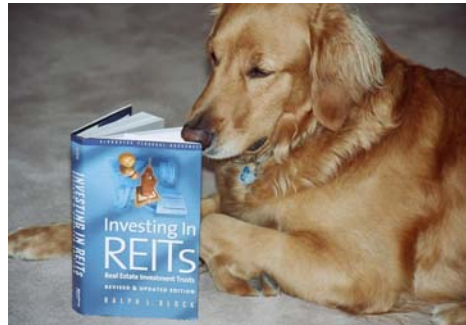


THE ESSENTIAL REIT

FORMERLY KNOWN AS

“REITWEEK”

July 26, 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. “Be Careful What You Wish For!”

Unlike Rap “music,” most new phenomena become more understandable with the passage of time and the wisdom of hindsight. Like 5th century monks arguing about the number of angels that can dance on the head of a pin, for well over a year we have been debating the issue of whether the awesome decline in real estate cap rates is “secular” or “cyclical.” However, I am now beginning to wonder whether it’s all beside the point. Perhaps the *real* issue is whether or not “real estate” is finally becoming a worthy investment heavyweight, in a position to compete for capital with the 800-pound gorillas of the investment world – equities and bonds. There is certainly some evidence that this is so:

a. The Giants Stir. Institutions ranging from private pension funds to charitable foundations to public retirement funds, though sometimes seemingly at a pace that would be disdainful to a snail, are now clearly allocating more of their assets to real estate (both direct and securitized). And there is lots of room for more increases, as most such institutions have allocated less than 10% to bricks and mortar, despite real estate’s (and REITs’) very competitive returns and low correlations over the past 20 years. Hey, guys, there are no more excuses for failing to bring your real estate allocations up to 10-20%.

b. Individuals’ Love Affair With Real Estate. Individuals have been pierced with Eros’ arrow, and have pursued what could be a long-lasting love affair with real estate (both residential and commercial – the latter, ever more increasingly, in the form of REIT stocks, and even so-called “private REITs”). While the cynics amongst us aver that this is just another manifestation of investors’ infatuation with “what’s working,” and argue that they may exit as quickly as they did at the end of 1997 to pursue tech and Internet stocks, there may be something a lot more permanent at work here. Why? I won’t bore you by restating the obvious reasons, which include the growing importance of dividend yields (particularly to those

boomers contemplating retirement), the awareness of the wisdom of combining low-correlating asset classes, more realistic return expectations and a greater sensitivity to investment risk.

Although it is certainly true that we won't know the extent of REIT investors' patience or persistency except with hindsight, we do know that REIT stocks have been the object of investors' affections for quite some time. REIT mutual funds continue to draw inflows,¹ the offering pipeline remains healthy, companies are increasingly offering REITs as 401k options, and guys like Leo Wells and Inland don't seem to have any trouble locating real estate-hungry investors. Since March 2000, REIT stocks' performance has consistently clobbered that of the S&P; while they won't always be able to walk on water, the interest in REIT stocks seems, to this admittedly-biased observer, like more than a passing fancy.

c. Persistently Declining Cap Rates. Cap rates have been declining steadily in the real estate markets, sale prices per square foot have increased, and anxious money continues to stalk real estate assets despite still weak "space" markets everywhere but in retail. We can, I think, safely assume that this is the effect of demand for real estate assets being greater than the supply. As Green Street's Craig Leupold noted this past week, "Apartment cap rates remain at very low levels. In fact, there is some evidence that cap rates may have actually dipped further during the last quarter or so." As though waiting for Godot, we continue looking, in vain, for higher cap rates and real estate bargains.

d. Steady/Increasing Inflows. Capital flows into real estate are not abating – even though short-term interest rates are on their way up and long-term rates have drifted higher since the spring. In a recent conference call with investors, Boston Properties' Mort Zuckerman, noting that his company has been beaten in deal after deal, stated that they "have seen no diminution in bidding for quality assets, and that there is no decent property available in Manhattan at a cap rate beyond 6 ¼ percent – and cap rates haven't moderated even by 25 basis points." The competition for commercial real estate is not only deep, but is also wide – as evidenced by the assortment of bidders for properties, from levered investment syndicates to conservative pension funds.

e. Increasing Foreign Interest. Interest in US real estate among foreign investors is hard to gauge, but seems to be increasing. Certainly, Asian investors have become enamored with US REITs, and there is a movement in a number of countries to adopt legislation to provide for REIT-like structures to accommodate local citizens' interest in securitized real estate with substantial dividend yields.

If real estate as an asset class is becoming the 4th leg of investors' dining table (along with US stocks, fixed-income investments and foreign securities), what are the implications for REIT (and real estate) investors? It is beyond the capabilities of this poor scrivener to know the answer to that question but, as I am often foolhardy and willing to go where angels fear to tread, I will humbly render a few guesses for your consideration.

1. The Supply of REIT Stocks and New Real Estate Will Expand. Just as the supply of new food diets seems to rise to meet the demands of a weight-obsessed public, the REIT industry will grow larger as hunger for securitized real estate is sated by new secondaries and initial public offerings of new REITs. One obvious implication of this would be that increasing demand for securitized real estate won't continue to drive REIT stock multiples and NAV premiums higher, but rather new entities will be organized to slake the thirst. After all, real estate is largely a commodity, and can easily be packaged within the wrapper of a 10-K and annual proxy statements. (Of course, some commodities are more commodity-like than others, and not all management teams are created equal).

Also, we may have to contend with a somewhat uncomfortable supply of new real estate development in response to ever-increasing capital inflows. As suggested below, there is likely to be less regard for on-the-ground conditions in the space markets, as institutions seek new assets (with lower ongoing cap ex requirements) and don't mind assuming some rental rate and occupancy risk.

¹ Through July 21, AMG Data has reported that inflows into REIT and real estate mutual funds this year have amounted to approximately \$3 billion. The inflows have been positive for almost every week of the year.

Item: In the US apartment markets, merchant builders have been able to generate respectable returns due to low cap rates – buyers have gobbled up these assets despite high concessions, sliding market rents and uncertain occupancy rates. And so the developers have built more apartment units than could readily be absorbed by tenant demand. Of course, properties requiring long-term leases prior to financing, like office buildings, would be less affected; however, some bizzaros are still building new office buildings in Chicago, and so even office supply might be affected by large and persistent capital inflows.

2. *Be Long Seat Belts.* We are apt to see a continuation (perhaps even an acceleration) of the increased volatility in REIT stocks – which, on some trading days, have caused me to wonder whether my office has been converted into a whaler plying the Drake Sea. The reason? “Non-dedicated” REIT investors, asset allocators and other assorted hedgies and traders seem to have found our world, and have discovered enough liquidity here to suit their needs. They will leap into our sandbox at a moment’s notice, and leave quickly when called by their mommies – or for any other reason, *i.e.*, when the allure of other asset classes beckon with better perceived risk-return ratios, or merely to build cash.

Item. I wrote in the last issue, “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.” We suffered similar damage on July 22, when the RMS closed down 2.3%, and a lot of that was inflicted during the last 10 minutes of trading. Dr. Panglossian types who thinks these violent moves are unusual and non-recurring probably view bengal tigers as X-large kitty cats.

3. *Lower Returns.* The range of cap rates prevailing from time to time will be pushed lower, not only due to greater investment demand for real estate product, but also as a result of the eventual evaporation of the traditional real estate “illiquidity premium.” I am not claiming that existing interest rates, perceived returns and all the other issues relevant to market cap rates won’t, as usual, work their influence upon market prices, but I suspect that both the top end and bottom end of the cap rate band will be lower than real estate investors have experienced over the past, say, 20 years.

If this is so, we real estate and REIT investors should expect lower returns on our investments, resulting, in part, from lower entry yields. More efficient pricing of real estate assets, resulting from the greater capital flows, including more bidders, will also tend to reduce returns. Further, returns may also moderate due to the increases in supply (of both real estate and REIT stocks) created to satisfy the demands of real estate-hungry investors, and we might experience this increased supply earlier in the real estate cycle.

Item. We are already seeing many knowledgeable private investors reduce their return expectations for unlevered commercial real estate. Guys who expect 10-12% unlevered returns are either taking horrendous risks or don’t have their heads screwed on right. My guess is that those who buy reasonably decent real estate today will generate average unlevered IRRs of about 9% annually, at best, and many consultants are coming around to this viewpoint. And a large number of REIT investors I’ve talked with would be delighted with 8-10% total returns on their investments. REITs’ cost of equity is coming down – the management teams and the investors just don’t know it yet.

4. *More “Disconnects.”* The prices of both REITs and real estate may become less dependent than in the past upon internal property fundamentals – existing and perceived – and more dependent upon the perceived values provided by other asset classes. Like Colombo, I am not a believer in coincidences, and believe that it’s been no coincidence that real estate assets and REIT stocks have performed very well over the past 4+ years – a time when returns in the equities markets have been skinnier than a hummingbird’s tongue, and when the yields on all but the junkiest of bonds have been pitiful.

We are likely to see a lot more “disconnects.” Capital and space markets will diverge more often, the result of rapidly changing risk and reward perceptions across *all* asset classes and in *all* geographies. As noted in a recent report of Prudential Real Estate Investors (US), “inevitably certain real estate assets or securities at times will attract or repel capital (at the margin) for reasons having very little to do with the real estate

space markets.”² Thus the price of an office building in Boston may depend, in substantial part, upon the expected returns on our investments in Intel or General Electric, or even the price of coffee in Brazil.

Item. We’ve already had two substantial “disconnects” within the past five years, one in the private markets and the REIT market over the past 2-3 years, and another in the REIT market in 1997-1998 when real estate was doing fine but REIT stocks cratered due to investors shorting yield and going long growth. These disconnects will become more frequent, and successful real estate investing – at least over relatively short time periods – will require some knowledge of worldwide capital markets and fund flows.

5. *Where Have All the Gazelles Gone?* During many periods in REIT history, a sizeable number of REITs have been able to raise huge amounts of equity when capital for real estate was elsewhere unavailable. This enabled them to launch acquisition binges, and pig out on great real estate deals; this, of course, created unusual amounts of value for shareholders. More recently, in the mid-1990s, some REITs with development expertise were able to create substantial value by buying land at modest prices, and putting bricks and mortar into the ground at stabilized returns in the double-digit range.

But when capital flows freely to anyone with two years of real estate experience and a cell phone, extraordinary value-creating opportunity will be almost as scarce as an alligator in the Arctic. Land prices will rise, merchant developers will flourish, and properties will go to those buyers willing to accept very modest returns. So, fewer REITs will be able to implement strategies that enable them to generate free cash flow growth rates beyond 6-7%, at best. REIT growth rates will converge and the Gazelle REITs (e.g., Chelsea, Centerpoint and a handful of others) will become nearly extinct. While we should be willing to pay a modest NAV premium for an increasing number of REIT stocks, we may not be willing to pay a huge premium for any of them.

Item. Could greater competition and eventually slowing growth rates be a reason for Chelsea’s agreement to sell out to Simon? Is a narrowing of extraordinary opportunities here in the US the impetus behind Pro Logis’ and AMB Property’s decision to go to Asia? Why has Kimco entered Canada and Mexico? Why is Simon experimenting in Europe? Are these all thoughtful responses to a dearth of unusual value-creating opportunities? Will risk levels for some REIT stocks rise as managements struggle to find ways to create extra value for shareholders in an increasingly competitive real estate world?

6. *Greater Importance of the “Global Strategist?”* One of the potential effects of an increased and persistent flow of capital into real estate could be that we’ll experience a greater divergence in the near-term performance of both real estate types and REIT stocks. Thus the 12-month performance numbers of bond-like real estate assets and bond-proxy REIT stocks may vary more widely than in the past from those real estate-related investments that are more sensitive to the economy. The “bonds” may perform even worse relative to, say, hotels and apartments in rising economic environments, and vice-versa. Investors will have more choices and more resources with which to analyze the relative risk and reward prospects for particular REITs and property types and, given the shorter time horizons of investors and their lack of patience with underperformance, will tend to act upon them.

Thus investors may rapidly shift their investment capital to one sub-sector or another of REITs or real estate. These “top-down” investment strategies could be based upon real estate sector analysis, interest rate, economic, and employment growth perspectives, and even the shifting sands of investment styles (e.g., higher-risk vs. lower-risk, large cap vs. small cap, etc). This will likely create greater demand for “global real estate strategists” who are able to effectively time macro real estate and interest rate cycles (if any such creature exists). If this occurs, we should expect even greater divergence in performance from year to year among REIT sectors, NCREIF real estate asset types and REIT stock investment characteristics.

Item. In the year 2001, and during a number of periods thereafter, the stocks of many high-yielding REITs, and those REITs with very modest long-term cash flow growth potential (those I have called “Oxen REITs”), performed a lot better than the larger, well-known REITs with better perceived long-term total

² Prudential Real Estate Investors (US), “Life After the Disconnect,” June 2004, p. 6.

return prospects. This was puzzling to a number of active REIT portfolio managers, who questioned the sanity of the new REIT investors. However, there was method to their madness, as the economy remained very soft until this year, interest rates were very low and growth prospects for most of the large REITs were conspicuous by their absence.

This year, however, through July 22 (per REIT Wrap), the RMS index had delivered a total return of 5.6%, which is almost 200 bps short of that of the large-cap populated Cohen & Steers Majors. Is this due to smart “global strategists” forecasting better investment returns for the growthier REITs, now that the economy seems finally to be on the mend? Perhaps they will shift gears yet again, whereupon the mortgage REITs and bond proxies will suddenly kick sand in the faces of the hotels, apartments and others counting on continuing economic recovery, more job growth and increasing demand for space. The change, when it comes, could be very violent and happen quickly. Life in a new Hobbsian REIT world, as in the broader equities market these days, could become solitary, nasty and brutish – though perhaps not “poor” or “short.”

Anyway, these have all been just random thoughts escaping from this fuzzy brain of mine. The future cannot be foretold; those of us who try to do so are fools, and mostly wrong. However, like Sammy pondering the timing of his next cup of ice cream, it never hurts to mull over these unknowables. While, as Santayana warned us, “Those who do not remember the past are condemned to repeat it,” it’s also rarely helpful to drive only by looking through the rear-view mirror.

Best regards,
Ralph (Block)

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