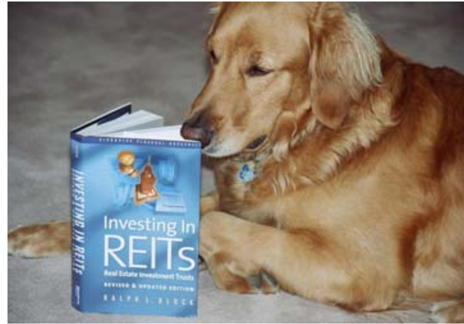
THE ESSENTIAL REIT

FORMERLY KNOWN AS

"REITWEEK"

July 5, 2004



"Writing does for me what giving milk does for a cow." --
H.L. Mencken

"Writing is not necessarily something to be ashamed of, but do it in private and wash your hands afterwards" –
Robert Heinlein

"Writing is like prostitution. First one writes for the love of doing it, then for a few friends, and, in the end, for the money." – Moliere

1. Not Your Father's REIT World.

The REIT world of our fathers used to be a very sedate place in which to live, work and play – and invest. Indeed, until fairly recently, I could lunch with my pals in the Bay Area amidst the quiet certitude that my favorite REIT wouldn't close at more than 10 or 20 cents from where I last saw it. And, of course, this way of life was entirely natural. Most of those who invest in REITs for quick trading gains are, for the most part, Whirling Dervishes who spin themselves around in circles. We veteran Reitsters know that capital appreciation beyond 4-5% a year is a gift from God; welcome indeed, but not expected.

So, let's assume an average 1% capital appreciation four times a year. Assuming 60 trading days per quarter and a $45 stock, that's less than a penny per day – on average. Of course, stocks are more volatile in the real world, and we've sometimes been surprised by 1-2% moves, maybe 45-90 cents per share. But such price gyrations weren't that common and, for the most part, reflected quarter-end "window dressing" or the perturbations of the odd large seller who "had" to exit the position for greener pastures elsewhere.

But we've all heard that old canard, "Be careful what you wish for." Almost for eons, the REIT industry has been waiting patiently to come of age, anxious to leave the sleepy backwaters of the equities world. Two major breakthroughs happened in 2001: (a) An Ibbotson study concluded that adding a 10-20% REIT component to a portfolio is likely to both increase returns and reduce risk, and (b) The S&P mavens finally recognized (duh!) that today's REIT organizations are active businesses, and allowed REIT stocks into the hallowed halls of the S&P 500. And, even more recently, REIT stocks have become tradable in the form of ETFs ("exchange-traded funds"), allowing investors to trade their butts off on baskets of REIT stocks at low commissions – and to short them without waiting for up-ticks.

So now that REITs have gained their rightful place in the world of equities, we are experiencing the dubious joys of equity investors everywhere: Increased volatility. As Barry Vinocur has put it, "Welcome to the big leagues." In a world where almost every investor suffers from ADD, and our performance measurement period is one trading day, REIT stocks have often become yo-yos, play-toys of the hedgies and other assorted weirdoes who now dominate the investment world. Item: From April 1 through May 10, REIT stocks (as evidenced by the RMS index) plummeted 18.6% and, at their closing lows, were off 9% for the year. But just six weeks later, after some nifty daring-do, the RMS was *up* for the year, by 4.7%.

Sure, rising interest rates contributed mightily to this volatility, but my view is that much of it was the nasty work of traders and hedge funds. Recently, on June 29, the RMS fell by 2.4%, and the moves in some shares were enough to give vertigo to a stunt pilot, *e.g*., AMB was chopped by 4.1%, and Heritage, Duke and PS Business Parks were down 3.5% or more. Nearly a year's worth of dividends was eliminated in a single trading day. Did these companies suffer a resignation of their auditors? Issue negative news releases? Guide earnings downward? Announce dilutive secondaries? Lose important tenants? Nossir. Although I believe that REIT stocks should be treated as a separate asset class[1], they do hang out on a daily basis in the equities market, and thus are fair game for those who like to sling stocks around as though they were slabs of pizza dough.

Are these trading fits of irrational exuberance (or despair) good – or bad – for REIT investors? For quite some time, I felt that volatility was as welcome in Reitdom as an oil spill in Monterrey Bay; after all, sleeping well at night is important to many Reitsters, and if we wanted lots of volatility we could go off and buy Internet rockets or Chinese infrastructure plays. And pure real estate investors are less likely to see REITs as real estate proxies when they act like errant pogo sticks. So I felt that when REIT stocks trade like pork belly futures, new investors might be scared off and prevented from enjoying the fruits of our rewarding world. But, more recently, I have begun to have second thoughts.

REIT stocks truly belong to long-term investors, and those who own REIT stocks for all the right reasons shouldn't care about whether their REIT portfolio is up or down 2%, 3% or even 5% during any particular week – or even a single day. I don't look at my net worth on a daily basis, and other REIT investors shouldn't either. This task is easier to accomplish when we understand what REIT stocks are capable of over long periods of time, including the power of compounding dividends. Volatility *can* be tolerated.

Increased volatility may actually *increase* the investment returns of those of us who are serious long-term REIT investors. If volatility is equated with risk (a belief shared by many), higher volatility = higher risk. And greater risk is normally compensated with greater returns. Indeed, perhaps REIT stocks have provided such excellent returns over the past 20 years (per NAREIT, equity REITs delivered 12.3% average annual total returns through July 1, 2004), in large part, because investors thought REIT stocks were riskier than they actually were (though perhaps I am confusing two very different definitions of "risk" here[2]).

In any event, higher volatility is the price we pay for increased liquidity and wider acceptance of the REIT idea. If this scares off marginal investors, so be it. Besides, those who worry about recurring 5%, or even 10%, fluctuations in the investment values of their portfolios ought, perhaps, to avoid REITs altogether and invest in CDs and T-bills, though they shouldn't fool themselves into thinking that Leo Wells has the answers. Oh, hell, I fear I'm becoming a crusty old curmudgeon in my later years.

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[1] According to NAREIT News Brief, June 2004, IBM's chief investment strategist stated that REIT stocks should be part of the company's 410k plan, as they will give plan participants "the opportunity to invest in what we consider to be a separate asset class."

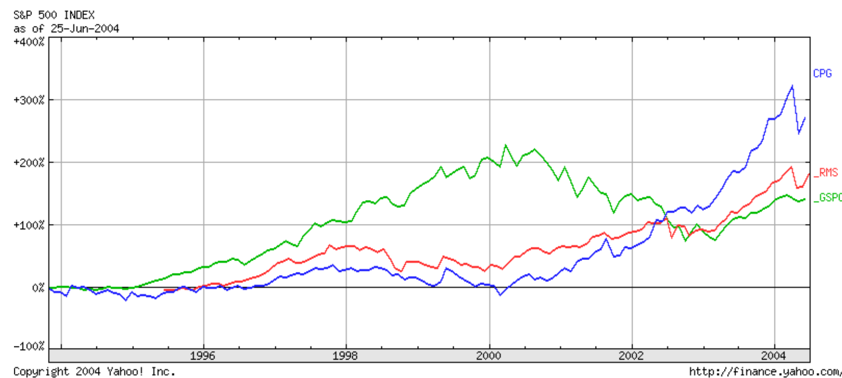
[2] Many (most?) B-school graduates assume that volatility = investment risk, and that company-specific risks can be hedged away via diversification. However, perhaps "risk" might also mean a permanent (or at least long-term) impairment of one's investment capital through an ill-timed or ill-advised investment in a particular asset class or sector. Is the "risk" in owning gold merely a function of its price volatility, or are there other more insidious risks involved?

But perhaps all these verbal gymnastics concerning volatility are beside the point. I have been trying all my life to cease worrying about things that I cannot control; and the hedgies and traders have a lot more money than me, and they will play their games if and when it suits them. Perhaps our only defense is to treat these characters the way we treat spoiled children whose antics demand attention – ignore them. Or, as the saying goes, "There it is – deal with it."

2. Godspeed, Lady Chelsea!

Every once in a while a truly outstanding REIT bursts into Reitland. An incredibly good management team may find itself staring at unique opportunities in the real estate markets, and is able to generate some very unREIT-like returns over a significant period of time. Eventually, returns always revert to the mean, but occasionally the ride can last for quite some time and be, well, *exciting* (though I an reluctant to use that word in Reitdom). Perhaps we can count the number of such REITs on the fingers of one hand (two at most), and we won't differ much on which REITs should be included in any such REIT "Hall of Fame."

One of the inductees ***must*** be Chelsea Property Group (CPG), particularly now that Lady Chelsea has chosen to wed Sir Simon in a merger valuing CPG stock at $66 per share (it's been trading at $65 since the announcement, give or take a half a buck). Thus she has wowed us for 11 years, and won't have the opportunity to screw things up – in effect, retiring at the very top of her game. Before filling up the balance of this issue of The Essential REIT with my thoughts, such as they are, on why and how the lady became so successful, let's take a quick detour. We live, for better or worse, in a "show me the money" world, and so nobody will be convinced of Lady Chelsea's character without looking at this chart:



As you can see, Chelsea has easily outperformed both the RMS and the S&P500 since her IPO in 1993. Why? How? And what lessons might we learn from reviewing this very interesting (and, for some, highly rewarding) story?

One of the most important criteria that I apply in REIT stock selection is the management team. Over a period of time, this group of executives will develop a history of activity in a number of areas, including business strategy, execution of that strategy, property and tenant management, balance sheet management, capital allocation, value creation and such. Part of our job as REIT investors is to assess the management of each REIT in all these areas; of course, we may not want to own the stocks of even the very best managed REITs, capable as they are of creating lots of value for shareholders over time, if their stock prices more than reflect those stellar investment characteristics. But, at the least, we need to make that assessment of management.

And Chelsea's management team, while not flawless, has truly been outstanding. They have been both selective and effective in their developments over the years. Chelsea has built some of the very best outlet centers in America and Japan – their occupancy rates have been 98-99% year after year, and sales per square foot have risen steadily to $399, on average (for their Premium brand centers), at the end of 2003. Value creation? Development returns have averaged 14-16%, with little risk (these centers are largely leased before ground is broken). These guys have been incredibly successful developers in a niche market.

The balance sheet has always been strong, allowing the company to become one of the few consolidators of the outlet center industry and to keep its cost of capital modest – particularly important for a development-oriented REIT. Chelsea has also, a la Kimco, maintained a very strong relationship with a specialized group of manufacturer retailers, thus helping the company to know where to build and what kind of space each tenant is looking for. Chelsea's centers offer upscale and designer-name brands at competitive prices, and are located in excellent suburban locations and at major tourist destinations. They tend to offer more than "me-too" goods, and the popularity of the centers with both Americans and foreign tourists attests to this. I personally am a retail REIT hypocrite, as I do little mall shopping – however, I love going to Chelsea's center in Camarillo, just 15 minutes north of us (Big Dog is, of course, my favorite venue).

Reasonably good internal rent growth (with strong occupancy rates), a very effective development strategy over many years (particularly including Chelsea's foray into Japan – done with the right partners in a very intelligent, low-risk manner) – and an excellent balance sheet can be credited primarily to management's skill and capabilities over the past 11 years, though a bit of luck helped (most of Chelsea's competitors have been inept or worse, with only Tanger proving to be a worthy peer in the public markets). The company has been able to grow its FFO *every year* at a rate exceeding 10%, which is REIT world's equivalent of running the 100-yard dash in 8.8 seconds. Its stock traded between $10 and $15 per share in 1993, following its IPO, and closed last year at $55, for a total return (including reinvestment of dividends) of 727% (and, of course, the $66 offer from Simon adds to that stellar performance). Chelsea's only stumble was its foray into Internet retailing, via "Chelsea Interactive," which lost money but was certainly no disaster for shareholders. Even here, management knew "when to hold 'em and when to fold 'em."

Why has Chelsea agreed to merge with Simon? The companies claim that there are synergies in both retailer relationships and overseas capabilities; and Chelsea will give Simon the opportunity to expand further into the outlet center world, and provide it with more property development flexibility. For that, it's willing to pay a price that's about 50% above CPG's estimated NAV. Chelsea is probably the best investment that Simon can make at a time when great acquisition opportunities are as numerous as anti-social Golden Retrievers (though one may fairly question whether Simon is paying too rich a price for Chelsea – but, if so, we're not talking about an Urban-type premium here).

From Chelsea's standpoint, the motivation is tougher to grasp. CPG will remain quasi-independent, in the sense that its management team will continue to operate out of Roseland, NJ (wherever that is – uh, oh, is this left-coaster showing his ignorance?). Chelsea is selling at a price that well exceeds the net value of its assets, so it's hard to argue that its shareholders are being sold down the river. Perhaps there is a "Spieker-type" issue here, *i.e*., that Chelsea's management team sees its growth rate eventually decelerating This is unlikely over the intermediate term, however, as Chelsea's development pipeline is as strong as ever; and this year's same-center sales (up 15% in Q1) are rising like politicians' tempers in Sacramento.

Maybe the management team wants to cash in on all its hard work over many years (the predecessor of Chelsea was organized way back in 1981, and Woodbury Commons was opened in 1985). Who could blame them for wanting to convert much of that success into a very large payday? The companies say that the key executives of Chelsea will continue on as part of the Simon family, and two key executives will sign long-term non-competition covenants. I believe that they will continue to work hard for at least the next couple of years (these fellows have a great deal of pride in what they have created), but the scenario beyond that depends upon how they are treated by Simon and whether they would rather work than play golf, spend time with their children and grandchildren, or travel to Ulan Bator and beyond. What drives any of us to work so hard? Despite their efforts, I don't think that even Freud and Jung ever found out.

In any event, while I am very sad to see a lovely and very successful lady leave Reitdom, I cannot quibble with Chelsea's Board and management for doing this deal, nor the price they are receiving for themselves and their shareholders. And Simon is an excellent company, and a worthy bridegroom. So, as a long-time Chelsea shareholder, I have shed plenty of tears over this marriage, as I would selfishly have liked the Chelsea management team to continue to create value for me over many more years as a separate company, and without subjecting me to capital gain taxes. But that's not my call to make, and I therefore wish Godspeed, sunny skies and smooth seas to Lady Chelsea; REIT world doesn't see her kind very often.

Finally, given my penchant for poetic nonsense, the following is offered to those who can withstand pain:

A star was born
In 'ninety-three –
(As Lady Chelsea
Appeared to me).

Debutantes many
Were presented that year,
But special you were,
As history made clear.

Your cousins – admit it –
Were a pack of whores,
Such as MacArthur Glen,
And Factory Stores.

But despite the fact
You were not well known,
You clearly were
In a class of your own.

You shunned the highways,
And ignored the bores;
Sought great locations
And brand-name stores.

Deserts and boonies
Were not your game;
But Woodbury Commons
Your claim to fame.

You were always choosy,
Your pace wasn't fast;
But as time has proven,
You were built to last.

Developing beautifully,
You soon cast your spell –
Camarillo, Cabazon,
And Orlando as well.

Your reputation would grow
Among your legions of fans:
Building fully-occupied centers,
Selling high-end brands.

You entered the land
Of the Rising Sun,
And before too long
We knew you'd won.

The skeptics thought,
"She's off on a lark;"
But you quickly hit
The ball outta the park.

Your development yields
Were almost obscene,
At fifteen percent,
A value-creation machine!

But to many investors
You were little known;
On your conference calls
You were nearly alone.

Yet your stock has soared
Over so many years;
It beat the S&P,
And all of your peers.

Having traveled so far,
To a crossroads you came;
You decided to wed
At the top of your game.

You're certainly not shop-worn,
Nor have you been abused;
But Mr. Simon's fine offer
Could not be refused.

In the eleven years,
Since your IPO birth,
You've added mightily
To our collective net worth.

And though your pending marriage
Adds a few dollars more,
I ooze great sadness
From each portfolio pore.

I *like* Mr. Simon,
As you clearly do;
A fine marriage is likely,
And I congratulate you.

But forgive me, please,
If I down a few beers;
As I do at most weddings,
I will shed a few tears.

Best regards – and I wish you a belated Happy Fourth!
Ralph (Block)

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