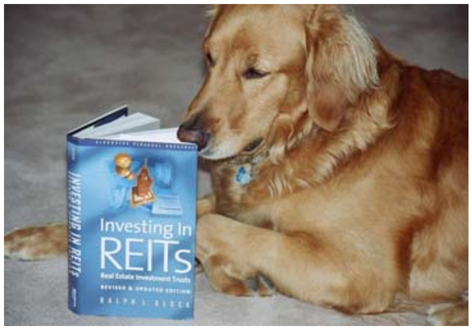
THE ESSENTIAL REIT

FORMERLY KNOWN AS

"REITWEEK"

May 26, 2004



*"There is nothing more frightful than ignorance in action." --
Johann Wolfgang von Goethe*

*"Life is a long lesson in humility" –
James M. Barrie*

"A fanatic is one who can't change his mind and won't change the subject"- Winston Churchill

1. "The Last Shall Be First" – But for How Long?

Three weeks ago, at the end of the last issue of The Essential REIT, I threatened to tackle several REIT investment issues that, had I done so, would have expanded this bizarre little publication to well over five pages; and five pages, given my loyal readers' tolerance for pain, has always been more than enough. But now let's plod on, shall we?

One question I asked myself – but did not answer – was: "Should I move more of my REIT holdings from retail to the apartment sector? That's what the sell-siders have suggested that I do." This question, which Green Street Advisors has called "The Trade," isn't new to Reitdom. Indeed, because we veteran investors know that all investment performance reverts to the mean, we have been wondering when the apartment REITs, those 87-pound weaklings of Reitland, would finally get up off their butts, brush the sand out of their trunks and beat the crap out of those tormenting, muscle-bound beach bullies (aka the retail REITs).

87-pound weaklings indeed! The "residential" sector of the NAREIT index, which is dominated by the apartment guys (as of May 1, the manufactured home communities were only 6.7% of NAREIT's "residential" sector), has, in recent years, been as weak as ABC's Nielsen ratings. They have badly lagged REIT industry performance in each of past three years (though they did much better in the previous two).

	2003	2002	2001	2000	1999
NAREIT Equity Index	37.1%	3.8%	13.9%	26.4%	-4.6%
Residential REITs	25.9%	-6.0%	9.0%	34.3%	9.5%
Retail REITs	46.8%	21.1%	30.4%	18.0%	-11.8%

Therefore, just as we all know that investments revert to that golden mean (as the retail REITs did in 2001 vs. all other sectors), we know that residential will, once again, outperform retail, right? Indeed, no less an illustrious personage than Sam Zell recently noted that, "Usually, in recoveries, apartments are first. I wouldn't expect it to be any different this time, and so I would suggest that the basic fundamentals of the apartment business are likely to improve significantly over the next 18 months."[1]

And, if recent trading activity is an indicator, this reversion to the mean has already begun. As I write, the total return of the NAREIT equity index, year-to-date through May 21, is –3.44%. The residential sector, having lagged through the first quarter, has been shooting the lights out recently and is now well ahead of the index, with an average total return of -1.65% and outperforming the index by 179 bps. (Retail continues to perform reasonably well on a YTD basis after its strong Q1; at -2.83%, it's pretty much in line with the NAREIT equity index, but has been particularly weak since April 1).

Certainly there is good reason – aside from reversion to the mean principles – for the performance of the apartment stocks to perk up. The troubles in the apartment sector have persisted for so long and become so well known that they have been likened to another hackneyed expression, "a Perfect Storm." Even REIT newbies know that: (a) apartment dwellers have been finding it easier to buy a home (new or used) than to buy a microwave oven, (b) job losses over the past couple of years have cut heavily into occupancy rates and induced across-the-board concessions from all apartment owners, and (c) due to the insatiable demand for apartment properties from everyone who has realized (finally) that he/it is underweighted in commercial real estate, merchant builders have been churning out new apartment units as if they were microchips, resulting in no drop-off in supply despite weak tenant demand. Rising interest rates, accompanied by strong job growth, will cause that Perfect Storm to leave our shores and head for Nova Scotia.

So what should we REIT investors do? Should we bail out of retail REITs and pour our resources into the residential sector? This strategy has been advocated by many performance-minded characters who aren't content with REIT-like returns, and feel the competitive need to do even better. They suggest that, in retail, it is now "as good as it gets," and claim:

(a) That the consumer is over-burdened with debt and, given the abatement of the purse-opening effects of last year's tax cuts, will be forced to reduce their retail spending;
(b) That rising interest rates, spiking gasoline prices, the grim news from Iraq trumpeted every day by frantic anchormen, and another in-your-face presidential election campaign will turn the consumer into a sour-faced, closed-fisted wretch and/or couch potato, unwilling to spend time at the local mall or even the neighborhood shopping center;
(c) That retail REITs, particularly the malls, are more exposed to rising interest rates than are other REITs, due to higher leverage and a bit more variable-rate debt; and
(d) That even if the retail sector of the economy holds up, the cash flow growth of the apartment guys will be accelerating, while retail property owners' growth will be abating – and today's market couldn't care less about values or profit levels, having eyes only for earnings momentum.

None of these claims are unreasonable, and might possibly be true. And, speaking of momentum, the apartment stocks are already demonstrating that lovely characteristic. So what are we waiting for? Hop aboard – the train's leaving the station –retail is ***so*** ten minutes ago!

But, unfortunately, the world ain't that simple. Although it seems clear to almost everyone that market conditions are about to improve for apartment owners while retail owners aren't likely to see accelerating growth rates, I have some issues concerning the *extent* of the apartment sector recovery, whether its earnings growth will catch up to that of retail property owners, and with respect to current valuations.

We ***do*** know that mortgage rates are up, and that job growth has been improving. This, of course, will help apartment owners. But we don't know by ***how much*** mortgage rates will rise. So far, they're up about 75 bps, to 6.3%, on average. But will that discourage those who regard home ownership as something akin to euphoric bliss? For a $250,000 mortgage, and assuming a buyer in the 33% tax bracket, the mortgage

[1] Interview of Sam Zell by The Motley Fool, May 21, 2004.

payments, at 6.3%, will be only $100/month higher, after taxes. Cut out two movies per month with the family and you've almost made up for it.

This extra burden may not discourage enough buyers to make a difference, particularly as many of them don't seem to have any fear or loathing of variable-rate loans (judging by recent statistics showing that mortgages of the floating rate kind have become increasingly popular with "What, Me Worry?" home buyers). My guess is that, while certainly beneficial, today's somewhat higher mortgage rates won't help the apartment owners a lot unless they spike significantly higher – to, say, well over 7%.[2] Can that happen? Sure – but that's certainly nothing that we can put in the bank.

Let's now talk about AFFO growth rates. We remain in murky waters here. About all we know for sure is that many apartment markets seem to be in a sort of "bottoming process" (though the cynics might claim that the markets have sunken slowly to the bottom of the Mississippi River and will have a hard time extracting themselves therefrom). Many markets remain weak and still show no real signs of improvement. Take a look at EQR's results for Q1; Atlanta, Dallas and Houston, among the "usual suspects," each suffered NOI declines of over 8%. But let's be optimistic and assume that NOIs and FFOs for most apartment REITs will flatten by Q4. We still must guess at the extent of the improvement in NOIs for 2005, which is when most expect the apartment REITs to generate some very strong growth rates.

But 2005 is still quite a ways off, and crystal balls are opaque. What will the US economy look like then? Will interest rates (and mortgage rates) be higher or lower? If flat or lower, why won't the American public continue to favor owning at the expense of renting? Will the politicians continue to encourage the expansion of "affordable" home ownership to every nook and cranny of every US city? Even now, thanks to Aunt Fannie and Uncle Freddie, quasi-bankrupts can get zero-down mortgages just for the asking. Will Iraqi and terrorism issues, higher gasoline and natural gas prices and other uncertainties derail the strengthening economy and cause job growth to flatten, thus causing abatement in household formations? Will developers continue to be besieged with buyers for newly completed communities, and thus continue to put sticks in the ground at perhaps even an accelerating pace despite somewhat higher interest rates? These are all questions to which I have no answers, but they tend to suggest, to your humble author at least, that loading up on apartment REITs may not be the slam-dunk that has been suggested.

Finally let's talk about valuations. According to the estimate of Green Street Advisors, cap rates on apartment properties have dropped 200 bps over the past two years; this is a larger drop than in most other sectors. Indeed, the spread between apartment cap rates and Baa bonds has been narrower in the apartment sector than in others. This seems to be a pretty good argument for the proposition that a recovery in the apartment sector has already been priced into apartment assets. One quarter ago, Green Street made the point that investors were dubious of the sustainability of these low apartment cap rates, as the apartment REIT stocks were trading at much smaller NAV premiums than were being awarded to non-apartment REIT stocks at that time (8.4% NAV premium vs. 16.1% NAV premium).

That, however, has changed dramatically due to the outperformance by the apartment REIT stocks in Q2 of this year. Apartment REIT stocks are now trading at an average NAV premium of about 2%, compared with 3% for other REIT sectors, and perhaps there is more upside risk in apartment cap rates than in other sectors. Where are the bargains? Sure, apartment REIT stocks could continue to outperform even from today's pricing levels. However, further meaningful outperformance would seem to require that a large slice of prospective homebuyers be kicked out of the market, while job growth would have to remain very strong well into the future – and, perhaps, new apartment supply would have to be ratcheted back at least modestly. Apartment owners could possibly generate higher NOI growth rates than in other real estate sectors beginning late this year, but that may not be sustainable beyond a 12-month period – and, more important, current cap rates and apartment REIT stock prices may already discount those prospects.

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[2] I have read this week that a spokesman for the homebuilding industry has stated that they intend to built new homes at the same frantic pace until mortgage rates breach the 8% level. Even discounting for their sunny bias, giving them even a modicum of credibility suggests that home ownership won't become a weak competitor to apartment owners unless and until mortgage rates zoom substantially higher.

On April 2, a "window of opportunity" to allocate more assets into the residential sector of Reitdom opened up, but that window closed faster than an Anchorage sunset in December. The sector now seems fairly valued to me; however, while I wouldn't bulk up on residential REITs beyond one's benchmark weighting, I don't think that performance-driven REIT investors (who seem to be more prevalent than cicadas these days) ought to risk being substantially underweighted in them either. As long as we see interest rates trending up, on both the long and short ends of the yield curve, and as long as we are enjoying job creation numbers that make President Bush smile from ear to ear, *i.e*., something like 325K+ per month, then prospects will, indeed, improve for owners of residential real estate, and they will no longer be 87-pound weaklings that the REIT industry will be ashamed of.

But let's be careful out there: The recently improved stock price performance in this sector has a lot to do with the economic statistics that have poured out of Washington governmental agencies during the past two months, along with the sharp jump in interest rates. Should we see any signs of these new trends reversing – or even flattening – the same guys who couldn't get enough apartment REIT shares since April 1 may decide that they have too many – and may commence to barf them quicker than Sammy can snag an errant tennis ball. And, meanwhile, despite some longer-term concerns, I see nothing preventing the retail REITs from growing AFFOs at 6-7% for at least another 12-18 months. Apartments may indeed outperform going forward, but perhaps it's fair to question whether moving out of retail and heavily into apartments at the present time makes a lot of sense when risk is accounted for. As is usually the case, ***balance*** is golden.

2. School's Almost Out: Final Exam Time?

About two weeks ago a very nice young lady at Bloomberg Press asked me if I would be willing to draft some questions on REITs and REIT investing for a test being given to prospective certified financial planners (CFPs). Hundreds of examinations have been mercilessly inflicted upon me over the years, in school and elsewhere, but I've never written one. I agreed to do so, and rather enjoyed that diabolical task…which gave me an idea:

As all of my subscribers are highly REIT-intelligent and could no doubt score at least 95% on the REIT exam for CFP candidates, why not prepare a different type of exam – much more difficult and focused on REIT trivia? So even though you can easily distinguish a rental rate from a cap rate, and NAV accretion from positive-spread investing, you will find this exam a real challenge. But whether you score well or not won't matter; nobody's going to flunk you if you miss two-thirds of the questions (though Sammy may have a bit less respect for you, and refuse to share his kibbles). So, Mr./Ms. Phelps, your assignment, should you choose to accept it, is to answer the following questions. The answers are at the end of this newsletter (though I cannot figure out how to present them, as the magazines do, upside down).

These are not easy questions. Many of the answers are readily available on NAREIT's website (www.nareit.com), but I am trusting you not to look them up before you begin. A score of 75% qualifies you to ghost-write my next book for me. Over 50% means that you are spending too much time on REITs, and need to "get a life." Over 35% indicates an inquiring mind, and a good balance between work and play. Under 35%? Buy a REIT mutual fund and go play golf.

1. How many equity REITs were there at the end of 1990? (There were 144 at the end of last year).
   a. 28
   b. 58
   c. 88
   d. Who cares?

2. What was their aggregate equity market capitalization back then? (It was $204.8 billion at the end of 2003).
   a. $5.5 billion
   b. $20.5 billion
   c. $40.5 billion

3. Chelsea and Tanger are well-known and widely-respected outlet center REITs today. Can you name two other outlet center REITs that, due to management miscues, inflicted great pain upon their investors and are no longer with us?

4. What has been the average annual total return for equity REITs (per NAREIT) for the 20-year period ending May 21, 2004?

a. 9.15%
b. 11.65%
c. 13.35%

5. Can you name at least two father-son teams in Reitdom? (It's not necessary for both to have been active in the business at the same time).

6. In 2000, Prudential Real Estate estimated the portion of investment quality commercial real estate owned by REITs in each of the major sectors. What portion of US malls was owned by REITs at that time (per Prudential's estimate)?

a. 12%
b. 22%
c. 34%

7. When was the following "poetry" written:

a, 1998
b, 2000
c. 2002

Where will this end?
Will the bubble just burst?
Are we headed for doom?
Is our investment world cursed?

We'll see Shumpeter's world
Of creative destruction:
Many 'Net models
No longer will function.

Throwing darts at the 'Net
Won't satisfy our ambitions;
Day-trading the techs
Just generates commissions.

Investor newbies will
Become risk-averse;
And the fortunes of REITs
Will gradually reverse.

More balance will enter
The stock market scene;
And expected returns
Will revert to the mean.

Our REIT stocks will enjoy
Their rightful roles –
Among rational investors
With reasonable goals.

8. Barry Vinocur, an experienced and widely-respected REIT veteran, runs Realty Stock Review. Who ran this publication before Barry, what was it called and where is he now?

9. Six REIT stocks are included within the S&P 500 index, including which of the following:

a. Boston Properties, Equity Office, Equity Residential and Simon
b. Equity Office, Equity Residential, Pro Logis and Archstone Smith
c. Simon, Pro Logis, Equity Residential and Aimco
d. Plum Creek, Simon, Equity Office and Kimco

10. What was the average equity REIT's dividend yield 10 years ago, at the end of May 1994 (it is just under 6% today)?

a. 5.9%
b. 6.9%
c. 7.9%

11. Which of the following was ***not*** a hallmark of the euphoric REIT bull market of 1996-1997?

a. large acquisition pipelines

b. forward equity transactions
c. asset recycling
d. unit investment trusts

12. NAREIT has estimated that $26.3 billion was raised by REITs in 1997, via IPOs and secondary common stock offerings, and an additional $14.6 billion the following year. What percentage was this of the year-end total equity market cap for the REIT industry at the end of 1996?
a. 19%
b. 28%
c. 46%

13. And what was REITs' total return in the bear market year of 1998?
a. -2.8%
b. –12.8%
c. –18.8%

14. Match the following companies with the following peccadilloes, er, tech ventures:

a. Pro Logis	a. Velocity
b. BRE Properties	b. Merchant Wired and FastFrog
c. Simon	c. Phat Pipe
d. General Growth	d. Frontline
e. Reckson	e. Malibu.com

15. Which of the following was never an apartment REIT?
a. Holly
b. Paragon
c. Urban
d. Merry Land

16. Which of the following former REIT executives do some REIT investors want to tar, feather and run out of town on a rail?
a. Paul Nussbaum
b. Mike Myers
c. Glenn Reschke
d. a and b
e. a and c
f. b and c

17. Which REIT was once public, then went private and then public again?
a. United Dominion
b. General Growth
c. Federal

18. According to figures compiled by Bloomberg, which industrial REIT has delivered the best total return performance over the 5-year period ending May 13, 2004?
a. AMB Properties
b. Centerpoint Properties
c. Duke Realty
d. Pro Logis

19. Which of the above delivered the worst performance?

20. There were 173 REITs within the NAREIT real-time index as of May 1, 2004. How many of them had equity market caps at that date of over $5 billion (excluding OP units and preferred stock)?
a. 4
b. 9
c. 14

Thanks for being a good sport and indulging my professor-wannabe inclinations. Have a fine Memorial Day weekend – and I apologize for the obscene length of this issue of The Essential REIT.

Best,
Ralph (Block)

Trivia Test Answers:

1. b (but if you chose d, you also can score a correct answer).
2. a (surprisingly small, huh?)
3. Factory Stores of America, Horizon Group, McArthur Glenn and Prime Retail are all now safely ensconced in the REIT Hall of Shame.
4. b.
5. Sanford and Drew Alexander (Weingarten), Matthew and John Bucksbaum (General Growth), John and John Kilroy (Kilroy), Ed and Doug Linde (Boston Properties), Melvin and David Simon (Simon), Al and Bobby Taubman (Taubman), and Bert and Scott Wolstein (Developers Diversified). And there are also the Rechlers (too many to keep track of, but you are correct if you mentioned Roger and Scott, Roger and Gregg or Donald and Mitchell (Reckson).
6. c. The number today would obviously be a lot higher, given the voraciousness of the mall REITs.
7. b (January 2000). Another example of "reversion to the mean" at work.
8. Kenneth Campbell, another REIT veteran of many years (and, like Barry, a genuinely nice guy), ran and managed this publication for a number of years before Barry; it was called "Audit's Realty Stock Review." Ken is now a managing director with ING Clarion CRA Securities and Chairman of the Investment Policy Committee.
9. c. How did Aimco get in there? Someone ought to teach the S&P guys "REITs 101."
10. b.
11. c. Asset recycling, which is a favorable trend in Reitdom, didn't come along until the REIT bear market taught REIT executives the importance of return on invested capital and the cost thereof.
12. c.
13. c. While the huge new supply of REIT shares in '96-'97 may not have single-handedly caused the subsequent REIT bear market, it no doubt was a contributing factor. Don't trust "coincidences."
14. ProLogis, Phat Pipe; BRE, Velocity; Simon, MerchantWired and FastFrog; General Growth, Malibu.com; and Reckson, Frontline. Score a point for 3 of 5 correct choices.
15. c. Urban was a mall REIT.
16. e. Mike was, of course, the widely-respected CEO of Bay Apartment Communities before its merger with Avalon, forming "Avalon Bay." He was one of the good guys.
17. b. The Bucksbaums know both private and public markets, and I am personally pleased that GGP is now public.
18. b. – Centerpoint's average annual return was 17.5%, followed by Liberty, AMB and Pro Logis. *Past performance is no guarantee…yada, yada, yada.*
19. c. – Duke's average annualized return was 10.7% (still not bad at all). Duke edged Catellus by 10 basis points, but the latter hasn't been a REIT until this year.
20. b. In order of descending size, Equity Office, Simon, Equity Residential, Vornado, General Growth, Plum Creek, Public Storage, Pro Logis, and Archstone-Smith.