REITs, are companies that own income-producing real estate

REITs do not pay corporate income taxes

REITs are taxed at the investor level

REITs must distribute at least 90% of their taxable net income as dividends

REITs must derive at least 75% of income from real estate

Taxable REIT subsidiaries (TRS) allows REITs to generate revenues through ancillary business activities

What is a REIT?

A REIT, or real estate investment trust, is a company that owns and in most cases operates income-producing real estate such as apartments, office buildings, warehouses, shopping centers, regional malls, or hotels. A small percentage of REITs (mortgage REITs) lend money to owners of real estate and therefore do not have direct ownership of the asset.

REITs were formed in 1960 when Congress passed the Real Estate Investment Trust Act. This legislation provided small investors access to the ownership of commercial real estate. Through securitization, REITs offer investors access to commercial property returns without the barriers to entry associated with traditional property ownership (mainly large price tags and illiquidity). In this way, REITs allow investors to own a “piece” of a mall or apartment building by simply owning shares of a REIT stock.

The REIT structure

The primary benefit of the REIT structure is that the entity does not pay corporate income taxes. Like direct real estate holdings, REITs are taxed at the investor level (as opposed to a corporation that is taxed at the entity level). In order to achieve this tax status, REITs must adhere to the following qualifications:

- Be structured as a taxable corporation
- Be managed by a board of directors or trustees
- Distribute at least 90% of taxable net income as dividends to shareholders
- Have at least 75% of assets in real estate (real property or loans secured by property)
- Derive at least 75% of gross income from real estate income (rents or interest from mortgages)
- Have a minimum of 100 shareholders
- Have no more than 50% of shares held by 5 or fewer individuals
- Have no more than 25% of assets invested in stocks of taxable REIT subsidiaries (TRS)

Source: NAREIT

Although REITs must generate 75% of their income from real estate or rental income, they can generate additional revenue through a taxable REIT subsidiary (TRS). The TRS was created through the REIT Modernization Act (RMA), which took effect on January 1, 2001. By forming a TRS, REITs can engage in ancillary business activities that were previously prohibited by the IRS. These business activities, which are fully taxed, allow REITs to potentially boost their earnings stream by providing services that their tenants need and/or want. This can include merchant development (developing with intention of selling to third parties), property management, and funds management.

Special rules for income tests

Additional rules for income to be classified as a rental income for a REIT are:

- Rental income for a REIT includes traditional rent, as well as certain charges for services customarily furnished in connection with the rental of property. Eg. parking facilities provided at the property
- Rents for a REIT may not be based on net income or profits of the tenant, but it can be based on a fixed percentage of gross receipt or sales of the tenant.
- Rents cannot be derived from an entity in which the REIT has a 10% or greater interest (by vote or value, assets or net profits)

Types of REITs

There are 3 types of REITs:

- Equity REITs
- Mortgage REITs
- Hybrid REITs

In addition, REITs can be:

- publicly-traded
- non-exchange traded
- private

- **Equity REITs:** An equity REIT is an entity that owns and operates income-producing assets, such as apartments, office buildings, warehouses, shopping centers, regional malls, or hotels. Many of these companies are fully integrated organizations, meaning they engage in the acquisition, development, and management of commercial real estate for their own account. Most REIT property portfolios are concentrated in a specific sector (e.g. apartment REITs or retail REITs), which is referred to as their "core portfolio." Some also own small percentages of other property types, called "non-core assets." Almost 83% of REITs are equity REITs.
- **Mortgage REITs:** A mortgage REIT is an entity that lends money to an owner of real estate and therefore does not have direct ownership of the asset. Mortgage REITs comprise roughly 17% of the REIT universe.
- **Hybrid REITs:** A hybrid REIT is a cross between an equity and a mortgage REIT. Hybrid REITs represent less than 1% of the REIT universe. NAREIT discontinued its Hybrid REIT Index in December 2010 and has thus stopped disclosing the number of hybrid REITs.

The REIT industry's trade organization is NAREIT, or the National Association of Real Estate Investment Trusts

REITs can be either publicly traded (most are listed in the NYSE), non-exchange traded, or privately held.

According to NAREIT, 162 publicly traded REITs are included in the FTSE NAREIT All REIT index, of which 133 are equity REITs and 29 are mortgage REITs (as of March 28, 2013).

Public non-listed or non-traded REITs file with the SEC but shares are not traded on a national exchange

Public non-listed or non-traded REITs are REITs that file with the SEC but shares do not trade on a national stock exchange. This makes these investments more illiquid as redemption programs vary by company. A typical investment ranges from \$1,000-\$2,500 and often includes distribution fees of up to 10% of the investment for broker-dealer commissions and other up-front costs. Many also charge ongoing management fees and some charge back-end fees. The non-traded REIT market is estimated to be approximately a \$50-80 billion market.

Private REITs are not registered with the SEC and do not provide financial or performance data publically

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Organizational structure

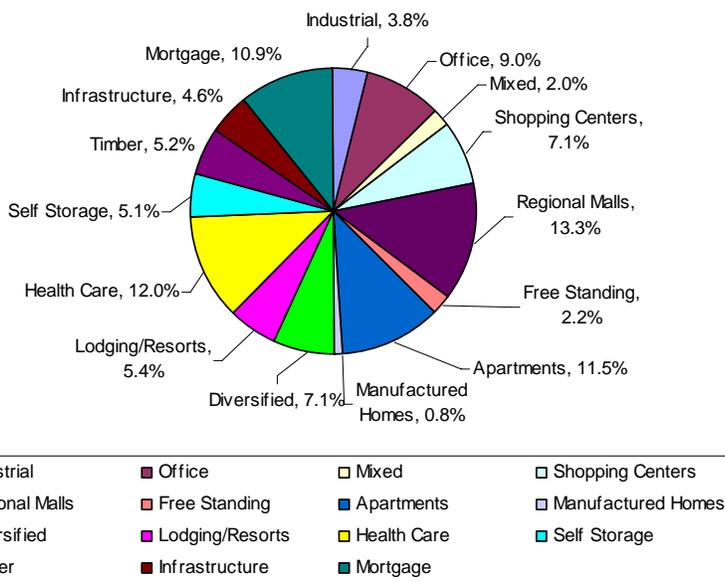
When first formed, REITs were thought of as a passive investment vehicle of real estate assets, with an external adviser managing the assets. In the late 1980s, the inefficiencies and conflicts of interests that existed between the external adviser and REIT shareholders were recognized. The Tax Reform Act was passed in 1986, which allowed REITs to integrate property management into the

organization. Following the “REIT modernization era” and KIM’s IPO, internally-managed REITs emerged and became the industry norm.

Today, most (but not all) equity REITs are internally-managed, while mortgage REITs commonly use the externally-managed structure.

For externally-managed equity REITs, potential conflicts of interest between REIT shareholders and the external manager/adviser include but are not limited to 1) structure of management fees if based on assets under management and not operating performance; 2) basis of compensation of senior management; and 3) structure of the termination fee.

Chart 1: U.S. REIT breakdown, by sector (weighted by market cap)



Source: NAREIT, as of March 28, 2013

Table 1: Lease duration, by property type

Property Type	Average Lease Duration
Hotel / Lodging	daily
Self Storage	monthly
Apartments	6-12 months
Retail - Inline (Strips)	3-5 years
Industrial	6 years
Office – Suburban	5-7 years
Retail - Inline (Malls)	7-10 years
Retail - Anchor	10+ years
Office - Central Business District	10-12 years
Healthcare (triple net leased)	10-20 years
Retail triple net leased	15-20 years

Source: BofA Merrill Lynch Global Research

Lease structure

REITs derive the majority of their revenue from rental income; however, leases are structured differently depending on the asset type/sector. Lease durations range from nightly (for hotels) to over 10 years (for select retail, healthcare, and office leases). Given that leases lock in a specific rate (or rate increases) for the duration of the lease, longer lease terms generally provide greater income visibility.

Sources of growth

REITs own income-generating properties, and collecting rent is their main source of revenue. REITs grow internally through rent increases, tenant upgrades, and redevelopment of existing properties. In addition, REITs can generate external growth through accretive acquisitions and ground-up development.

Equity REIT sectors

Multi-family (\$81 billion market cap)

The multi-family sector includes apartments, student housing, manufactured housing and single-family rental REITs.

The main driver for apartment REITs is employment

Apartments

There are three main apartment property types: garden-style with two or three floors, mid-rise averaging five to seven stories, and high-rise, which includes anything above mid-rise. The average lease duration for apartments is usually one year. This means apartment REITs can mark their leases to market more frequently.

The main driver for apartment REITs is employment, as it directly impacts rental revenues. In a downturn when unemployment is high, tenants tend to trade down, double or triple up, or even decide to move home with parents or family in order to save money on rent. As a result, effective rents could decline significantly in order for landlords to buy occupancy. The strategy for most apartment landlords is to try to maintain 94-95% occupancy at virtually any cost, which means that effective rents could fall dramatically through higher concessions and/or lower rent rolls. There is typically a lag between unemployment and the time it impacts apartment fundamentals, usually between six months and a year.

Another main driver for apartment REITs is new supply of apartment inventory. When there are extended years of limited, muted or no new supply in the market, apartment REITs can drive rental rate growth and maintain occupancy.

Factors affecting apartments are interest rates and condominium supply

Other factors affecting apartment REITs are interest rates, condominium supply, and rental housing supply. Relatively high interest rates on home mortgages tend to help apartment owners, as this makes single-family dwellings less affordable. Condominiums, on the other hand, often present a threat to apartment owners in the form of a "shadow market," meaning excess condominiums could be converted into apartment rentals, thereby increasing the supply in a market.

Another factor is the decline in home ownership rate and a secular shift to renting

As a result of the residential mortgage crisis that began in 2007, we are seeing a significant shift occurring in the US from owning to renting. The US home ownership rate peaked in 2005/2006 at about 69% and ended 4Q10 at 66.5%. Every one percentage point decline represents approximately 1.1 million households that enter the renting population. The decline in home ownership is expected to continue. Current rhetoric from Washington suggests that potential policy changes will make homeownership less attractive and incentivize private development of affordable multifamily rentals.

Foreclosed homes could also become competitive supply, as rental homes, against apartments

The overall multifamily sector will benefit from this shift to renting, especially from historically low levels of supply. However, increased construction is expected to ramp up to meet the increasing demand for multi-family rentals. In addition, foreclosed homes could become competitive against apartments as rental homes, and supply could come on faster than expected and/or above demand.

Purpose-built student housing properties are non-university owned communities targeted towards students

Student housing

Student housing is non-university-owned properties targeted to university students, primarily at large, public, four-year universities. This subsector is viewed as more defensive than other multi-family property types, as college enrollment tends to be less sensitive to macroeconomic conditions and even increases when unemployment rises.

The industry exhibits seasonality given the academic calendar. Revenue is lower in 2Q and 3Q as full time students move out during the summer. Operating expenses increase in 3Q because the bulk of tenants move during August and September. Deal activity also tends to be seasonal, as owner/operators focus on leasing in 1Q and 2Q. Many owners wait until 3Q to market assets for sale.

Manufactured housing communities are either all-age or age-restricted and are viewed as defensive due to lower turnover

RV/resort communities exhibit more seasonality from timing of holidays and weather

Newly formed sector, as groups aim to institutionalize a mom & pop industry

Most leases for senior housing, skilled nursing, and hospitals are triple net, long in duration, with low turnover

The main drivers of health care REITs include: aging demographics, proximity to the oldest daughter, and proximity to the nearest hospital

Manufactured housing communities.

Companies in this defensive sector own, operate, and develop manufactured housing and recreational vehicle communities within the US. Tenants rent individual land sites with utility access for placement of manufactured homes and RVs. The manufactured housing sector is viewed as defensive because it generates steady SS NOI due to low annual resident turnover and consistent increases in average rents, even through the downturn. In addition, recurring capital expenditures only amount to \$150-250 per site annually. Communities can be all-age or age-restricted (for retirees).

RV/resort communities exhibit more seasonality based on timing of holidays and weather.

Single-family rentals

This is a newly-formed subsector that is in its early stages. There is an estimated 14 million single-family rental homes in the US, primarily owned and operated by mom and pops. Given the large fall in home values in select US markets, institutional players have started to amass portfolios of single-family homes through multiple channels with the intent to renovate, lease and manage them. Industry trends are favorable for single-family home price appreciation, and niche demand for rentals exists. However, longer-term investors are concerned about expenses and capital expenditures.

Health care (\$80 billion market cap)

The key types of health care facilities that REITs invest in include: senior housing communities (independent living, assisted living, and CCRCs), skilled nursing facilities (SNFs), hospitals, medical office buildings (MOBs), and life science properties. Unlike other REIT sectors that only have one type of business, the health care REITs are able to diversify their investments by business and payor mix. For example, the four types of health care facilities have varying pay mechanisms: senior housing (private pay), skilled nursing (public pay), hospitals (public pay), and medical office buildings (private pay).

Most leases for senior housing, skilled nursing, and hospitals are triple net (meaning the landlord passes on expenses to the tenant). In our view, triple nets are attractive because of their limited downside risk. Landlords have stable cash flows from collecting rents (essentially 100% NOI margin), while the tenants pay rent and all operating expenses (including capital expenditures). The landlords therefore do not have direct exposure to operating earnings of the tenants. Most triple net leases are long duration, typically 10-15 year lease terms with multiple five-year extensions. Since the tenants pay for the majority of the capital expenditures and want to reap the benefits of these improvements for as long as possible, the leases tend to be long in duration and encourage low turnover.

The main drivers of health care REITs include aging demographics, proximity to the oldest daughter, and proximity to the nearest hospital. Health care REITs are generally thought of as relatively defensive, given that the industry is necessity-based (there are always people getting older who need care) and the triple net lease structure.

One of the biggest risks is credit exposure to operators. This becomes a concern if the tenant is struggling to keep afloat and the risk can be amplified if a health care REIT has a large exposure to one or two operators. Historically, health care REITs had large concentrations with a particular tenant. Health care REITs also face government reimbursement risk, meaning cuts to Medicare or Medicaid reimbursement rates. This risk is somewhat mitigated by the fact that the majority of most REITs' exposure is to senior housing, which is private pay.

Health care REITs have transformed their portfolios to diversifying tenant base, private/public pay mix, geographic exposure, and with TRS/RIDEA deals

In recent years, through acquisitions, health care REITs have worked to diversify their tenant base, both in number and in private/public pay mix, as well as their geographic exposure. Health care REITs have also increased their exposure to senior housing operating properties through TRS/RIDEA deals. The RIDEA structure allows health care REITs to benefit from the operating margins of senior housing communities but also exposes them to the risks of operations. Health care REITs pay a fee to a health care operator to run the community. If margins improve, health care REITs benefit. On the flip side, this structure adds risk to health care REITs' cash flows because if margins shrink, the health care REITs' cash flows decline, as the fee to the operator does not change.

Industrial properties include: distribution centers, bulk warehouse space, light manufacturing facilities, research and development facilities, and "flex" office space for sales or administrative functions

Industrial (\$25 billion market cap)

Assets owned by industrial REITs typically include: distribution centers, bulk warehouse space, light manufacturing facilities, research and development facilities, and "flex" office space for sales or administrative functions. Industrial assets may be freestanding, but are commonly located within industrial or warehouse parks. These buildings range in size from 25-50K square feet at the low end to over 1M SF at the high end. Development trends and demand for large distribution centers increased the average building size for the sector over the past decade. While the properties are often leased to a single user, landlords can easily subdivide them for multiple tenant use.

When compared to other real estate types, industrial assets tend to require lower levels of maintenance capital expenditures given they are largely comprised of large concrete slab floors surrounded by four walls and a roof with large parking lots and truck courts. Modern warehouses include design traits such as dock doors on multiple sides of the building to promote the efficient flow of goods and 30 foot clear ceiling heights.

Key drivers of warehouse demand come from inventory storage or the flow of goods through tenant supply chains either in the manufacturing process or during distribution to the end user

Key drivers of warehouse demand come from inventory storage or the flow of goods through tenant supply chains either in the manufacturing process or during distribution to the end user. Therefore, demand growth depends primarily on consumer spending, manufacturing, and import / export activity (we note historic trends suggest imports require three times the amount of warehouse space than exports). A recent focus among tenants on growing profitability through improved supply chain design created demand for new and larger distribution center developments. As part of this process, third party logistics providers (3PLs) became a larger part of REIT tenant rosters. Typical industrial REIT leases last 3-5 years, with 3PL leases at the shorter end. 3PLs tend to match their lease durations to the underlying distribution contracts they sign. The global nature of trade and tenant warehouse needs provides industrial REITs with opportunities to grow outside the US.

Industrial assets tend to have shorter construction periods (6-12 months) than most other real estate types

Industrial assets tend to have shorter construction periods (6-12 months) than most other real estate types. Until the most recent downturn, these short lead times kept industrial building supply and demand relatively in balance. In fact, sector occupancy historically remained in a tight range from 88-92%. However,

the availability of capital and optimistic growth outlooks led to large amounts of speculative development in many markets ahead of the late 2007 downturn. When demand declined, it upset the historic supply / demand balance and the sector occupancy rate dipped below its historic range.

Property funds are a unique part of industrial REIT business models. Property funds are portfolios of industrial properties owned by the REIT and a group of institutional partners. The REITs typically own around 20% and then collect management fees and bonuses / promoted interests upon meeting certain return requirements. Assets enter the funds through acquisitions from third parties, acquisitions from the managing REIT, or when the managing REIT completes and leases new developments.

Development projects on fund balance sheets from their outset have become a rising trend. Institutional investors invest in the funds due to the challenge of fulfilling their investment allocations in the industrial real estate sector as direct owners given the relatively small dollar amount of individual real estate assets. Industrial REIT operating platforms also provide valuable scale and expertise.

Lodging (\$35 billion market cap)

Lodging REITs are not able to receive income from hotel operations, nor operate owned hotels

However, Lodging REITs have set up TRSs to generate income from hotel operations

Lodging REITs consist of a portfolio of hotel properties with no unifying brand and are managed by a third party operator. This is the direct result of a legal restriction placed on REITs – in addition to complying with the restrictions placed on other REITs, lodging REITs are not able to receive income from hotel operations, nor operate owned hotels. Lodging REITs have historically proven to be highly cyclical as the extremely short-term nature of their leases (nightly) can lead to highly volatile room rates and occupancy levels. Many operating expenses cannot be easily pared back, which can lead to volatile earnings cycles.

Lodging REITs are not able to receive income from hotel operations, nor operate owned hotels. Instead, the Lodging REITs have set up TRS (taxable REIT subsidiaries) that generate income from the hotels, and the TRS' in turn pay the REIT. When the Lodging REITs report earnings, they show the actual room revenue and food/beverage revenue; however, the income from hotel operations is not received by the REIT directly.

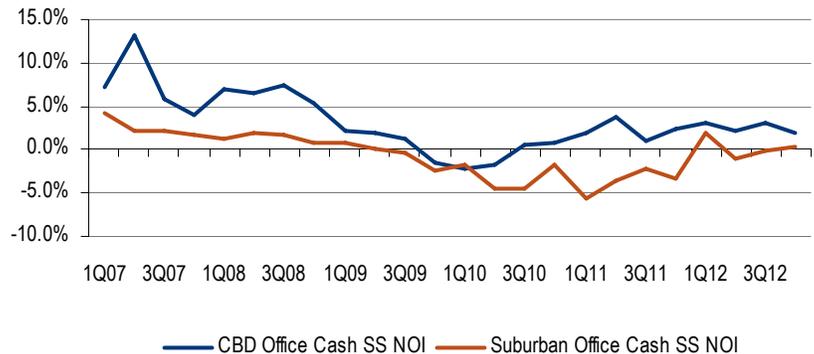
Office (\$73 billion market cap)

Office REIT assets fall into two primary categories: central business district (CBD) or suburban

Office REIT assets fall into two primary categories: central business district (CBD) or suburban. CBD typically means high-rise buildings in urban infill markets. Suburban typically means stand-alone office buildings or corporate office parks outside the urban core. Development costs, operating costs and rents are usually lower for suburban assets than CBD assets. However, these assets also face greater supply risk given their location in lower barrier-to-entry submarkets.

In Chart 2, we provide the historic average same store NOI growth for CBD and suburban office REITs. We note the long term average shows stronger growth over time for CBD names.

Chart 2: Historical comparison of SS NOI of CBD vs. Suburban Office



Source: Company reports, BofA Merrill Lynch Global Research

Job growth is the key driver of office space demand

Job growth remains the key driver of office space demand. The average lease duration for office REITs is 5 to 7 years for suburban assets and 10 to 12 years for CBD assets. Some large CBD leases may last up to 20 years. These lease durations position office leases as the longest, on average, in the REIT sector. In down markets, this locks in a stable income stream of above market rents with downside risk to in-place rents when leases mature. In improving markets, this could lock in below market rents for an extended period of time with the prospect of material in-place rent increases when leases mature.

Office rents are typically quoted as either “gross” or “net”, and per month or per year, depending on local market convention. Gross rents include building operating costs (utilities, taxes, common area maintenance) in the first (or “base”) year’s rent paid to the landlord. The landlord then pays these expenses directly. The tenant then reimburses the landlord for any growth in building operating costs above the base year level in subsequent years. Under a net rent structure, the tenant pays the landlord rent but the tenant pays its share of the building operating expenses directly starting in the base year. The commonly heard term “triple net” refers to the payment of rent after the three categories of operating expenses listed above.

We pay close attention to office REIT dividend coverage given the impact of leasing costs on portfolio cash flow

A noteworthy aspect of the office sector, and office REIT earnings models, comes from the capital expenditures necessary to maintain office buildings. Office capital expenditures take the form of either leasing costs (broker commissions and tenant improvements on new leases and renewals) or property maintenance expenses. When office market conditions weaken and office landlord lease negotiating power deteriorates, tenant improvement capital expenditures tend to rise. However, when office market conditions improve, tenant improvement capital expenditures tend to decline.

Based on this, we pay close attention to office REIT AFFO (Adjusted Funds from Operations) or FAD (Funds Available for Distribution). These synonymous terms reflect FFO less these routine capital expenditures less any non-cash revenues / expenses, and best reflect the operating cash flow generated by the office REIT portfolio. We calculate AFFO and FAD payout ratios as dividend / AFFO or FAD, and find this metric most useful to determine dividend coverage and an office REIT’s dividend safety or dividend growth prospects.

About 56% of the 1,150 malls in the nation are owned by REITs

Mall REITs are impacted by a weakened consumer through increased vacancies and less robust leasing spreads

Important qualities for malls: demographics, tenant mix and location, breadth of retailers, and site location

Shopping centers can take many forms: grocery-anchored neighborhood centers, non-grocery-anchored centers, larger community centers, and big box centers

Retail malls (\$88 billion market cap)

Malls are typically characterized by larger centers (400,000 square feet or higher), with two or more anchors (often department stores) and a number of “in-line” specialty tenants. Malls typically draw from a radius of 7 to 25 miles and focus on general merchandise/fashion. Of all the various real estate sectors, malls have the highest ownership percentage. About 56% of the 1,150 malls in the nation are owned by REITs and over 80% of the stronger malls are held within REIT portfolios. The high level of ownership is a double-edged sword, as it provides the existing landlords with strong pricing power but limited external growth prospects via acquisitions.

Traditionally, malls have been comprised of 60% anchor tenant space and 40% specialty or in-line tenant space. Anchor tenants have historically been the major draw to a mall, although this dynamic is changing. Select retailers have risen in importance in terms of drawing customers to the mall, such as Apple or Forever 21. Anchor tenants typically pay a relatively low rent, while the specialty tenants pay the majority of the rent.

Malls REITs are very much tied to consumer spending, as a weakened consumer can impact REITs through both increased vacancy (stemming from tenant bankruptcies or reduced store openings) and less robust leasing spreads (on both new leases and renewals). Retailers typically base their ability to pay rent increases on cost of occupancy relative to retail sales. If sales haven't significantly grown over the term of the lease, then rents will not aggressively grow or could even decline. One misperception is that mall revenues are driven by percentage rent (the portion of sales above a pre-determined level where tenants have to pay additional rent). In fact, very little of REIT revenue is tied to sales (under 3% on average).

Demographics are one of the key variables when examining retail (e.g. median household income and number of households within a trade area) as they provide an important measure of portfolio quality. If a company has a strong portfolio, there is a greater probability it will withstand the ups and downs of the economy and changes in the local market.

In addition to demographics, factors that affect the success of a mall include: tenant mix (mix should be tailored by market to meet the needs of the local consumer) and location (landlords can create synergies by placing a toy store next to the food court), breadth of retailers (to drive traffic and achieve critical mass), and site location (should be visible and accessible from major roadways). As there are fewer opportunities in the mall sector to acquire additional properties and or develop in prime locations, growth in the sector is mostly generated through tenant upgrades and redevelopment opportunities.

Retail shopping centers (\$47 billion market cap)

By CoStar's count (excluding malls and outlet centers), there are nearly 91,000 shopping centers in the U.S., including over 45,000 that are 30,000 square feet or greater. The main property types include: convenience center (less than 30,000 square feet, anchored by a convenience store), neighborhood center (30,000 to 150,000 square feet, anchored by 1+ supermarkets or drug stores), community center (100,000 to 150,000 square feet, anchored by 2+ discount department stores, supermarkets, home improvement, or drug stores), and power center (250,000 to 600,000 square feet, anchored by 3+ discount department stores, warehouse clubs, or home improvement stores). Lifestyle centers are also open air but generally attract fashion/specialty retailers and can have up to two anchors (or none).

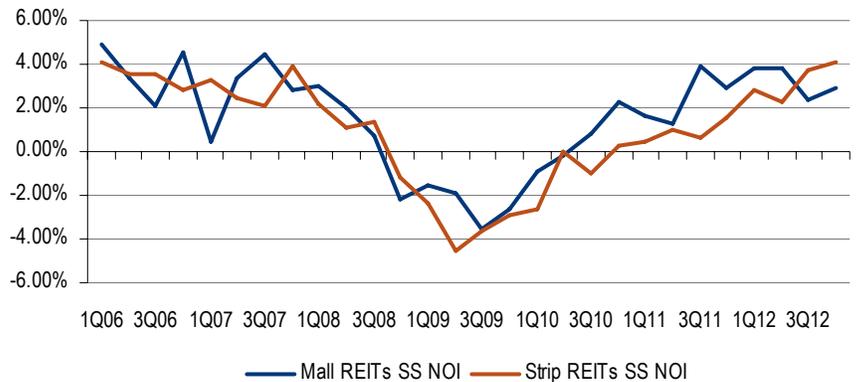
Important qualities for strips:
demographics, site location, grocery and
general merchandise dominance

Similar to malls, shopping center REITs are highly dependant on consumer spending. Vacancies in shopping centers are impacted by net store closings (meaning store closings net of any store openings during that time), and historically lag the end of recessions by one or two years. In addition, shopping centers are impacted by a weakened consumer through less robust leasing spreads (on both new leases and renewals).

Like malls, we believe that properties with stronger demographics are more resilient against a slowdown in the consumer and perform better in the long run. Other factors that affect the success of a shopping center include: site location (visibility and easy access are important), grocery market dominance (it is important to have the number one or number two grocer in the market), and general merchandise dominance.

Coming out of the recent downturn, shopping center REITs have lagged the mall REITs in terms of SS NOI (see Chart 2). In our view, this is due to the larger number of tenant bankruptcies in the shopping center space during the downturn (e.g. Circuit City, Linens 'N Things) coupled with a higher exposure to local tenants who struggled to get credit even after the recession ended.

Chart 3: Historical comparison of SS NOI of Mall vs. Strip REITs



Source: Company reports, BofA Merrill Lynch Global Research

A typical storage facility is located on 2.5 to 5 acres with five to seven buildings with drive-up accessibility

Self storage (\$34 billion market cap)

Self storage facilities are facilities offering rental on a month-to-month basis where the tenant supplies his own lock and has direct access to his unit. While many types of structures have been converted from warehouses and other buildings, the majority of facilities that are being developed today are specifically designed for consumer/business storage. The users of self-storage are roughly split: 25-30% business users and the remaining 70-75% the residential consumer.

A typical storage facility is located on 2.5 to 5 acres with five to seven buildings with drive-up accessibility. All-in, the storage facility may contain anywhere between 50,000 and 80,000 sf of rentable space. More advanced storage facilities offer climate controlled units or above-average access from interior hallways, which can charge higher rents. Investment grade facilities have at least 30,000 sf and are comprised of at least 300 units.

The 5 public self storage REITs own less than 10% of the industry's facilities

The industry is extremely fragmented, with the five public self storage REITs owning less than 10% of the self storage industry's facilities. Self Storage Data Services, an independent research firm, estimates the total number of self-storage facilities in the United States to be over 45,000 (and other estimates range 50,000-60,000).

Datacenter REITs own and operate buildings that house networking, storage and communications technology infrastructure

While zoning issues are making the construction of newer self storage facilities more difficult, the reality is that within the gamut of real estate options, the self-storage facility is one of the more accessible for small entrepreneurs. Therefore, one of the bigger risks to the industry is future new growth in otherwise saturated areas of self-storage.

Datacenters (\$10 billion market cap)

Datacenter REITs own and operate buildings that house networking, data storage and communications technology infrastructure. This infrastructure includes servers, storage devices, switches, routers and fiber optic transmission equipment. The unique design of datacenters satisfies the specialized needs of tenants for power, facility cooling capacity, building security and network connectivity. Typical tenants are those that require large amounts of data storage or network connectivity, and include corporations, governments, telecommunications carriers, media content providers, cloud providers, and financial and educational institutions.

Datacenter REIT-owned properties typically fall into two primary categories:

- **Internet gateway datacenters:** Serve as hubs for Internet and data communications connectivity within and between major metropolitan areas
- **Corporate datacenters:** Provide secure, continuously available environments for the storage and processing of critical electronic information. Data centers are used for disaster recovery purposes, transaction processing and to house corporate IT operations.

Some datacenter REITs also own technology manufacturing assets or large offices of technology companies in their core markets.

Datacenter REITs develop, own and operate datacenters. Most are also in the process of converting their non-datacenter real estate assets into datacenter space through redevelopment. Acquisitions serve another key driver of datacenter REIT portfolio growth. Datacenter REIT portfolios span North America, Europe and Asia with the largest concentration in the US. Given similarities for datacenter demand and design across continents, we expect overseas expansion for this sector to continue.

Unlike most REIT sectors, many datacenter REITs price their space based on capacity usage (\$/kW) rather than rentable square feet

Unique to this REIT sector, datacenter REITs typically price their space to tenants based on power capacity usage (\$/kW) rather than rentable square feet. However, datacenter REITs convert their rent and operating metrics to per square foot numbers when they report earnings and operating metrics to the street for consistency with REIT sector peers.

Data storage demand forecasts vary widely making them difficult to quote, but all point to a healthy growth trajectory for datacenter demand. The recent boom in smartphones, mobile computing and the cloud continues to generate rapidly growing demand for data storage. At the same time, corporate, financial services and government data collection requirements and IT spending should also continue to grow. Gartner expects global IT spending to grow at an average annual pace of 3.9% through 2016. Based on these factors, datacenter REITs should become an increasingly investable sector within REITs.

Retail freestanding REITs own free-standing retail properties such as gas station/convenience stores, fast food or buffet restaurants, drugstores, etc.

Leases are structured on a triple net leased basis, which lends to the sector nickname of "triple net" REITs

Recent conversions include infrastructure and tower REITs

Increasing discussion of potential conversions to REIT-status by non-traditional real estate companies, such as prisons and billboards

While REITs avoid corporate-level taxes, REITs have a burden in distributing 90% of taxable income as dividends

Retail freestanding / triple-net (\$15 billion market cap)

REITs that own retail freestanding properties are also known as triple-net REITs because leases with their tenants are on a triple-net lease basis. These property types include gas station/convenience stores, fast food and buffet restaurants, or retail/service such as drugstores, fitness centers, child care, auto repair, etc.

Triple-net lease agreements are structured in a way where the tenant is responsible for all operating expenses (insurance, taxes, capex), and the landlord collects a net rent. Leases have a relatively long lease terms (15-20 years), low rent bumps embedded (1.5-2% or CPI escalators) and renewal options at the end of the lease. As a result, the cash flow of a triple-net lease is fairly predictable and stable. The triple-net lease sector is popular in the non-traded and private REIT format for investors to receive stable dividends.

Infrastructure/Tower (\$31 billion market cap)

REITs of this non-traditional real estate sector own and operate various types of infrastructure. The largest company in this sector is American Tower (AMT), a \$30.8 billion market cap tower REIT that owns wireless and broadcast communications towers worldwide. AMT converted to a REIT in 2012 after its shareholders approved the conversion in late 2011. AMT's core business is leasing space on its wireless towers to wireless carriers, government agencies, and broadband data providers.

Currently, two other micro-cap REITs (total market cap less than \$200 million) are included in this infrastructure sector. They own real estate related to energy and transportation.

REIT conversions

There has been an increase in conversions to the REIT structure from companies in non-traditional REIT sectors. Recent examples for potential conversions include towers, datacenter operators, correctional facilities, billboard companies and death care services providers. Some retailers are exploring the possibility of spinning off their owned real estate into REITs as well.

Some potential advantages to REIT conversion may include no corporate-level taxes and possible multiple expansion. That said, the REIT structure does have a tax burden. REITs must distribute 90% of taxable income as a dividend; on average, we estimate REITs are currently paying out 75% of their annual cash flow. As a result, REITs must depend heavily on the capital markets to fund growth. This could pose a hurdle for some companies contemplating a conversion to REIT status.

Evolution of the REIT industry

The REIT industry has changed dramatically over the decades since its initial formation in the 1960s. Two cycles in 1970s and 1980s saw small increases in the number of REITs, but it was not until the early 1990s that the sector experienced explosive growth and wide acceptance among investors.

REITs had a market cap of just \$1.5B in 1971, which climbed to a peak of \$400B in 2006

REITs gained strength through 2011 and experienced growth in 2012 and YTD 2013 through organic growth, secondary issuances, and IPOs

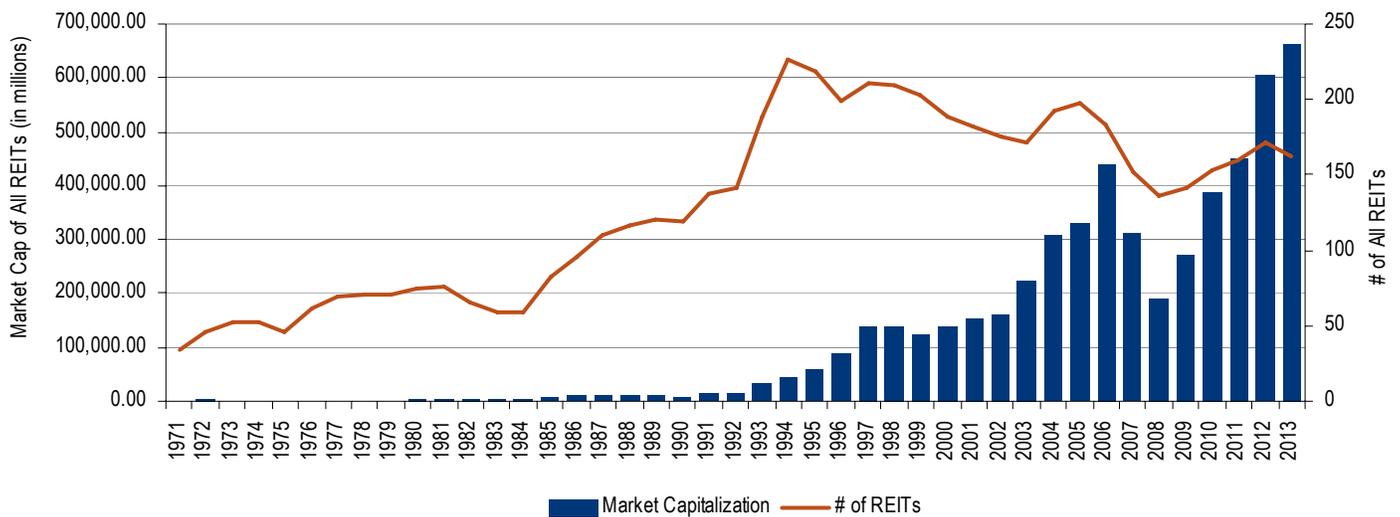
As shown in Chart 2, REITs had a market cap of just \$1.5 billion in 1971 (representing 34 REITs) and was still under \$10 billion in 1990. At the peak in 2006, the market cap of REITs was over \$400 billion. In 2007, both the market cap and number of REITs declined after years of growth due to increased mergers and acquisitions and private equity deals. The SOX Act also placed strict regulations on board structure and cost pressures on smaller REITs. Finally, the economic recession in 2008 put pressure on the stock prices of many REITs, in part due to their leverage.

However, REITs have gained strength through 2012 and 2013 leading to a surge in their market capitalization to record a peak of \$665 billion as at 28th March 2013. The number of REITs, however, has reduced to 162 (as of 28th March 2013) vs 172 at 2012 year-end due to consolidation and M&A activity witnessed in the REIT space.

Given significant changes in the industry, it is difficult to draw conclusions simply based on historical averages. Over the years, the industry has also gone through important regulatory changes (e.g. the 1999 REIT Modernization Act), and many investors believe REITs were greatly undervalued during the dot-com boom.

Chart 2 shows the growth in number and market cap of all REITs, including equity, mortgage, and hybrid REITs.

Chart 4: All REITs (Equity, Mortgage, and Hybrid REITs) - number and market cap



Source: NAREIT; Note: Includes all REITs: equity, mortgage, and hybrid REITs; as of 3/28/13

Table 2: Equity offerings by REITs, in millions

Year	# of Equity Offerings (1)	\$ Amount Raised (2)
1988	26	\$2,159
1989	26	\$1,797
1990	18	\$1,271
1991	28	\$1,594
1992	32	\$1,974
1993	100	\$13,191
1994	97	\$11,121
1995	101	\$8,260
1996	145	\$12,309
1997	253	\$26,266
1998	233	\$14,572
1999	31	\$2,258
2000	11	\$1,172
2001	58	\$4,204
2002	88	\$6,393
2003	90	\$8,117
2004	108	\$15,318
2005	82	\$12,310
2006	80	\$17,966
2007	60	\$13,674
2008	62	\$11,623
2009	96	\$24,234
2010	100	\$25,604
2011	100	\$33,382
2012	114	\$36,965
2013	46	\$13,537

Source: NAREIT, as of 3/31/13

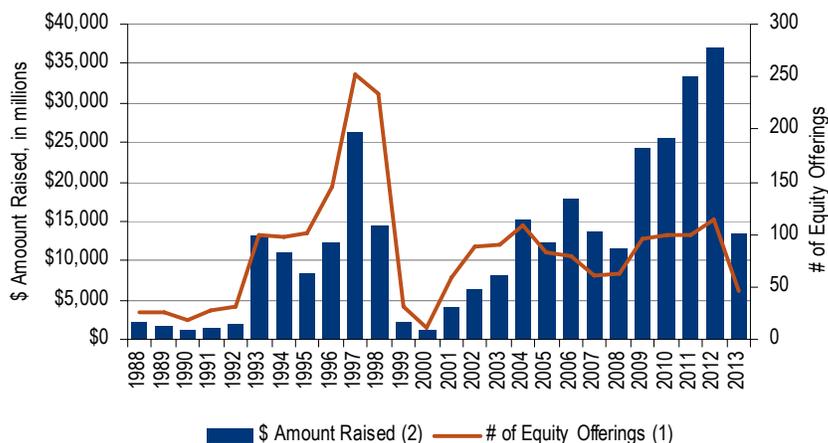
(1) Includes IPOs and secondary offerings

(2) Prior to 1997, secondary figures include preferred stock deals.

Equity raises

As can be seen in Chart 3 and Table 2, the first wave of equity offerings occurred in the 1990s. There was another spike in 2009, as many REITs tapped the equity markets in order to repair their balance sheets amid a global credit crunch. This was followed by further equity issuance in 2010. The year 2012 was a landmark year as the equity issuances by REITs' peaked in 2012 at nearly \$37 billion, including both secondaries and IPOs. 2013 is on track to be another strong year of issuances, with \$13.5 billion raised as of 3/31/13.

Chart 5: Number of equity offerings and amount raised by REITs, in millions



Source: NAREIT, as of 3/28/13 (1) Includes IPOs and secondary offerings; (2) Prior to 1997, secondary figures include preferred stock deals.

M&A Activity

In addition to equity raises, the REIT industry has also seen a number of mergers and acquisitions. Over the last 10 years, there have been almost 110 M&A deals. The period 2006-2007 saw a wave of privatization of REITs, with 34 public-to-private transactions worth a total of \$122.5 billion, according to NAREIT. Transactional activity peaked in 2007 and then fell off dramatically in 2008 and 2009, as capital was difficult to come by.

Table 3: Historical deal statistics

Year	Aggregate Deal Value (\$M)	Number of Deals
2000	\$9,007.6	9
2001	\$10,762.2	11
2002	\$2,316.3	7
2003	\$3,383.0	8
2004	\$20,722.9	13
2005	\$25,647.1	16
2006	\$65,357.5	26
2007	\$73,232.5	26
2008	\$523.9	2
2009	\$1,756.3	2
2010	\$5,078.4	4
2011	\$14,695.8	4
2012	\$7,344.6	7
2013 YTD	\$1,512.8	1

Source: SNL, BofA Merrill Lynch Global Research

Note: Aggregate deal value calculated by SNL as of 4/16/2013; does not include assumed debt

However, activity started picking up again in 2010 and gained strength through 2011 & 2012 with big public-to-public transactions being announced namely, AMB & PLD merger of equals and VTR's acquisition of NHP & VTR's acquisition of CSA (completed in April 2012).

Synergies are realistic and achievable in the CRE space, and for the smaller companies, the costs of being a public company makes it difficult to justify the advantage of access to the capital markets. The key variable is whether or not opportunities on the private side exist for the public REITs to acquire. In our view, larger REITs could pursue the smaller REITs if opportunities do not emerge on the private side.

Table 4: REITs in the S&P 500 as of 3/28/13

Entry Date	Ticker	Market Cap	% of S&P
6/25/2002	SPG	49,160.9	0.34%
NA	AMT	30,391.3	0.21%
8/18/2005	PSA	27,433.6	0.19%
11/1/2001	EQR	19,817.8	0.14%
7/16/2003	PLD	18,486.0	0.13%
3/4/2009	VTR	21,370.3	0.15%
3/31/2008	HCP	22,605.5	0.16%
8/11/2005	VNO	15,618.5	0.11%
3/31/2006	BXP	15,324.7	0.11%
1/9/2007	AVB	16,377.7	0.11%
NA	WY	17,111.3	0.12%
1/30/2009	HCN	17,742.1	0.12%
3/19/2007	HST	12,709.9	0.09%
4/3/2006	KIM	9,136.6	0.06%
1/16/2006	PCL	8,473.5	0.06%
3/31/2003	AIV	4,470.9	0.03%

Source: NAREIT, Bloomberg, BofA Merrill Lynch Global Research

REITs in major indices

As time has passed, REITs have been increasingly accepted as an asset class. This is evidenced by their inclusion in major indexes. The first REIT to be added to the S&P 500 index was Equity Residential in 2001. Today, there are 16 REITs in the S&P 500 index.

There are 29 REITs in the S&P 400 Mid Cap index and 29 REITs in the S&P 600 Small Cap index.

On 3/16/12, Simon Property Group (SPG) was added to the S&P 100 index. SPG is the first REIT to be included in this index.

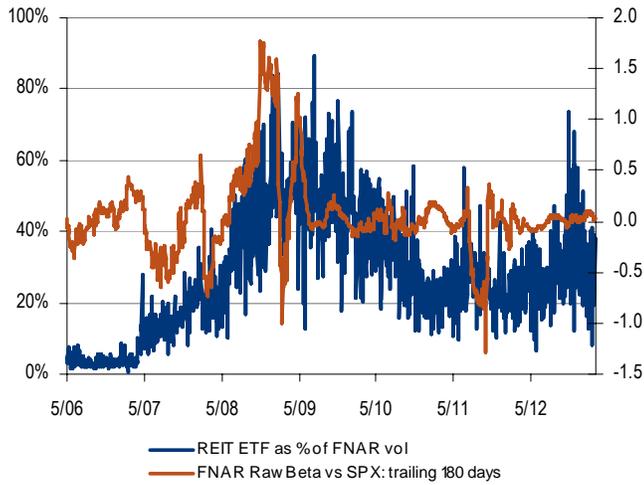
REIT ETFs

As REITs were added to the S&P 500, increasing more ETF baskets included REITs, as well as the increased creation of REIT ETFs. This is evident in the increase REIT ETF volumes over the recent years, as well as REIT ETF volumes as a percentage of total REIT volumes.

In the SPDR S&P 500 ETF, the SPDR S&P 500 Financials ETF and the iShares Russell 2000 ETF, REITs currently weigh in at 1.8%, 13.8% and 8.7%, respectively. Based on the daily fund flows of these three ETFs, along with the Vanguard REIT ETF and the iShares DJ Real Estate Index ETF, our BofAML small-cap strategist estimates \$145 million dollars of daily REIT volume from these five ETFs.

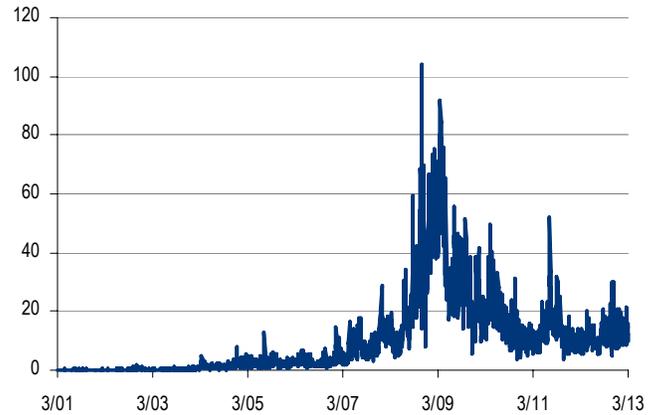
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Chart 6: REIT ETF volume share and trailing 6 mo. FNAR beta



Source: Bloomberg; FNAR: FTSE NAREIT ALL REITS index

Chart 7: Total REIT ETF share volume (in millions)

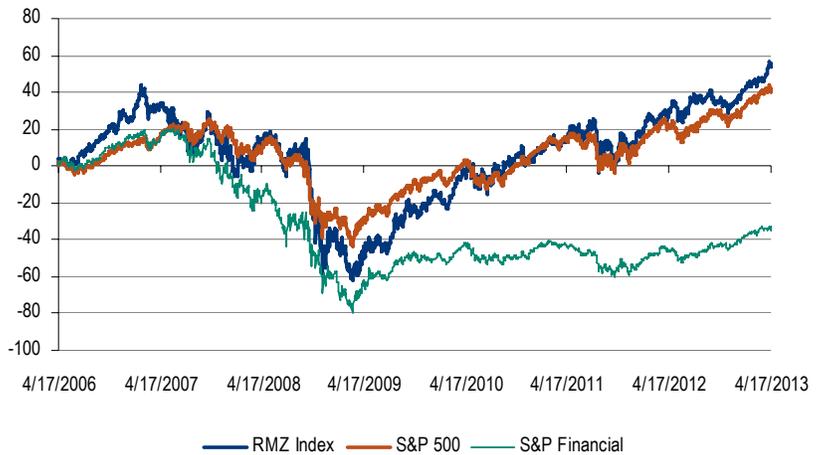


Source: Bloomberg, BofA Merrill Lynch Global research

REITs are considered Financials now

Today, REITs are generally included within the larger financials sector. As shown in the chart below, REIT returns were moving with the S&P Financials during the 2006-09 period but have moved away from the S&P Financials since 2009 and are more in sync with S&P 500 returns.

Chart 8: Comparison of total return values



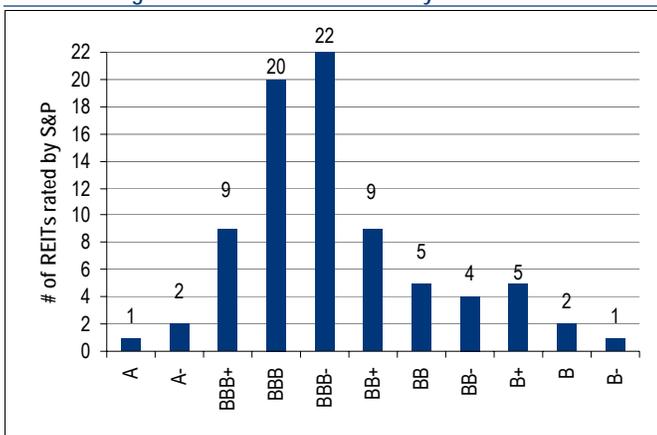
Source: Bloomberg, BofA Merrill Lynch Global Research

REITs rated by rating agencies

Rating agencies like S&P, Moody's & Fitch rate REITs based on multiple criteria which includes debt coverage ratios, fixed cost coverage ratios, company size, diversity of portfolio, management capabilities, etc. As of April 17, 2013, S&P had ratings on 80 publicly traded REITs, Moody's had ratings on 73 and Fitch had ratings on 41 publicly traded REITs.

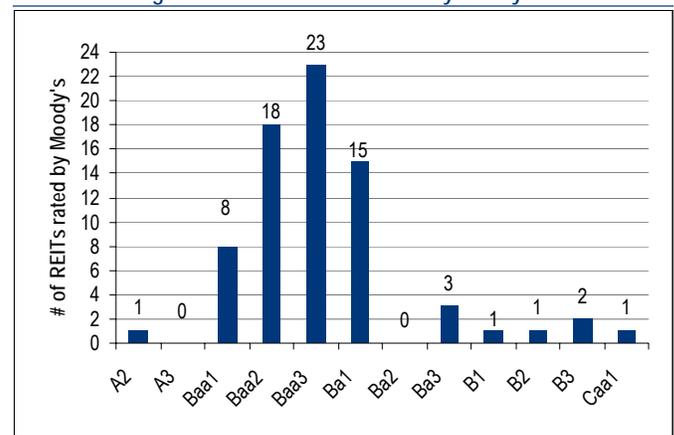
The charts below shows the number and ratings of S&P rated, Moody's rated, and Fitch rated REITs. For S&P, A to BBB- implies investment grade. BB+ and below implies speculative grade. The majority of the S&P rated REITs (54 out of 80) fall in the investment grade category. For Moody's ratings, Aaaa to Baa3 ratings are considered investment grade (currently 50 REITs out of 73). For Fitch ratings, AAA to BBB ratings are considered investment grade (34 out of 41).

Chart 9: Ratings distribution of REITs rated by S&P



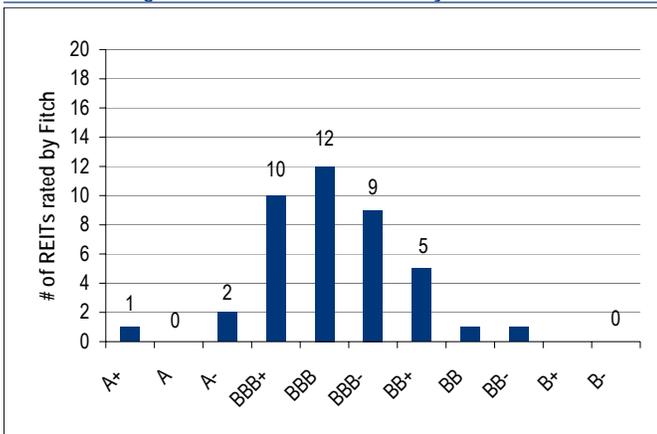
Source: SNL, BofA Merrill Lynch Global Research

Chart 10: Ratings distribution of REITs rated by Moody's



Source: SNL, BofA Merrill Lynch Global Research

Chart 11: Ratings distribution of REITs rated by Fitch



Source: SNL, BofA Merrill Lynch Global Research

Structural changes of REITs over time

Prior to 1986, REITs used to be just owners of real estate assets. Today, most REITs follow an active, hands-on, owner-and-operator model. Business models now have room for growth through acquiring, developing, and managing real estate as well as through ancillary businesses.

1986: REITs can integrate property management into their business

Tax Reform Act of 1986

The tax reform act of 1986 allowed REITs to integrate property management into the organization. Prior to this act, REITs were legally required to source property management to outside companies.

1991: Kimco's IPO paved the way for many REITs to tap the public market

The Modern REIT Era - Kimco leads the way

In November 1991, the REIT era as we know it started when Kimco Realty (KIM) completed its IPO by raising \$128 million of capital through the issuance of 6.4 million shares. Thirteen months later, Taubman Centers (TCO) completed its IPO and transformed the securitization of the real estate industry by utilizing a new structure known as an Umbrella Partnership REIT (UPREIT).

1990s: New REIT structures are formed - the UPREIT and the DownREIT

UPREIT and DownREIT

Created by investment bankers in the early 1990s, these two new structures allowed real estate operating companies to place assets into a REIT structure in a tax-free manner. In an UPREIT, the founders of the company contribute assets to the REIT in return for operating partnership (OP) units while public shareholders receive traditional common stock as part of the IPO.

OP units are convertible into common stock on a 1:1 basis

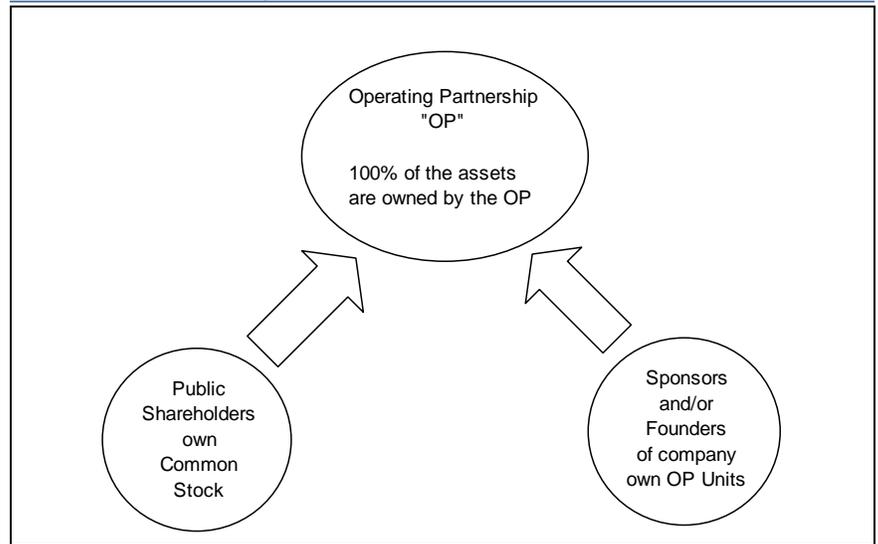
From an economic standpoint, OP units and common stock are equivalent as the OP units are convertible into common stock, usually on a 1:1 basis after a certain period of time. Dividends paid are the same on the OP units and the common stock. The major difference is that OP units are not freely tradable and the holder of the OP units will face a taxable transaction if and when they sell their OP units.

If the REIT decides to sell the properties, a taxable event would occur for OP unit holders (original owners of the properties) in an UPREIT structure

One issue with the UPREIT structure is that the founders of the REIT (the original owners of the assets and now owners of OP units) have a different tax basis for their units or shares than the shareholders. This creates a potential conflict of interest as the OP unit holders (often members of management) would not want the REIT to sell their properties, as a sale would create a taxable event.

A DownREIT is similar to an UPREIT but is generally created when the REIT is already a public company and owns and operates separate properties in addition to the controlled partnership's properties.

Chart 12: UPREIT ownership structure



Source: BofA Merrill Lynch Global Research

The creation of these new structures paved the way for a number of IPOs (the IPO boom of 1991-1998). This wave of IPOs increased the attractiveness of REITs, as it enhanced liquidity, provided investors with greater transparency, and gave REITs access to more capital with which to grow.

The REIT Modernization Act

In 2001, the REIT Modernization Act went into effect, which allowed the formation of taxable REIT subsidiaries (TRS). A TRS, which is taxed at the corporate level, can engage in non-rental, ancillary business activities, such as property management, leasing, or merchant development. All of these activities contribute to a REIT's earnings. A REIT can own 100% of the stock of a TRS.

2001: REITs can boost earnings through taxable REIT subsidiaries (TRS)

REIT returns

The return profile for REITs exhibits characteristics of both equities and bonds. Through the lease structure, REITs receive a steady stream of income, like bonds. However, about 10-20% of leases come due each year and rents are marked to market, which allows REITs to take part in the economic cycle. In addition, REITs experience earnings growth, like an equity, through their various sources of growth (e.g. acquisitions, development, and redevelopment).

The return profile for REITs exhibits characteristics of both equities and bonds

For investors of REIT shares, an attractive total return offers both equity- and bond-like benefits. Investors can achieve gains (and losses) through both stock price appreciation as well as the dividend yield (dividends are discussed in further detail on p. 31). However, REITs can also experience the downside of equity-like returns, as they did in 2007 and 2008, and macro-driven volatility, as they did in 2010-2012.

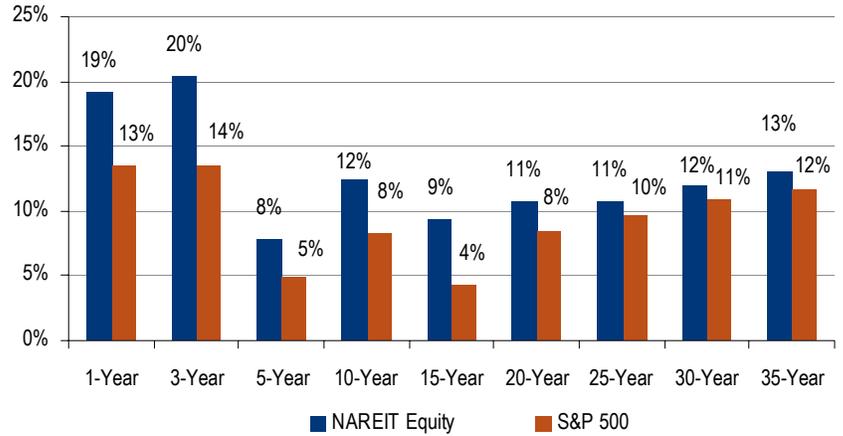
The total return profile of REIT stocks includes stock price appreciation as well as the dividend yield

Historical performance of REIT shares

Many investors have historically viewed real estate as a slow growth asset class with limited return potential. Chart 5 shows that REITs outperformed the broader market over the 10-year, 15-year, and 20-year periods of time. The sector underperformed broader market indices beginning in 2007, as REIT shares were more greatly impacted by the global recession and credit crunch. However, REITs bounced back strongly over 2010 and 2011 (depicted by the strong 3-year return)

as more investors were looking for safety and dividends. Over the past 1-year and 3-year period, uncertainty has been persistent in the market with respect to policy decisions, Eurozone crisis and other macro factors. However, the REITs have still fared better with a 19% return over the past 1-year vs 13% return of S&P 500 as of 2/28/13.

Chart 13: Historical compound annual total returns of REITs vs. S&P 500 (1) as of 2/28/13



Source: NAREIT, BofA Merrill Lynch Global Research; as of 2/28/13

(1) All return periods are run through 2/28/2013; using the FTSE NAREIT Equity REIT index

Funds from operations (FFO)

This section addresses many accounting issues impacting REITs including:

- Definition of funds from operations (FFO) and explanation of how it differs from GAAP net income
- The difference between reported and “normalized” FFO
- The purpose and definition of adjusted funds from operations (AFFO)

Fund from operations, or FFO, is the standard reporting measure of operating performance for the REIT industry

In 1991, NAREIT adopted a definition of funds from operations (FFO) as a supplemental industry-wide standard measure of REIT operating performance that would not have certain drawbacks associated with net income under generally accepted accounting principles (“GAAP”). The definition was clarified in 1995, 1999 and 2002. Today, FFO represents the industry’s key earnings metric.

Table 5: Net income to FFO

GAAP Net Income (including any impairment charges)

- Minus gains from sales of property

+ Plus losses from sales of property

+ Plus Impairment charges

+ Plus real estate depreciation & amortization
(including pro rata share of unconsolidated joint venture net income & depreciation)

= FFO

Source: NAREIT, BofA Merrill Lynch Global Research

Depreciation and amortization are added back to GAAP net income to get to FFO

Real estate depreciation & amortization

Although GAAP treats real estate depreciation as an expense, real estate values have historically not eroded over time because of increasing land costs and higher replacement costs. Therefore, operating results for real estate companies that use GAAP historical cost accounting can be misleading. The term funds from operations was created to address this problem and essentially excludes (adds back) historical cost depreciation from GAAP net income. Since the introduction of the term, FFO has become widely used by REITs and is useful in determining the operating results of REITs as well as comparing results between REITs.

In 2012, NAREIT announced that SEC is now neutral to exclusion of impairment charges to calculate FFO. REITs have now started adding back impairment charges in their FFO calculation.

Impairment charges

Until 2004, REITs added back impairment losses to FFO, which in essence, were just an early recognition of a loss on a sale. Initially, this add-back made intuitive sense, since gains and losses on real estate were also excluded from FFO. In 2004, NAREIT issued further guidance on reporting FFO based on SEC discussions and clarified impairment write-downs should not be excluded from FFO. However, in 2012, NAREIT announced that SEC is now neutral to exclusion of impairment charges to calculate FFO. REITs have now started adding back impairment losses in their FFO calculation, even though they must exclude gains on sale and are permitted to exclude the loss on a sale - which is identical to an impairment loss except in the timing of the event.

Normalized FFO adds back non-recurring items to reported FFO in order to get a recurring FFO figure

Non-recurring items are often one-time expenses or non-cash items that are not part of the normal operations of the company

However, a trend has emerged for companies to adjust for non-recurring items and provide results and guidance based off of these adjustments

Street estimates can vary based on the inclusion or exclusion of non-recurring items

FFO/share

FFO per share is derived by dividing FFO by the weighted average of fully diluted shares and units. We also call this reported FFO per share.

Normalized funds from operations

While most REITs adhere to the strict definition of FFO when disseminating their quarterly and annual results (known as “reported FFO”), this figure can provide a distorted view of the company’s underlying fundamentals as it includes non-cash charges and non-recurring items. A normalized FFO figure removes these non-recurring items, thereby providing investors with a clearer picture of a company’s recurring earnings power.

Table 6: Reported FFO to Normalized FFO

Reported FFO

+ Plus topic D-42 charges

+ Add back non-recurring items

= Normalized FFO

Source: NAREIT, BofA Merrill Lynch Global Research

Topic D-42 charges

This charge occurs when a company redeems an existing series of preferred stock outstanding. As part of the redemption process, a company must “write off” the original issuance cost related to the preferred stock that the REIT capitalized onto the balance sheet at the time of the offering. Since this charge is non-cash in nature (the underwriting fees were spent several years ago), we believe it distorts a company’s true earnings power.

Non-recurring items

We also add back (or deduct) other non-recurring items to get to normalized FFO. Common examples are: one-time acquisition/deal costs that were expensed, gains or losses from early extinguishments of debt and foreign currency exchange gains or losses.

To adjust for non-recurring items, companies have started providing multiple sets of guidance ranges, namely reported/actual FFO and an alternative FFO measure (sometimes called “normalized” or “as adjusted”). To add to the confusion, Street estimates vary regarding which guidance range their estimate is based off of, creating a meaningless consensus average value. Investors should take care to determine whether results/guidance for these companies actually meet or miss Street expectations. See our report [Tackling the problem of "alternative FFO" reporting](#) for more details.

Adjusted funds from operations

Although FFO is a starting point for measuring a REIT’s profitability over time, it tends to overstate a REIT’s profitability. Therefore, further adjustments should be made to FFO in order to better determine a REIT’s true cash flow. The resulting measure, adjusted funds from operations (AFFO), is also known as cash available for distribution (CAD) or funds available for distribution (FAD).

Adjusted funds from operations (FFO) is also known as cash available for distribution (CAD) or funds available for distribution (FAD)

AFFO is a better proxy of a REIT's available cash flow than FFO

Table 7 highlights the three deductions we take from FFO in order to arrive at AFFO. We note there is no GAAP definition or universally accepted method of calculation for AFFO.

Table 7: FFO to AFFO

Reported FFO

- Minus recurring capital expenditures

+/- Adjust for straight-line rent

+/- Adjust for FAS 141/142/143 income

= AFFO

Source: NAREIT, BofA Merrill Lynch Global Research

Recurring capital expenditures

Recurring capex expenses are used to maintain the value of the building (rather than enhance the value). These costs are capitalized and then depreciated, which means they are overlooked when measuring "earnings" for REITs since depreciation is added back to net income in deriving FFO. Since we view recurring capex as an economic expense (accounting treatment notwithstanding), we deduct recurring capex from each company's FFO, so as better to arrive at a company's "true" cash earnings. We identify three types of recurring capital expenditures:

Three kinds of recurring cap-ex are:

1. Capitalized maintenance
2. Tenant improvements (TI)
3. Leasing costs

- **Capitalized maintenance:** Capitalized maintenance capex are routine expenditures that do not really enhance the value of a property but are necessary to maintain the property. Examples include painting the parking lot of a shopping center, or routinely replacing the roofs, appliances, and carpets in an apartment building.
- **Tenant improvements (TI):** Tenant improvement (TI) allowances are given to tenants to build out the rental space to suit their needs. The amount of TI is determined during lease negotiations and is generally found in leases for office and retail properties. Since TI varies by tenant (and has limited re-sale value), the build-out does not necessarily contribute to the property's value.
- **Leasing costs:** Leasing costs are commissions paid to brokers for leasing the space. These costs are capitalized and amortized over the life of the lease rather than expensed at once.

Recurring capital expenditures is obtained from information directly reported by REITs or extracted from various sections of financial disclosures.

Table 8: Straight-line rent calculation

	Cash Rents	St.-Lined Rents (1)	St.-Lined Rent Adjustment
Year 1	\$40	\$45	(\$5)
Year 2	\$45	\$45	\$0
Year 3	\$50	\$45	\$5
Total Collections	\$135	\$135	\$0

Source: BofA Merrill Lynch Global Research

(1) Equal to the average of the cash rents over 3 years.

To get to AFFO, we make adjustments to reflect above/below market rent

Straight-line rent adjustment

Non-cash revenue known as straight-line rent occurs when a landlord enters into a long-term lease with a tenant and the lease contains contractual rent increases over the life of the lease. Based on GAAP accounting, the company must “straight-line” the entire revenue stream over the term of the lease rather than recognize revenue as the cash is collected each period. Table 8 provides an example of how a lease (with contractual step-ups) overstates the actual cash collected during the early portion of the lease and understates the cash collected during the later part of the lease.

FAS 141/142/143 adjustments

Financial Accounting Standards (FAS) 141 requires a company to “value the existing leases” on a newly acquired asset. While the actual mechanics of this calculation are complicated, the basic idea is that a company needs to determine whether the existing leases within a newly acquired building are above or below the current market rent and then record that difference on the balance sheet and amortize that figure (whether positive or negative) into revenue over the life of the remaining lease term.

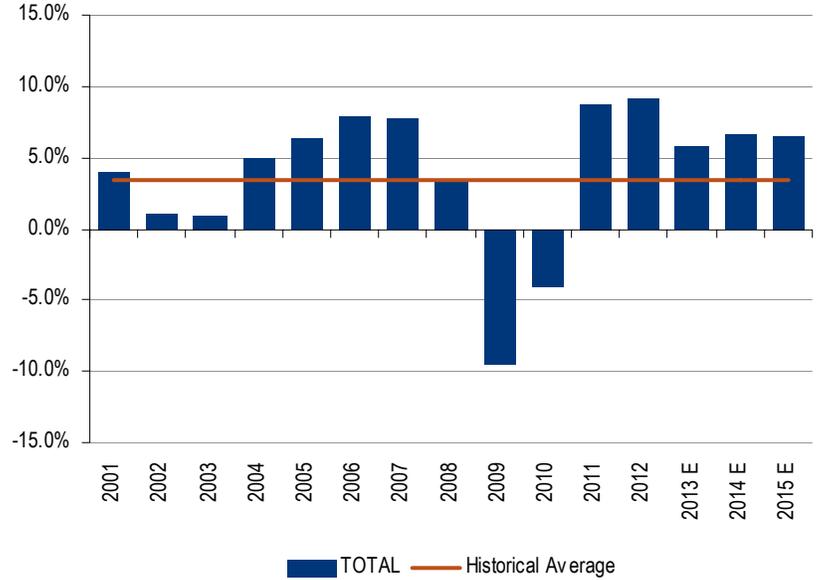
All REITs disclose FAS 141 (sometimes called “above/below rents”), while FAS 142 and 143 are less commonly reported. FAS 142 relates to accounting for goodwill and other intangible assets upon acquisition, and FAS 143 relates to the retirement of tangible long-lived assets and the associated retirement costs of such assets.

Historical normalized FFO/share growth

Chart 14: Normalized FFO/share growth – All REITs under coverage by BofAML REIT team

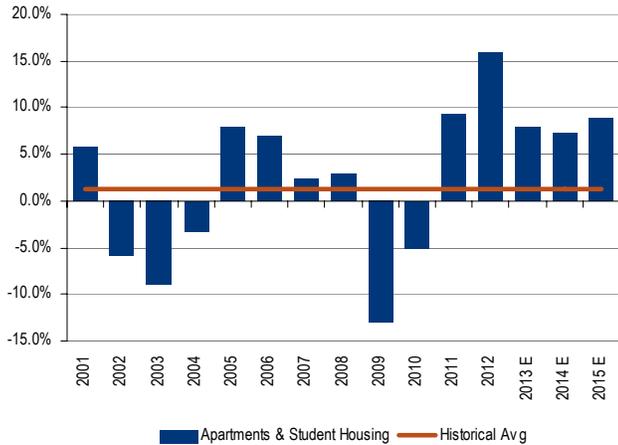
REITs saw Normalized FFO/share grow in 2011 and even stronger in 2012 after witnessing a fall in 2009 and 2010 following the downturn

We expect positive but lower growth in 2013



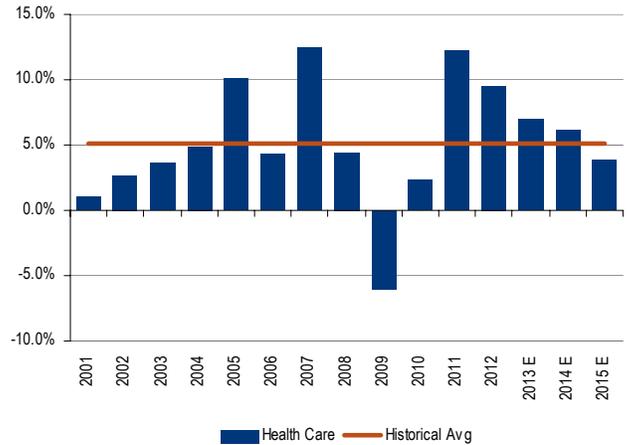
Source: SNL, BofA Merrill Lynch Global Research; Note: Excludes lodging REITs and mortgage REITs covered by other teams at BofA Merrill Lynch

Chart 15: Apartments & Student Housing - Normalized FFO/sh growth



Source: SNL, BofA Merrill Lynch Global Research

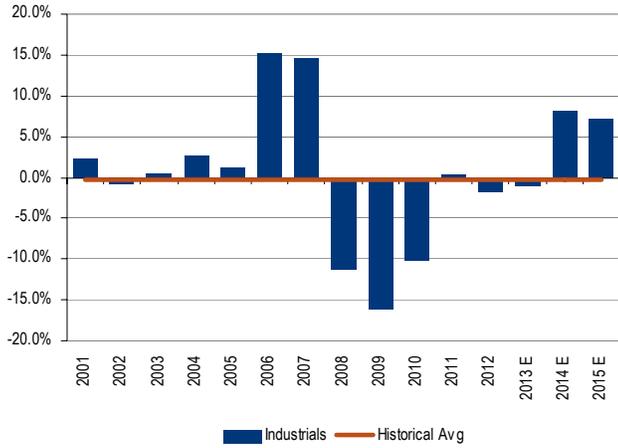
Chart 16: Health Care - Normalized FFO/sh growth



Source: SNL, BofA Merrill Lynch Global Research

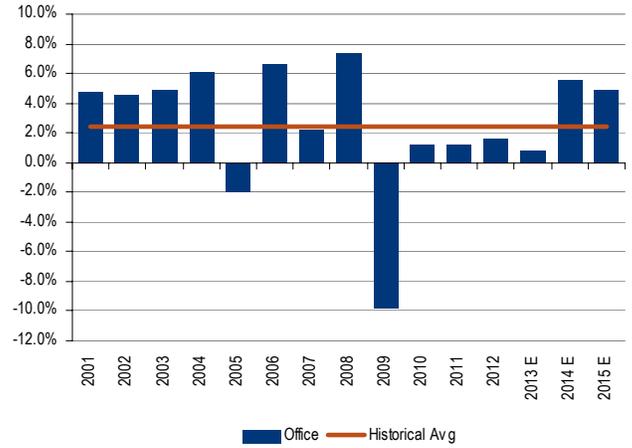
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Chart 17: Industrial/Mixed - Normalized FFO/sh growth



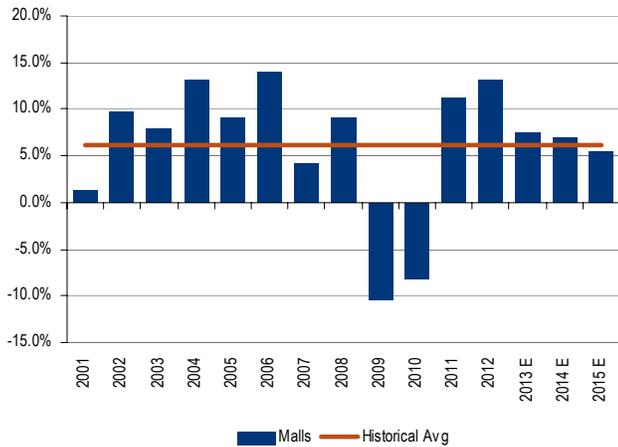
Source: SNL, BofA Merrill Lynch Global Research

Chart 18: Office - Normalized FFO/share growth



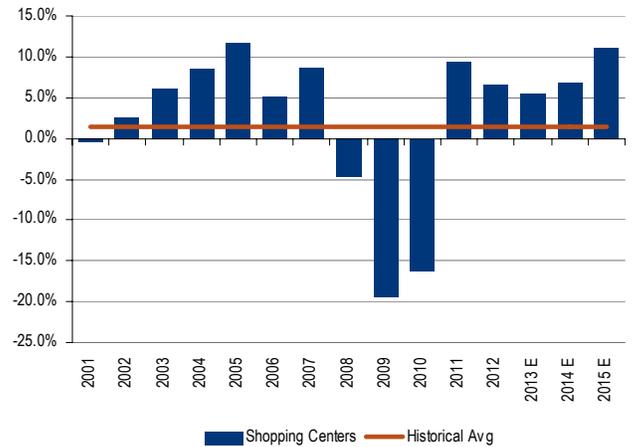
Source: SNL, BofA Merrill Lynch Global Research

Chart 19: Malls - Normalized FFO/sh growth



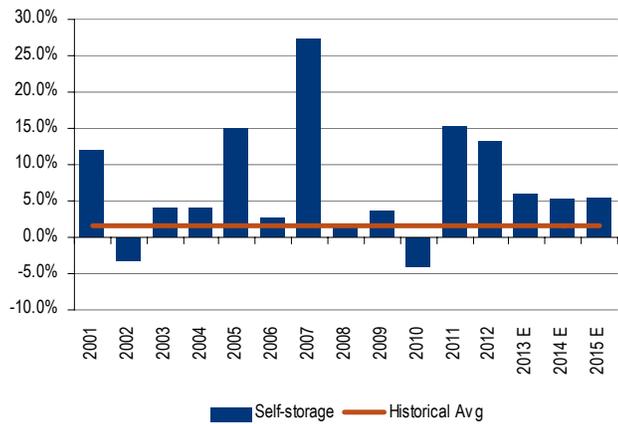
Source: SNL, BofA Merrill Lynch Global Research

Chart 20: Shopping Center - Normalized FFO/sh growth



Source: SNL, BofA Merrill Lynch Global Research

Chart 21: Self Storage - Normalized FFO/sh growth



Source: SNL, BofA Merrill Lynch Global Research

Net asset value (NAV)

One of the main valuation metrics for REITs is net asset value (NAV), which tries to determine the underlying value of a REIT.

Calculating NAV

Calculating the NAV is essentially an attempt to approximate the liquidation value of the underlying real estate, before the impact of taxes on property sales. NAVs are generally not disclosed in financial statements or reported by companies. Therefore, analysts and investors must estimate the market values of a REIT's assets and liabilities. Although differences between operating characteristics in various real estate sectors cause difficulties for developing a consistent framework for determining NAVs, the biggest challenge is determining the appropriate cap rate to use for each company's underlying real estate value (see p. 22 for a discussion of cap rates).

The BofAML REIT Team uses the following steps to calculate NAV estimates:

Step 1.

Determine forward 12-month cash net operating income (NOI)

Core NOI, or GAAP NOI, calculated by annualizing current quarter's result.

property level revenue, minus property level expenses and lease termination fees, plus acquisition income, plus annualized pro rata share of JV NOI, and adjustments for mid-period acquisitions, dispositions, and development coming on line. We may apply a seasonality factor or a forward growth rate, depending on the sector (e.g. malls exhibit seasonality).

The current period is chosen because buyers of real estate focus on the earnings potential of a property, not its past performance. Cap rates are forward looking and generally defined as a consequence of income over the next 12 months.

After removing annualized straight-line rent and FAS 141 from the core NOI, we add construction in process (CIP) rental income at the estimated development yield. Last, we deduct management fees and a capex reserve to reach net pro forma NOI.

Step 2.

Determine market value of assets by applying a cap rate

Divide the net pro forma NOI with the appropriate cap rate. A cap rate is simply the inverse of the cash flow multiple. For example, dividing the cash flow estimate by a 10% cap rate is the same as applying a 10x multiple to the cash flow. Dividing the company's forward NOI by the cap rate gives us an estimated market value of the company's properties. Various methods are used to determine the appropriate cap rate to use for each company, including market observations and running investor IRR hurdle models.

Step 3.

Determine value of third party income

Apply a cap rate to the third party income stream. After determining the cash flow produced from a company's ancillary businesses, we apply a cap rate to this income stream. Since management contracts are typically cancelable on short notice (often 30 days), we generally ascribe a lower valuation to fee income than to rental income.

Step 4.

Determine gross market value of assets

Add assets. After adding the results of steps 2 and 3 together, we then add cash and cash equivalents, other assets, land held for development (most apply a discount based on market conditions), value of unleased space, and existing development projects (valued at cost) to derive the gross market value of assets.

Step 5. Determine net market value of assets

Deduct liabilities. This includes wholly owned debt, other liabilities, pro rata share of JV debt, and preferred stock. The resulting estimate is our net asset value (NAV).

Step 6. Determine NAV per share

Divide the net asset value by the total number of fully diluted shares outstanding to derive net asset value per share.

Forward NAV

We calculate forward NAV (meaning one year out) by growing the core net operating income by our estimated internal growth rate for months 13-24. We can also apply different cap rate (if we expect a change) and any share issuance/buy backs that are expected. Future developments are also accounted for, as are potential acquisitions.

Calculating BofAML price objectives

In order to derive our price objectives, we apply a premium or discount (or neither) to our forward NAV estimates for each company. These premiums and discounts are generally based on our perception of expected earnings growth, balance sheet strength and quality of management teams.

Capitalization rates

Cap rates represent the initial yield on a real estate investment

Cap rate = first year NOI / purchase price

The capitalization rate, or cap rate, is the initial yield on a real estate investment. It is often used during acquisition/disposition discussions as a way to express the value of real estate. The cap rate is computed by taking the cash flow during Year 1 and dividing by either the acquisition price or the total expected development cost. The cap rate can refer to a singular asset or a portfolio of assets.

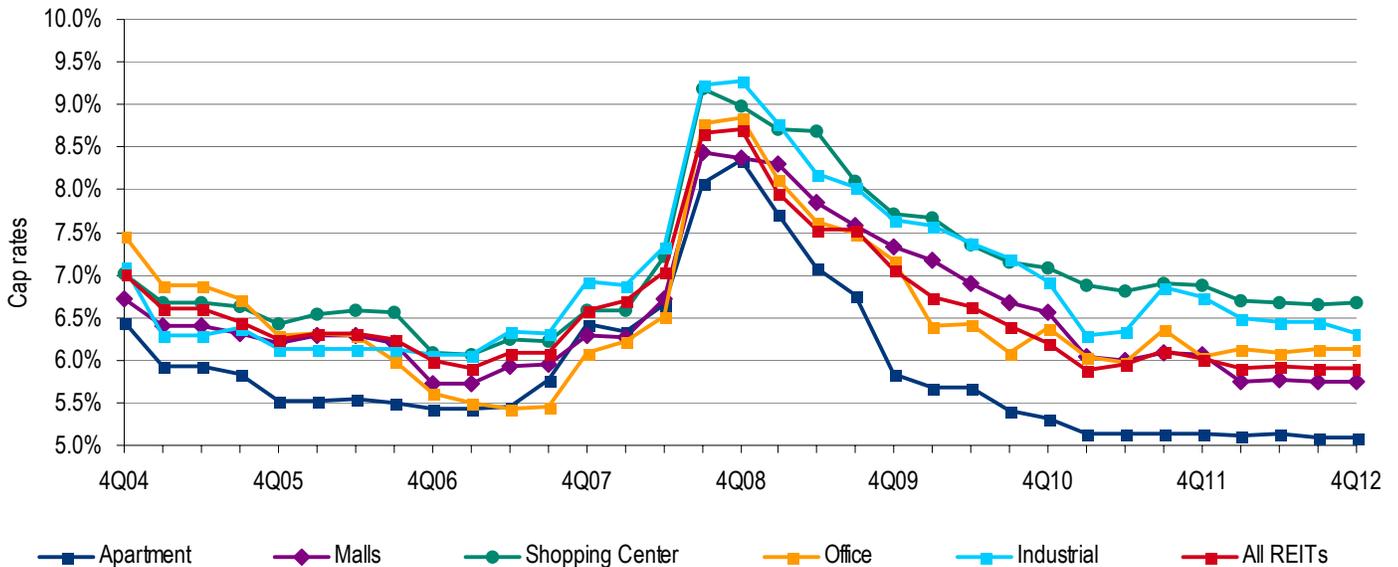
As an example, an 8% cap rate means the buyer of a property will receive \$8 of cash flow for every \$100 investment. Said differently, the buyer paid a multiple of 12.5x ($1 \div 8\% = 12.5x$) to acquire the asset. A buyer wants to purchase an asset at a high cap rate (meaning a lower purchase price), while a seller wants to sell the asset at a lower cap rate (and higher value).

A cap rate is applied to determine the market value of assets during the NAV calculation

Cap rates in NAV valuation

Estimating and applying the appropriate cap rate is particularly important in valuing REITs by NAV. The cap rates applied to NAV valuations are estimated and can be based on recent actual transactions or reverse engineered through investor return hurdles.

Chart 22: Historical BofAML cap rates in NAV valuation



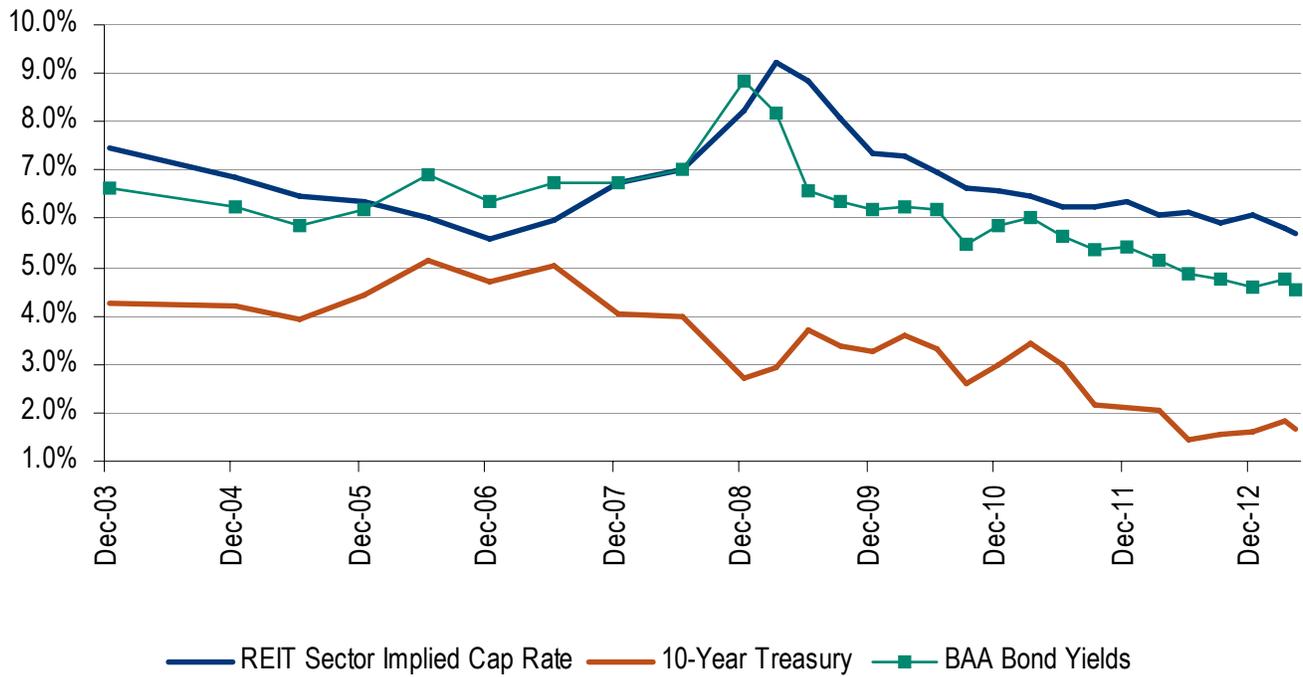
Source: BofA Merrill Lynch Global Research; as of 4/19/13

Implied cap rate = forward NOI / sum of equity market cap + NAV liabilities - NAV assets

Implied cap rates

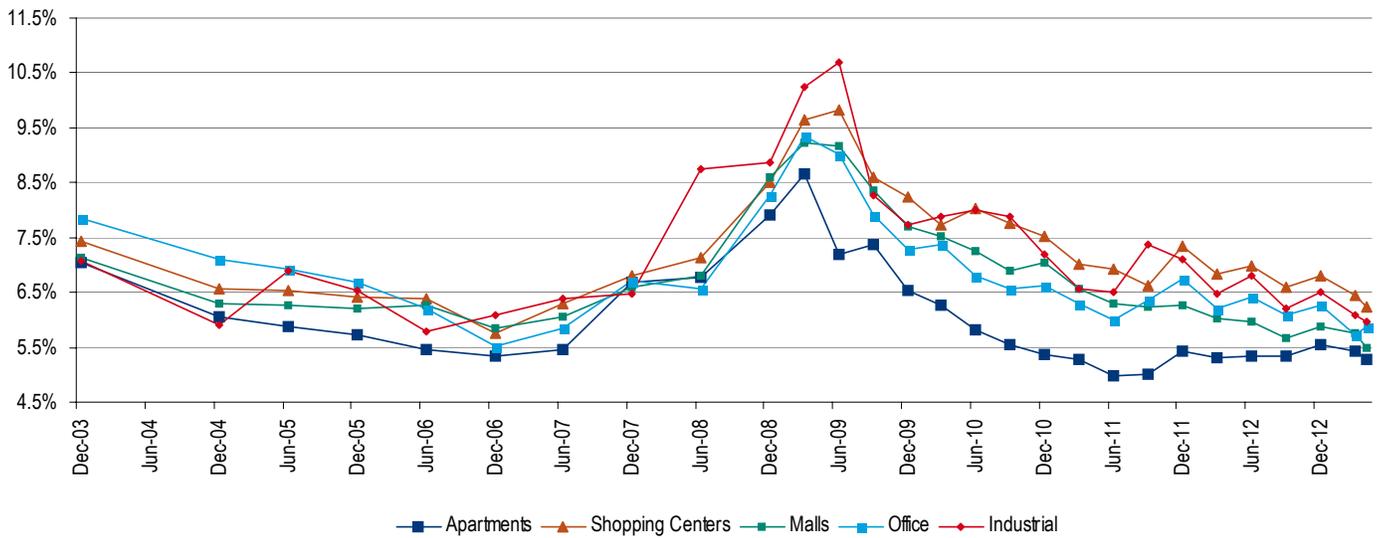
Cap rates can also be understood on an implied basis, which uses the current stock price to determine the real estate returns required by the capital market (investors). The implied cap rate is calculated by dividing the forward NOI estimate by the sum of equity market cap based on today's stock price, plus NAV liabilities minus NAV assets. Essentially, the NAV calculation works backwards based on today's stock price to determine the implied cap rate.

Chart 23: REIT implied cap rates



Source: FactSet, BofA Merrill Lynch Global Research; as of 4/19/13

Chart 24: Historical implied cap rates for selected asset classes



Source: FactSet, BofA Merrill Lynch Global Research; as of 4/19/13

Valuation

Unlike traditional companies, which are valued on EPS or book value, REITs are valued under different criteria including FFO, AFFO, and NAV (see previous section for a complete discussion of these metrics). The reason we use these metrics is that real estate is purchased in the private sector based on cash flow streams from the asset, not on GAAP earnings or historical book values. As a result, several metrics were created to evaluate REITs in the early 1990s. In the following sections we outline the valuation metrics and provide historical time series to show how the REIT sector has traded over the past 10+ years.

We use the following valuation methods:

- Price-to-FFO
- Price-to-NAV
- Yield spreads
- Direct real estate pricing
- Implied cap rates
- Dividend Discount Model & FFO multiple

The valuation metrics we look at are price-to-FFO, price-to-forward NAV, yield spreads, and implied cap rates. We also consider the trends of direct real estate pricing in the overall commercial real estate market, as REITs make up only about 15% of the institutionally owned commercial real estate market and 5-10% of all commercial real estate.

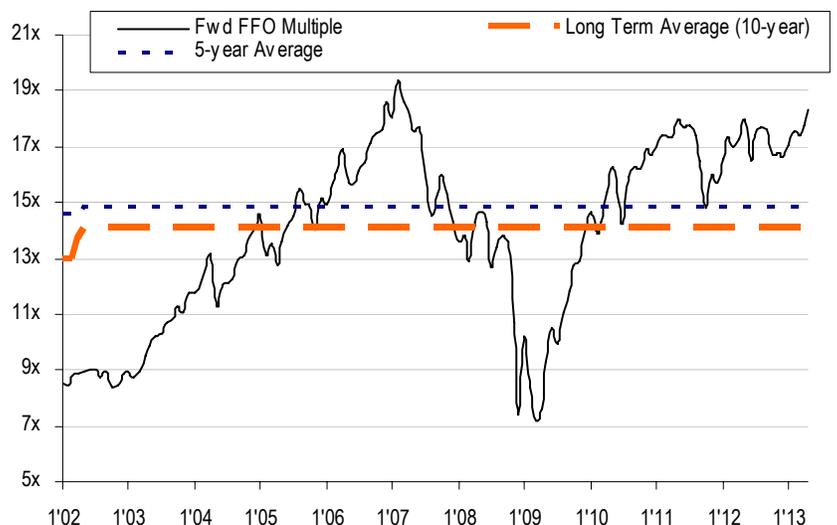
Price-to-FFO

Price-to-FFO (or FFOx) is analogous to the price-to-earnings (P/E) ratio in other industries. FFOx is the most widely used ratio for valuation purposes, as FFO is the main earnings metric for REITs.

Lease termination fees and non-recurring items (both included in FFO) can skew results, so we recommend using P/FFO in conjunction with other valuation methods. Normalized FFO or AFFO may provide better approximations of a company's true cash flow, but calculations can vary among investors and analysts.

As shown in the Chart 25, REITs are currently trading at a forward FFO multiple of around 18.3x, above the long-term (10-year) average of 14.1x and 5-year average of 14.9x (as of 4/18/13).

Chart 25: Historical price-to-FFO multiples



Source: BofA Merrill Lynch Global Research; as of 4/18/13

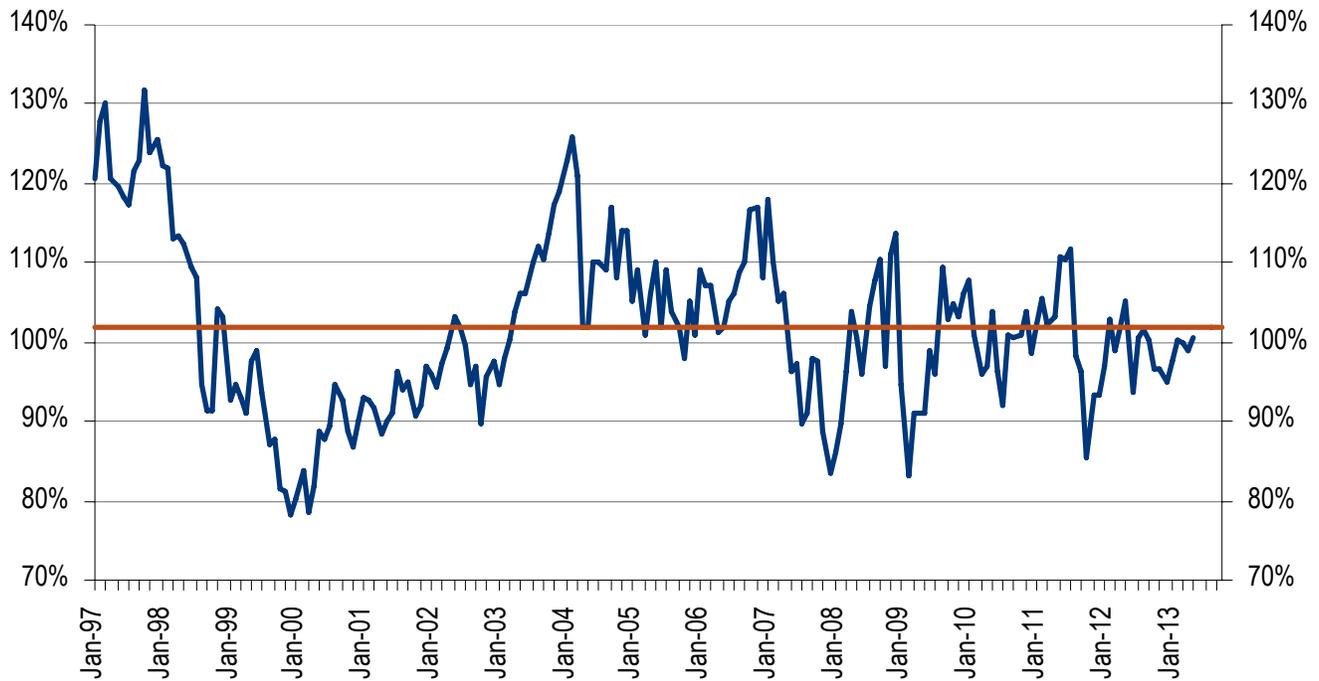
Price-to-forward NAV

Comparing price-to-NAVs for REITs is similar to using price-to-book ratios to evaluate other public companies. Price-to-book ratios are not a useful tool when evaluating REITs because book value is based on historical costs and does not reflect the rise and fall of property prices and land values. Therefore, we use NAVs as a surrogate for the underlying value of REITs.

Price/NAV calculations generally use an estimate of the company's forward NAV. This forward NAV metric is useful because expected NAV growth may explain why one REIT trades at a higher premium to NAV versus another REIT. In general, REITs with higher NAV growth should trade at larger premiums to their current NAV and vice versa. If this relationship is inconsistent when comparing two REITs or a group of REITs, then it may provide an opportunity to identify expected outperformance for a REIT or group of REITs.

As shown in Chart 26 and Table 9, REITs are currently trading at a price to forward NAV of 101%, slightly below the long-term (10-year) average of 102% (as of 5/1/12).

Chart 26: Historical price-to-NAV



Source: BofA Merrill Lynch Global Research; as of 5/1/13

Table 9: Market cap weighted price-to-NAV for selected asset classes

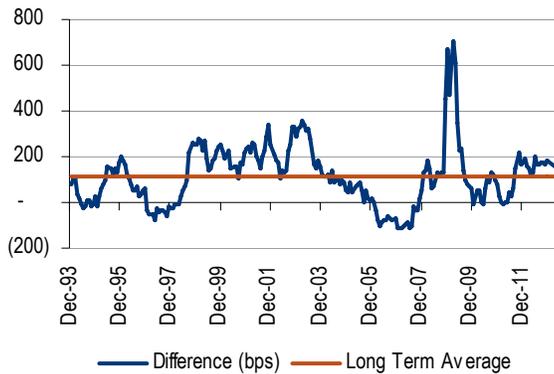
	Total REITs	Apartments	Shopping Centers	Regional Malls	Office (1)	Industrial	Self Storage
Dec-97	126%	114%	127%	105%	140%	139%	128%
Dec-98	103%	98%	94%	107%	106%	101%	108%
Dec-99	78%	85%	67%	75%	76%	80%	79%
Dec-00	90%	97%	92%	78%	97%	97%	79%
Dec-01	97%	105%	114%	95%	97%	92%	104%
Dec-02	98%	91%	109%	110%	87%	98%	99%
Dec-03	119%	111%	121%	133%	112%	119%	113%
Dec-04	114%	112%	118%	114%	111%	122%	113%
Dec-05	101%	100%	106%	101%	99%	101%	108%
Dec-06	108%	107%	114%	102%	107%	114%	108%
Dec-07	83%	78%	87%	81%	75%	98%	90%
Dec-08	114%	108%	115%	94%	114%	113%	150%
Dec-09	106%	107%	105%	106%	104%	109%	108%
Mar-10	96%	96%	100%	95%	94%	67%	102%
Jun-10	96%	95%	92%	96%	99%	91%	103%
Sep-10	101%	101%	97%	100%	100%	97%	111%
Dec-10	99%	102%	96%	101%	96%	102%	103%
Mar-11	102%	101%	102%	100%	100%	108%	106%
Jun-11	110%	120%	104%	108%	106%	115%	115%
Sep-11	96%	104%	96%	96%	101%	89%	102%
Dec-11	93%	92%	90%	95%	90%	91%	105%
Mar-12	99%	94%	100%	97%	100%	103%	104%
Jun-12	94%	94%	94%	94%	93%	90%	95%
Sep-12	100%	94%	104%	102%	99%	105%	104%
Dec-12	95%	89%	98%	97%	94%	97%	101%
Mar-13	100%	91%	107%	100%	101%	102%	104%
Apr-13	102%	94%	109%	106%	96%	100%	106%

Source: BofA Merrill Lynch Global Research; (1) Price/NAV's for Aug-96 through Jun-02 are for the office/industrial sector; ; as of 4/19/13

Dividend yield spreads

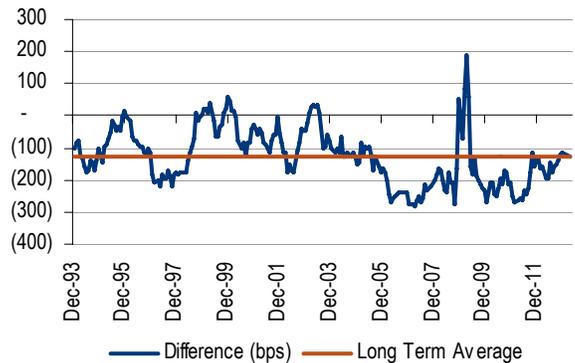
REIT dividend yields can be compared against the yields of other asset classes to determine relative value. We find it useful to look at the current and historical spread between the REIT dividend yields and the 10-year Treasury yield, the BAA corporate bond yield, the S&P 500 yield, and the S&P Utility yield.

Chart 27: REIT dividend yield vs. Treasury yield



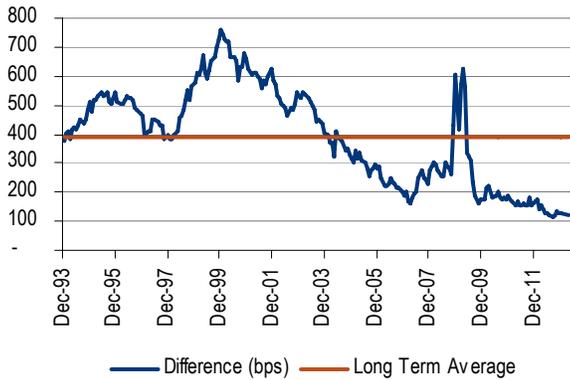
Source: FactSet, BofA Merrill Lynch Global Research; as of 4/19/13

Chart 28: REIT dividend yield vs. average US corporate BAA yield



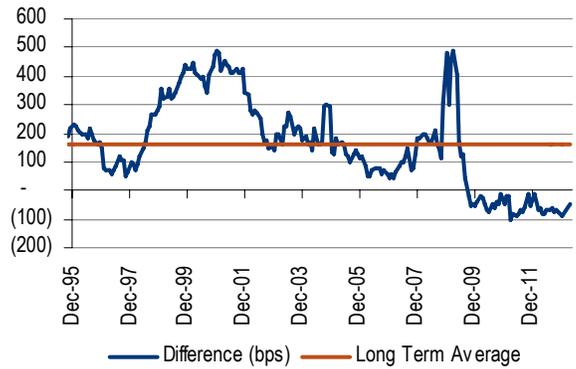
Source: FactSet, BofA Merrill Lynch Global Research; as of 4/19/13

Chart 29: REIT dividend yield vs. S&P 500 yield



Source: FactSet, BofA Merrill Lynch Global Research; as of 4/19/13

Chart 30: REIT dividend yield vs. S&P Utility yield



Source: FactSet, BofA Merrill Lynch Global Research; as of 4/19/13

Direct real estate pricing

REITs only make up about 15% of institutionally owned commercial real estate. Therefore, much of the transactional activity that occurs in the overall commercial real estate market can impact REIT returns and performance. Direct property values can be derived by examining their: (1) cap rates, or initial yield on a property (see p. 22 for a discussion of cap rates); (2) replacement value, which represents the cost to replace an asset; and (3) repositioning potential, which signifies the value the property could obtain if it were converted to a more productive use.

In 2008 and 2009, transactional activity slowed dramatically, making it difficult to use transactional data to determine the appropriate cap rate. Transactional activity picked up in 2010 and 2011 but was far less than the amount of activity witnessed in 2006 and 2007. Year-to-date 2012 has seen more activity than the same period in 2011.

Chart 31: Total historical real estate transactions



Source: Real Capital Analytics, BofA Merrill Lynch Global Research, As of 3/31/13

Implied cap rates give a good indication of where the market is valuing a particular stock or sector

NAV approach is problematic for asset classes that have higher cap rates than traditional real estate sectors

The dividend discount model (DDM) captures the long-term view through predicting future dividends and discounting them back to present value

The FFOx multiple approach captures the one-year forward short-term view

Implied cap rates

Another valuation tool is looking at the implied cap rates of stocks and sectors, which fluctuates based on market cap. The implied cap rate lets us know where the market is valuing a particular company or sector. It is calculated by taking the forward NOI estimate, and then dividing by the sum of the current equity market cap, plus NAV liabilities, and minus NAV assets. We find implied cap rates are a useful tool to see what returns investors require as a check against the cap rates we are applying in our own NAV calculations.

Blended Dividend Discount Model and FFOx

In our view, the NAV approach for deriving price objectives for the healthcare REITs and triple net REITs is problematic. Cap rates for healthcare assets often trade 100-150 basis points higher than office, industrial, and retail assets and 250-300 bps higher than multi-family assets. The spread may be due to a more limited pool of buyers as some direct real estate investors are not comfortable trading healthcare assets. In the triple net space, there is a lack of competition for triple net assets due to the specialized nature of the business, which leads to higher cap rates than we think are warranted given the stability of the NOI streams.

Therefore, instead of an NAV approach, we use a blend of the dividend discount model (DDM) and FFO multiple to derive our healthcare REITs' and triple net REITs' price objectives. We think the DDM is appropriate as the healthcare REITs and triple net REITs' have more predictable and stable cash flow streams than other REIT sectors. For healthcare REITs, leases are typically triple net with 10-15 year terms and +2.0-3.5% rent escalators. For triple net REITs, leases are 15-20 years on average and carry annual rent bumps of +1.5%. These long term leases provide a stable and rising income stream, which should allow companies to continue to raise dividends. This long-term, predictable, growing income stream is captured through the use of a DDM for valuation. The DDM uses predicted future dividends and discounts them back to present value.

To capture a shorter-term view, we blend the DDM approach with a FFOx multiple approach. For healthcare REITs, our FFO multiple is based on a five year trading average, to which we apply a premium or discount. For the triple net REITs, we apply a premium or discount to the current multiple. We use the current multiple for triple net REITs because of the large changes to the triple net REITs' portfolios over the last five years, which have resulted in significantly more stable and diversified portfolios.

Dividend Discount Model steps

1. We use our estimated dividends from our earnings models.
2. Calculate a terminal value.
3. Calculate the cost of equity.
4. Take the net present value of the future dividend payments and terminal value using the discount rate (cost of equity).

FFOx steps

1. We take the 5-year average FFOx (for healthcare REITs) or the current FFOx (for triple net REITs) and apply a premium or a discount.
2. We apply this to our forward four quarters of FFO estimates.

We recommend evaluating all 4 metrics: P/FFO, P/NAV, dividend yields, and implied cap rates

There are pros and cons of each metric if used in isolation

Price-to-NAV

Pros: Can apply different multiples to different cash flows; Can adjust the capital structure to see levered vs. unlevered

Cons: Many assumptions needed in the NAV calculation by analyst; Ignores the company's business enterprise

Price-to-FFO

Pros: Most standardized comparison across all REITs

Cons: May not be a robust proxy for cash flow; Does not adjust for differences in capital structure

Pros & cons of valuation metrics

As discussed in the previous section, we use P/FFO, P/NAV, dividend yields, and implied cap rates to determine the relative value among our REIT universe. We recommend evaluating all four metrics, as there are pros and cons of using just one of these metrics in isolation. Looking at where companies are trading vis-à-vis peers on all metrics, as well as comparing where individual companies are trading versus historical valuations, allows us to derive a complete picture of relative valuation.

Price-to-NAV

Net asset value attempts to approximate the liquidation value of the underlying real estate, before the impact of income taxes on property sales. If a company's stock price becomes too cheap relative to NAV, then that company could go private to capture any implied arbitrage. The NAV can be used to calculate an implied price per square foot or price per unit for a company, which can then be compared to where similar assets are trading in the private market.

- **Pros:** NAV allows an analyst to apply different multiples to different cash flows depending on the risk profile of the cash flows. The NAV concept also adjusts for different capital structures so we can look at where a company is trading on both a levered and unlevered basis.
- **Cons:** The NAV calculation is subjective as it requires a lot of assumptions by the analyst and every analyst uses different assumptions and calculation methodologies. Some argue that NAV is not a REIT's true market value because it ignores the value of the REIT's business enterprise.

Price-to-FFO

FFO is the industry's main earnings metric so P/FFO is analogous to the P/E ratio in other industries. FFO is calculated as net income, plus depreciation and amortization, plus/minus the gains/losses on the sale of assets.

- **Pros:** As opposed to NAV, which requires many assumptions to calculate, FFO (and the values used to derive FFO) is reported by most REITs. This allows for a more standardized comparison across companies and sectors.
- **Cons:** FFO may not be the most robust proxy for free cash flow, as it contains several non-cash items. Normalized FFO adjusts for one-time charges and impairments, and AFFO adjusts for other non-cash charges to reach a closer approximation of free cash flow. However, estimates for normalized FFO and AFFO vary among analysts.

Additionally, there is still some variation in how some companies calculate FFO. For example, certain companies include gains on sale of properties while others do not. Lease termination fees can also skew results, if included. These gains may be incorporated with other items on the income statement, making it difficult to pull this item out of the calculation.

Finally, FFO and AFFO do not adjust for differences in capital structure. This can lead to a company appearing more expensive on a P/FFO (or P/AFFO) multiple basis simply because they employ more equity or more fixed rate capital.

Dividend yields

Pros: No assumptions needed

Cons: Need to look at AFFO estimate (no consensus estimate) and payout and coverage ratios to determine the quality of the cash flow

Implied cap rates

Pros: Reveals the real estate returns required by the market

Cons: Variations exist in calculating implied cap rates

Dividend yields

Dividend yield is calculated as the forward four quarters dividend divided by the share price.

- **Pros:** Dividend yields require no assumptions and are easily compared across all companies as well as against indices such as the S&P 500.
- **Cons:** Dividends may be set too high if the supporting free cash flow has declined or the quality of AFFO supporting the dividend is poor. When using dividend yields as a valuation tool, investors need to develop a sense for the safety of the dividend by computing the AFFO coverage ratio and determining the overall quality of cash flows. A good approximation of a REIT's ability to pay its dividend is the AFFO payout ratio (forward dividend divided by AFFO) or the AFFO coverage ratio (AFFO divided by the dividend; the inverse of the payout ratio). Dividend growth is also important and is a function of AFFO growth and the AFFO coverage ratio.

Implied cap rates

As discussed in a previous section, implied cap rates are calculated by dividing the forward NOI estimate by the sum of equity market cap based on today's stock price, plus NAV liabilities minus NAV assets.

- **Pros:** Implied cap rates reveal the real estate returns required by the capital market (investors). As this measure provides an aggregate view of many investors' assumptions, it helps smooth differences among investor assumptions and provides a consensus view for the value of a REIT stock or sector.
- **Cons:** There can be some variations in calculating implied cap rates, e.g. whether to include capex reserve or management fee, which may also vary by sector. Implied cap rates are also impacted by the amount of construction-in-progress included as well as the expected development pipeline. There is therefore no one way to calculate an implied cap rate, which can generate differences among investors and analysts.

REIT dividends

90% of taxable income must be distributed to investors as dividends

A cornerstone of maintaining REIT-status is that at least 90% of taxable income must be distributed to investors as dividends. The dividends come primarily from the relatively stable and predictable stream of rents paid by the tenants who occupy the properties. Since rental rates usually rise during periods of inflation (as many lease rates are tied to CPI), REIT dividends tend to be protected from the long-term corrosive effect of rising prices.

Dividends are taxed at the investor level

REIT dividends are taxed at the investor level, and each company provides information to their shareholders as to how the prior year's dividends should be allocated for tax purposes. This information is distributed by each company to its shareholders on IRS Form 1099. Dividend distributions can be allocated to: 1) ordinary income; 2) capital gains; or 3) return of capital – all of which are taxed at different rates. A return of capital distribution is defined as that part of the dividend that exceeds the REIT's taxable income.

In December 2008, a ruling allowed REITs to pay up to 90% of dividends in stock

Prior to 2008, dividend growth for REITs averaged at 5.5% a year over the prior eight years, and investors enjoyed a steady stream of all-cash dividends. In December 2008, the IRS ruled that REITs could choose to pay up to 90% of the dividends in stock. Many boards revised their dividend policies and cut their dividends significantly or reverted to paying a combination of cash and stock dividends in order to preserve cash amid the global credit crunch. In 2009, Vornado Realty Trust (VNO) and Simon Property Group (SPG), among others, chose to pay quarterly dividends partially in stock.

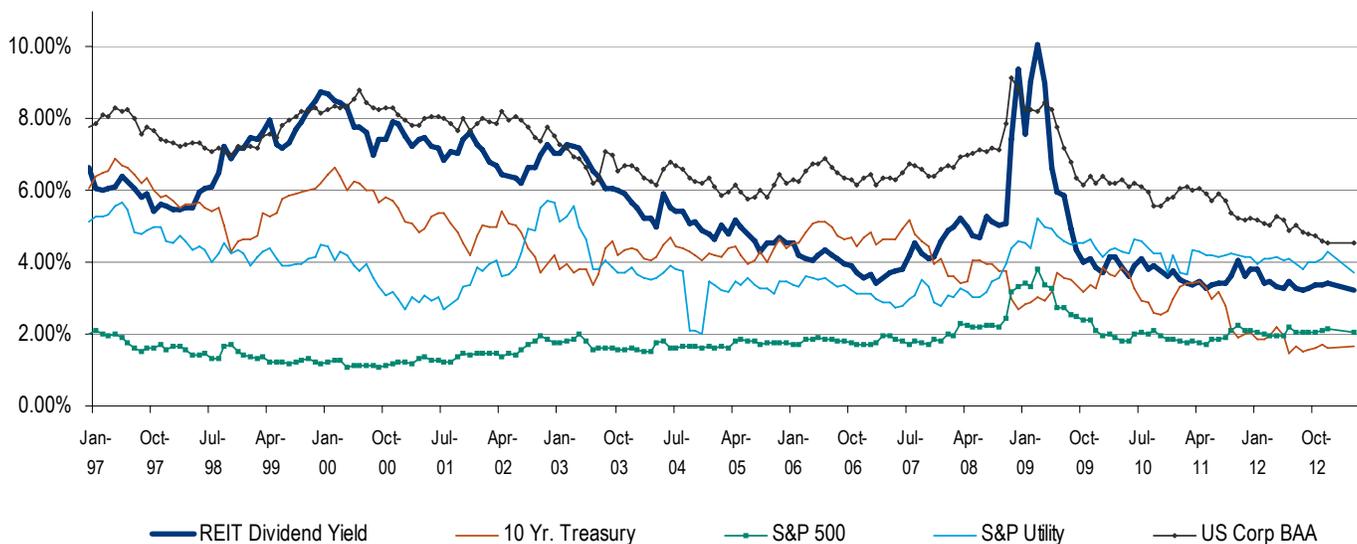
Most returned to all-cash dividends during 2010. By year-end 2010 and early 2011, many REITs began to raise their dividends.

Investors and analysts use the FFO or AFFO payout ratio to measure a REIT's ability to pay dividends. The ratio divides the dividend by either FFO or AFFO, which are proxies for cash flow.

As of April 2013, the REIT industry's dividend yield is at 3.17%

The REIT dividend yield (calculated as the forward four quarters dividend divided by the stock price) is currently at 3.17% (as of April 2013).

Chart 32: Historical REIT dividend yield



Source: Source: FactSet, NAREIT, BofA Merrill Lynch Global Research; as of 4/19/13

Frequently asked questions

REITs represent only about 15% of total institutionally-owned commercial real estate

REITs are not partnerships;

REITs participate in partnerships in the form of joint ventures (JVs) - often with large institutions, foreign REITs, domestic and foreign pension funds, etc.

REITs are not homebuilders

REITs aim to hold assets for the long-term and collect a steady stream of income from tenants whereas homebuilders often develop and sell

What's the difference between REITs and private real estate companies?

REITs represent only about 15% of total institutionally owned commercial real estate. As public corporations, REITs must file financial statements with the SEC, providing investors with more transparency than private real estate companies or limited partnerships. REIT shares also have the advantage of being liquid securities, easily bought and sold on listed exchanges, with minimal transaction costs. REITs have greater access to the capital markets and can more easily raise equity either for growth (e.g. acquisitions) or to de-lever balance sheets.

What's the difference between REITs and Limited Partnerships?

REITs are not partnerships, but like other corporations, REITs participate in partnerships through the Joint Venture (JV) structure. REITs often form JVs with other large institutions, foreign REITs, domestic or foreign pension funds, etc.

Major differences between a REIT and a partnership are:

1. REIT shares are liquid securities that are publicly traded on major exchanges
2. There is no minimum investment for REITs
3. Investors re-elect directors, with the majority independent of management
4. REITs must have at least 100 shareholders; partnerships are made up of any number of general and limited partners
5. REITs can raise equity and debt through the capital markets
6. REITs cannot pass losses on to investors

Source: NAREIT

REIT shareholders report taxes in a different manner than investors of limited partnerships. Investors of REITs receive the traditional IRS Form 1099 with information about the amount and type of income they received. Limited partnership investors receive an IRS Schedule K-1, which is much more complex than the Form 1099. REIT investors also pay less state taxes when filing compared to a limited partnership investor.

What's the difference between REITs and homebuilders?

The main business for REITs is generally to own and operate real estate whereas homebuilders tend to develop and sell real estate. The revenue stream of these two businesses is different, as REITs derive most of their revenue from rental income, which is a generally stable and visible income stream. Homebuilders, on the other hand, generally develop on a speculative basis, meaning there is limited pre-commitment from buyers which can make income streams more variable. Additionally, there is generally some level of pre-commitment from future REIT tenants before a REIT begins to build an asset, whereas homebuilders often develop without any pre-commitment from buyers and therefore undertake additional risk by developing the property on their own balance sheet.

Under tax code section 1031, a seller of a building does not have to pay taxes on the gains if the proceeds are used to purchase another building within a certain time period

Tax code section 721 allows owners to exchange properties for a REIT's OP units on a tax-deferred basis

REITs can own assets overseas. A few of the REITs under our coverage that do are: DLR, KIM, PLD, and SPG

Our correlation analysis showed REITs have been more highly correlated over the last 18 months, versus over the last six months

What is Section 1031 and Section 721?

Under tax code section 1031, an owner of a building that sells an asset and purchases another building within a specific period of time does not have to pay taxes on the gains from sale of the building. The original owner has 45 days from the date of sale to identify the new building to be purchased and 180 days to complete the purchase. The proceeds cannot be used to purchase REIT stocks on a tax-free basis, however, since the tax-free basis only applies to like-kind exchanges (other physical assets).

Tax code section 721 permits an owner to transfer properties to a REIT's operating partnership (OP) and in return, receive partnership interests (OP units) on a tax-deferred basis, certain conditions permitting. Operating partnerships are generally found in the UPREIT and DownREIT structures, discussed in a previous section. After a certain period of time, the OP units can be converted into REIT stock or cash, but the conversion is taxed. OP unit holders receive interest distributions, similar to dividends received by holders of REIT stocks.

Can REITs own assets overseas?

Yes, many U.S. REITs do own assets overseas, although for most, only a small percentage of their portfolio is overseas and a small percentage (5-6%) of earnings come from these assets. Some of the REITs under our coverage that own and operate assets outside the U.S. are Digital Realty (specialty), Kimco (retail), ProLogis (industrial), and Simon Property Group (retail).

REITs are subject to local taxes on foreign earnings in each location and therefore the company needs to evaluate every project outside the U.S. on an after-tax basis. This allows the companies to properly assess the risk/reward characteristics of these foreign investments against investment opportunities in the U.S. Finally, companies must take into account the exchange rate risk associated with any investments outside the U.S.

What is the correlation between REIT performance and equities?

When measuring against the S&P 500 and the Russell 2000, REITs have increasingly grown to be more correlated with the broader movement of equities in the last five years. Evaluated at year-end 2012, the strongest correlation was over the last 18 months (0.86 versus the S&P 500 and 0.88 versus the Russell 2000). The correlation is lower over the last 6 months (-0.03 versus the S&P 500 and 0.07 versus the Russell 2000).

Table 10: REITs vs. equity indices

	6-mo	1-yr	18-mo	3-yr	5-yr	10-yr	25-yr
REITs vs. S&P 500	(0.03)	0.61	0.86	0.85	0.82	0.77	0.56
REITs vs. Russell 2000	0.07	0.64	0.88	0.85	0.86	0.80	0.66
S&P 500 vs. Russell 2000	0.72	0.90	0.97	0.94	0.95	0.92	0.81

Source: NAREIT, BofA Merrill Lynch Global Research; evaluated at year-end 2012

Appendix: acronyms & definitions

1031 exchange

A real estate transaction where the landlord sells an existing property and uses the proceeds to purchase another property on a tax-free basis.

Adjusted funds from operations (AFFO)

A closer measure of cash flow or economic profitability for REITs than FFO. This metric also provides a better indicator of the sustainability of a REIT to pay dividends. AFFO is calculated as FFO minus recurring capex, minus straight line rent adjustment, minus adjustment to FAS 141.

AFFO coverage ratio

AFFO divided by the dividend; the inverse of the payout ratio.

AFFO payout ratio

Dividend payment divided by AFFO.

A-REITs

Australian REITs.

Common area maintenance (CAM)

Mostly found in retail real estate, CAM charges are expenses charged to tenants related to maintaining the common areas of the property, such as snow removal, cleaning, trash removal, and security.

Capital expenditures (capex or cap-ex)

Recurring capital expenditures is capital spent by the landlord to maintain the upkeep and status of a property – but does not enhance the overall value of the property. When calculating AFFO, recurring capex is deducted from FFO, among other adjustments.

Capitalization rate (cap rate)

The initial yield on a real estate investment and a way to value real estate in terms of acquisitions and dispositions. The “cap rate” of a property is determined by dividing asset cash flow divided by asset purchase price or the total expected development cost. Asset cash flow is usually the property’s first year NOI stream.

CBD

Central business districts (office REITs).

CCRC

Continued care retirement communities (health care REITs).

Class A, B, C

Classification of the quality of real estate; a subjective measure. “Class A” is the highest-quality real estate, in the best locations and commands the highest rents, “class B” is a slightly below class A assets in terms of quality and location, and “class C” is usually average/fair, older, and un-renovated in weaker locations.

CMBS

Commercial mortgage-backed securities. A type of mortgage-backed security that is secured by the loan on a commercial property. CMBS provides another source of financing for real estate companies.

Co-tenancy

A common clause in retail lease contracts that allows tenants to get a reduction in rent from landlords if key tenants or a certain number of tenants leave the center.

CRE

Commercial real estate.

DDM (Dividend Discount Model)

Dividend discount model is a valuation tool that can be used to value REIT stocks by using predicted dividends and discounting them back to present value. Generally used for companies with stable cash flows and stable dividends.

DownREIT

Structured similarly to an UPREIT in that it allows properties to be placed into a REIT on a tax-free basis. Existing partners receive OP units (operating partnership units) in exchange for the assets, which can be tendered for cash later or REIT shares. A DownREIT differs from an UPREIT in that it is generally created when the REIT is already a public company.

EBITDAR coverage

EBITDAR is earnings before interest, taxes, depreciation, amortization and rent. The EBITDAR coverage ratio is the ratio of EBITDAR to contractual rent for leases (or interest & principal for loans). This ratio is used by the health care REITs to view tenant cash flow coverage. Compared to the EBITDARM coverage ratio, EBITDAR is a stricter, more conservative ratio.

EBITDARM coverage

EBITDARM is earnings before interest, taxes, depreciation, amortization, rent and management fees. The EBITDARM coverage ratio is the ratio of EBITDARM to contractual rent for leases (or interest & principal for loans). This ratio is used by the health care REITs to view tenant cash flow coverage. Compared to the EBITDAR coverage ratio, EBITDARM is a more flexible ratio.

Equity REIT

A REIT that owns and operates real estate properties.

FAS 141

GAAP accounting requirement for newly acquired assets where landlords must determine whether existing leases are above or below market rents, book the difference on the balance sheet, and amortize over the remaining life of the lease. An adjustment for the FAS 141 income ensures true cash flow is measured during the calculation of AFFO.

Funds from operations (FFO)

The REIT industry's key earnings metric. Calculated as GAAP net income, plus real estate gains (minus real estate losses), plus impairment charges, plus GAAP real estate depreciation and amortization. FFO includes the pro rata share of unconsolidated joint venture net income and depreciation.

GSE

Government-sponsored enterprises. Financial services corporations sponsored by the US government that aim to enhance the flow of credit to targeted sections of the economy. Fannie Mae and Freddie Mac are examples. Apartment REITs and Health Care REITs have accessed GSE funding.

Gross lease

Under a gross lease, the tenant pays a special rental rate, and the landlord agrees to pay for the first year's operating expenses, also known as the expense stop. Tenants will pay for their pro rata share if operating expenses increase in the future.

Gross leasable area (GLA)

A building's total floor area, in square feet, designed for tenant leasing. It is generally the area for which tenants pay rent, and thus the area that generates revenue for the owner.

Hybrid REIT

A REIT that is a crossover between an equity REIT and a mortgage REIT.

Implied cap rate

Calculated by taking the forward NOI estimate, and dividing by the sum of: equity market cap (based on current stock price), plus NAV liabilities, minus NAV assets. The implied cap rate is essentially the NAV calculation backwards.

Joint venture (JV)

A partnership between a REIT and another entity, where they jointly buy, sell, and own income-producing properties together. The partner can be a pension fund, another REIT, a foreign REIT, foreign investor, etc.

J-REITs

Japanese REITs.

Lease cancellation fees

Income received for the early cancellation of leases.

Life cos

Life insurance companies. Often a source of lending to REITs.

Loan-to-value (LTV)

A measure of how leveraged a loan is. Calculated by dividing the value of the mortgage loan by the value of the property, given in percentage form.

MOB

Medical office buildings (health care REITs).

Mortgage REIT

A REIT that lends money to real estate owners and owns portfolios of real estate debt, rather than directly owning real estate.

NAREIT

National Association of Real Estate Investment Trusts. The REIT industry's trade organization.

Net absorption

A measure of demand in the market. Typically calculated as the percentage change of total square feet leased during a specific time frame.

Net asset value (NAV)

NAV seeks to calculate the "net market value" of all the company's assets, after subtracting liabilities. NAV is calculated by taking the fair market value of the company's assets, minus the fair market value of the company's liabilities. To derive NAV per share, divide the NAV by fully diluted shares outstanding.

Net operating income (NOI)

NOI is the cash flow generated at the property, excluding corporate-level expenses. NOI is calculated by taking property level revenue, and subtracting property-level expenses (real estate taxes, operating expenses, and marketing expenses).

Non-core assets

Assets owned by a REIT that are not its core asset type (e.g. a retail REIT owning a small collection of warehouses). REITs may own a small percentage of non-core assets in order to diversify their own portfolio.

Normalized funds from operations (normalized FFO)

Normalized FFO makes adjustments for impairment charges that skew FFO. This provides a better measure of the REIT's long-term FFO-generating ability or business performance, excluding one-time, unusual charges.

Operating partnership (OP)

A new partnership formed in the UPREIT or DownREIT structure where the REIT owns the majority interest of the partnership. Owners of assets sell their assets to the Operating Partnership and receive interests, or OP units, in return.

Operating partnership units (OP units)

Interests in the Operating Partnership of a REIT. Original owners of assets exchange their properties with the OP to receive OP units, which can be exchanged as stock or cash after a specific period of time.

Payout ratio

Dividend divided by FFO. Dividend sustainability is better measured by AFFO, since adjustments are made to FFO to get to a closer proxy of recurring cash flow.

Price-to-NAV

Price-to-NAV is a valuation metric for REITs, similar to price-to-book value. Book value is based on historical costs and does not reflect the rise/fall of property prices; therefore REITs use NAV to derive the underlying value of its properties.

Real Estate Investment Trust Act of 1960

Federal law that authorized the formation of REITs to provide small investors the opportunity to participate in the benefits of direct ownership of commercial real estate, but with less and diversified risk and with the benefits of liquid, publicly-traded securities.

Real estate investment trust (REIT)

A security that sells like a stock on the major exchanges and invests in real estate directly, either through properties (equity REITs) or mortgages (mortgage REITs). REITs receive special tax considerations and typically offer investors high yields, as well as a highly liquid method of investing in real estate.

REIT Modernization Act

Federal law that went into effect in 2001. It allowed REITs to own up to 100% of stock of taxable REIT subsidiaries (TRS).

Rent concessions

Rent abatement granted to the tenant by landlord. Usually occurs during lease negotiations.

RevPAU

Revenue per available unit. Used by apartment REITs to derive a proxy for rental revenue growth.

RIDEA

REIT Investment Diversification and Empowerment Act of 2007 allows health care REITs to participate in higher level of entrepreneurial activities through TRSs.

RMS

MSCI US REIT Index; the Morgan Stanley REIT Index. RMS is an end-of-day and total return index, which includes the dividend distribution.

RMZ

MSCI US REIT Index; the Morgan Stanley REIT Index. The RMZ is a real-time price-only index.

Same-store net operating income (same-store NOI or SS NOI)

Measures NOI on a static number of properties to give insight as to how a portfolio of assets performs over a period of time. This provides a clearer picture of the operational performance because REITs acquire and dispose of properties frequently.

SNFs

Skilled nursing facilities (health care REITs).

Special servicing

Loans are transferred to special servicers who handle collection and foreclosure efforts for delinquent loans greater than 60 days, defaulting loans, and loans in receivership.

Straight-line rent

In GAAP accounting, long-term leases have contractual rent increases built in but rent must be "straight-lined," or averaged, over the life of the lease. During the AFFO calculation, an adjustment is made to extract the true cash amount of rent collected rather than the average value.

Taxable REIT subsidiaries (TRS)

Authorized in 2001, TRS – which are taxed at the corporate level – allows REITs to engage in ancillary business activities and boost earnings by providing services to tenants and others. REITs can own up to 100% of stocks of the TRS, but only up to 25% of the REITs' assets may be in a TRS.

Tax Reform Act of 1986

Federal law that allowed REITs to integrate property management into the organization. Prior to this act, REITs were legally required to source property management to outside companies.

Tenant improvement (TI) allowance

Tenant improvement allowances are given to tenants to build out the space to suit their needs. TIs are usually found in leases for office and retail properties.

3PLs

Third party logistics providers. Product distribution in Industrial REITs can be outsourced to 3PLs.

Triple net leases

A lease where the tenant is contractually responsible for all the expenses of the property, including operating expenses, real estate taxes, insurance, etc.

Umbrella Partnership REIT (UPREIT)

A structure created in the early 1990s as a way for properties to be placed into the REIT on a tax-free basis (without actually having to sell them). Existing partners receive OP units (operating partnership units) in exchange for the assets, which can be tendered for cash later or REIT shares.

Link to Definitions

Financials

Click [here](#) for definitions of commonly used terms.

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06 May 2013

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