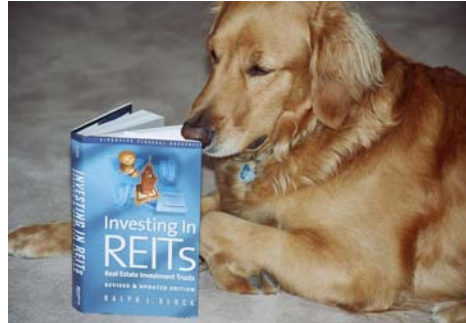


THE ESSENTIAL REIT

FORMERLY KNOWN AS

“REITWEEK”

August 16, 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

Preliminary Note: Nothing in this issue of The Essential REIT will help you make any money (of course, I'm not sure anything in the other issues accomplish that noble objective either). Rather, the major part of this issue is devoted to a topic I've long wondered about – under what circumstances should a REIT's board of directors be required to seek shareholder approval before making fundamental business that might affect the intrinsic values of our REIT stock investments? I have no answers, but hope that you will join me in these peregrinations...

1. Just Who's Money Is It, Anyway?

The 6th of August in the year 2004 is a day that should live in infamy for shareholders of Sizeler Property Investors (SIZ). On that afternoon, the company tossed a Molotov cocktail at its loyal yield-hungry shareholders. Its press release announced that the company's dividend would be cut 56.5%, from 23 cents to 10 cents per share; the reason given, in a statement almost as cryptic as the answer to the question, “Have you made any money in your REIT investments during the past four years,” was: “to generate greater funds for future real estate investment.” The company added that it “is considering changing its strategy both geographically and by types of property it buys.”

Ah, well, that certainly clarifies things. Shareholders were, not surprisingly, less than impressed. On the following Monday, the first trading day after the announcement, the stock fell 15.4% – as I write, it's still sliding, but “groping for a bottom” – and investors were left holding a very foul-smelling bag. Now, one might legitimately wonder (as I have) whether Sizeler's shareholders would be asked to consider and approve such a fundamental change to the REIT's business strategy and asset composition, let alone its dividend policy, but the company has made no such suggestion. (In a press release also issued on August

6, the company stated that its FFO per share for Q2 amounted to 22 cents per share, flat with the prior year and only a penny below the pre-existing dividend rate).

In fairness to Sizeler's management, the company did file an 8-K with the S.E.C. on August 10 that fleshed out the press release a bit. But it did not address the issue of shareholder approval for these radical changes, nor did it explain its "new opportunities," which "will enhance its long-term cash flow." One can only assume that the board has taken the position that "Father knows best," and that its children are expected to be seen and not heard (from). All of which, of course, raises important questions for REIT investors – whether or not they have been entangled like a fly in Sizeler's bizarre web.

Business law 1A. Corporations are creatures of the state, and each is governed by the laws of the state in which it is incorporated. These state laws are varied, and include what corporations may lawfully do and whether shareholder approval is required for certain corporate actions, among other things. While they will vary from state to state, most laws governing corporate conduct require shareholder approval for the election of directors, corporate mergers and similar transactions (almost always for the acquired company and often for the surviving corporation), transactions between the corporation and "interested" directors or shareholders, *i.e.*, where there's a conflict of interest, changes to the certificate of incorporation to change a corporate name, changes in voting rights, a reincorporation in another state, and even, in many cases, stock splits or reverse stock splits.

Over a number of years, the S.E.C., New York Stock Exchange and NASDAQ have added their own two cents, requiring those companies that are public, and/or listed on an exchange (or other trading network), to comply with certain rules and regulations deemed to be necessary for good governance, some of which require that shareholders be asked to approve certain transactions proposed by the board. If you go to Google and key in "SEC shareholder approval requirements," most of the first 10 pages or so will be filled with analyses of the recently adopted rules requiring shareholder approval for most equity compensation plans.¹ The NYSE has its own set of rules, in which shareholder approval is required not only for equity compensation plans, but also the issuance of stock to "related parties," the issuance of new stock in any transaction where the new shareholders will have voting power equal to 20% or more of the total voting power before the transaction, and changes in corporate control.²

But these corporate laws, SEC regulations and listing requirements seem to have grown, kudzu-like (*does anyone know what "kudzu" is?*), over the years, with as much coherence as Sammy's backyard excursions. And, for some reason unknown to this naive observer (albeit former corporate lawyer), there is no general rule that requires shareholder approval for non-specified important actions that are likely to alter the nature of one's investment – such as a major change in corporate strategy of the type that Sizeler announced. And what about major changes in dividend policy for companies such as REITs that are frequently owned largely for their dividend yield?

Fortunately, REIT organizations are precluded by law from engaging heavily in non-real estate businesses;³ thus Equity Office Properties may not, even with shareholder approval, sell most of its assets and use the proceeds to buy, for example, all the major US airlines (unless it de-REITs). But, to my knowledge, nothing precludes Boston Properties from moving heavily into the hotel business or Reckson from buying a huge office portfolio in Dallas – in each such case without having to ask shareholders what they think. This is apparently why Sizeler decided to just "do it," and not to bother with their shareholders.

All of which brings us back to my silly question: Should boards of directors be required to ask their shareholders for approval before making major changes in business strategy or balance sheet management? What types of major changes or transactions *should* trigger a shareholder approval requirement? Or are

¹ On June 30, 2003 the S.E.C. approved changes to the listing requirements of the NYSE and NASDAQ that would require most equity compensation plans to be approved by the shareholders.

² See, for example, N.Y.S.E. Listed Company Manual, Rule 312.03, "Shareholder Approval."

³ A company cannot be a REIT unless, among other things, at least 75% of its assets are invested in real estate and at least 75% of its gross income comes from rents on real estate owned or interest from real estate mortgages.

these thoughts just plain goofy – and just another disincentive for management to take bold action to create value for its shareholders? Hasn't Sarbanes-Oxley done enough to discourage risk-taking? Or are boards and management teams still not yet sufficiently accountable to the shareholders for whom they are stewards?

American corporate law, ever since the 19th century, has always given boards of directors substantial discretion to manage the company without undue shareholder interference. Shareholders have been given power to vote only with respect to “key events,” such as board elections, merger transactions and proxy solicitations, as well as changes in the corporate charter and “interested party” transactions. Increasing the number of events that must be submitted to shareholders would, some argue, simply create increased costs and inefficiencies. And, after all, shareholders approve board and management recommendations in the vast majority of voting situations anyway – and those who don't like what's going on simply “vote with their feet” and dump their holdings.

But in this post-Enron era there is a much greater sensitivity to the frequent conflicts of interest between board members and management, on the one hand, and outside shareholders on the other. Shareholders are, in many cases, becoming “activists,” and want to exert some additional control over management's actions. And, as pointed out by Messrs. Burch, Morgan and Wolf in a recent research paper,⁴ “Merger votes [although almost always approved by shareholders] may *indirectly* monitor managers by providing an implied threat of a failed vote, thereby disciplining managers in the types of acquisitions they propose.”

This comment calls to mind a strange event in Reitland, a few years ago, where a proposed merger between Mack-Cali and Prentiss Properties was aborted due to shareholder dissatisfaction with the proposal. In my former life as a corporate lawyer, I sat in at many meetings of client boards of directors, and remember the look of sheer horror on the faces of the board members when I advised them, on certain rare occasions, that the action they were proposing would have to be submitted to shareholder vote. There is little doubt that having to draft a proxy statement asking shareholders for approval does, indeed, exert a moderating influence on boards and management teams, and encourages them to “know thy shareholder.”

Thus perhaps a reasonable argument can be made for the proposition that shareholders should have the opportunity to vote upon more major corporate changes that could substantially alter the value of their investment than is the case presently. And perhaps REIT shareholders should have still *more* opportunities to vote on major changes. Although many REIT investors are willing to give management wide discretion in how they run their business (and I, personally, would allow Milton Cooper to do anything he wants at Kimco), others are attracted to REITs because of the properties they own, by the large dividend yields they provide and by their requirement to pay out 90% of pre-tax income to shareholders – thus precluding the management from channeling all free cash flow into “wonderful” new investments. The Mack-Cali/Prentiss Properties deal was wildly unpopular with shareholders, who were perhaps only able to back management down because the transaction was structured as a merger. Unfortunately, not all such major transactions require shareholder vote.

I am certainly not suggesting that every significant change in policy should require shareholder approval. Boards should be free to make important decisions and enter into transactions of significant size without having to go back to their constituency. They should be free to set dividend policy, raise equity and debt, repurchase stock, make large portfolio acquisitions and change development strategies as the situation dictates. However, I wonder whether boards of directors shouldn't have to argue their case to shareholders before implementing such major events as leveraging up the balance sheet well beyond historical parameters, chopping the dividend (*e.g.*, perhaps by more than 30%) despite the adequacy of current cash flows, materially changing the company's business strategy or otherwise altering in a substantial manner the risk profile of the company. A well-conceived change in direction will invariably be approved by the shareholders (*e.g.*, Manufactured Home Communities' strategy to slash its dividend, increase leverage and buy a large volume of quality assets), but a really dumb proposal may not be.

⁴ “Is Acquiring-Firm Shareholder Approval in Stock-for-Stock Mergers Perfunctory,” University of Miami Department of Finance, dated May 2004.

Is reducing the dividend by 55%, as Sizeler has done, when cash flow is just about adequate to pay the existing dividend and when many shareholders rely upon it for living expenses, less important than a change in corporate name or the implementation of a new equity incentive program? Is acquiring a major real estate portfolio of a very different type or location, or fundamentally altering the basic business model upon which investors have relied, less important than granting options to directors, or reincorporating in Maryland?

There certainly is a trade-off between encouraging boards and management teams to take advantage of new opportunities quickly and allowing them to solve looming problems in a cost-efficient manner, on the one hand, and providing the shareholders with greater influence over major corporate events that may affect the values of their interests, on the other. A requirement for Vornado's shareholders to approve the Mendik purchase may have impeded a deal that has created huge amounts of wealth for VNO's shareholders (although most merger agreements are conditioned upon shareholder approval anyway, and most are approved in due course). However, if the Sizeler management team and board knew they had to obtain the green light from shareholders ahead of time, would they have been so quick to chop the dividend in an attempt to "generate greater funds for future real estate investment?"

The devil is, as usual, in the details, and shareholder voting legislation and regulations need to be crafted to balance the competing interests. I don't have The Answer to this issue, and nobody has asked me for my opinion. However, perhaps there's room for more dialogue and discussion here, and perhaps shareholders ought to be given a bit more say in how *their* precious capital is allocated. Perhaps I might be forgiven for imagining campaign buttons attached to lapels of suits haunting the halls of state capitols reading: "No More Sizelers!"

2. Reversion to the Mean?

The REIT market has, in recent years, been giving some professional REIT asset managers, who must play the relative performance game, a few migraines. It seems that, beginning in 2001, the REIT benchmarks against which their performance, bonuses and reputations are measured have been tough competitors. The big caps, which are generally favored by institutions and REIT mutual funds, have had sand kicked in their faces by their smaller peers in both 2001 and 2002, and this unpleasantness abated only since last year.

I did some quick back-of-the-envelope calculations, and present the following for your perusal. The Morgan Stanley REIT index (RMS) is, of course, a widely followed market-cap weighted REIT index providing real time information, and the C&S Majors is a REIT ETF composed of the 30 largest equity REITs, reflecting the performance of the large caps.

| YEAR | MORGAN STANLEY REIT (RMS) | C&S MAJORS (RMP) | PERFORMANCE DERBY |
|----------------|--|---------------------------------|------------------------------|
| 2000 | 26.8% | 31.0% | C&S by 420 bps, or 15.7% |
| 2001 | 12.8% | 10.3% | RMS by 250 bps, or 24.3% |
| 2002 | 3.6% | 3.3% | RMS by 30 bps, or 9.1% |
| 2003 | 36.7% | 37.4% | C&S by 70 bps, or 1.9% |
| 2004 (to 8/12) | 6.0% | 8.4% | C&S by 240 bps, or 40.0% |

As we can see from the above table, something odd is happening this year: The large-cap REITs seem to be extracting a bit of revenge from the rest of their peers in REIT world, outperforming them by 240 basis points – which is very substantial on a percentage basis. On Friday, Advest's REIT analysts noted the

same phenomenon. They compared the year-to-date performance of the REITs with market caps of over \$2 billion with those below \$500 million. Result? The large caps scored 6.4% total returns vs. only 2.4% for the smaller caps.

Is Advest right in suggesting “there may be some opportunities among the small-cap REITs to boost performance?” Or was the modest turnabout that we saw last year a harbinger of more outperformance by the big guys over the next 12-18 months? I do not know, and would rather spend my time listening to a Haydn quartet or taking Sammy to the park than spending lots of time trying to forecast such imponderables. However, my guess is that the larger REIT organizations will see their stocks continue to outperform, assuming the economy shakes off its apparent lethargy and continues to forge ahead.

Why? First, a caveat: Any explanations for the large-cap outperformance are suspect, and there are plenty of exceptions to every trend, *e.g.*, the torrid 26.9% return of small cap (\$175MM) apartment REIT Associated Estates this year, beating even the 23.6% performance by large-cap Avalon Bay. And the last time I looked, small cap Acadia Realty was continuing to kick butt and take names, easily outdistancing Kimco in the NSC space. But I do believe that the outperformance this year by the big guys is no fluke.

Reason #1. The smaller REIT organizations tend to trade at lower multiples and higher dividend yields than the large caps, and are often bought for these high yields. That itself tends to make them more interest-rate sensitive, and less of a magnet for investors’ capital when interest rates are expected to rise (while the 10-year T-note yield isn’t much different from where it began 2004, most bond market participants expect higher long-term rates, and the Fed has already begun to push up on the short end of the yield curve).

Reason #2. The larger cap REITs tend to have larger and deeper organizations, with strong capabilities for creating substantial value for shareholders when market conditions are right (but, like every generality (even this one), this isn’t accurate all the time). Generally speaking, the big guys stand to benefit more by improving real estate markets, which may give them greater opportunities, over the next few years, to launch development projects that can add substantial value for shareholders. Over the past few years, that expertise was as utilitarian as a mega-mall at Elephant Island, and so shareholders didn’t want to pay a premium for it.

Reason #3. The oft-frenzied bidding action and low cap rates in the direct commercial real estate markets suggest that institutional investors want to continue to push more of their assets into real estate, and REIT stocks are an obvious proxy for such investment – and much more liquid. Where are they apt to go? Simon and Vornado, or Pennsylvania REIT and Glenborough? And, cross-over investors and hedge funds, whose performance numbers are as important to them as a stylish haircut is to Donald Trump, have been moving significant chunks of their assets into REIT stocks – which continue their 4+ year skein of outperformance. Not wanting to invest in roach motels, where it’s easy to check in but very difficult to check out, they are most likely buying the more liquid big cap REIT names.

Reason #4. Although I have no figures on hand to prove it, it’s my guess that the higher quality properties in high-barrier markets have started to open a performance gap over more modest assets in lower-barrier markets in recent quarters, *e.g.*, performance appears to be improving more quickly in Avalon Bay’s and Archstone-Smith’s apartment markets than in Gables’ and Post’s, and we certainly know that, for the most part, office markets in CBD locations are firming up more quickly than suburban markets. I believe we are seeing the same trends in retail where, for example, Macerich’s coastal malls are performing better than those in the Midwest, and Nieman-Marcus’ same-store sales are well ahead of those of Ross. To the extent that the large cap REITs tend to own class A assets in stronger markets, their properties will probably perform better, and this obviously attracts new capital to their shares. Compare Boston Properties’ operating and stock performance this year with those of Highwoods.⁵

⁵ Through August 12, Boston Properties’ stock was up 9.7%, while Highwoods’ was down 10.7%. Same-store NOI growth for Boston in Q2 was –0.6% (on a cash basis), while Highwoods’ was – ah, well, the company hasn’t reported Q2 results yet (its same-store NOI was down 9.7% last year and 3.3% in Q1).

All of the foregoing thoughts are merely speculations, and you, dear reader, should take them with barrels of salt. For example, Equity Office, one of the very largest REITs, has seen no rebound in its property performance, and its shares were down 8.6% thru August 13. But, even if my explanations of the recent past are modestly accurate, there is, of course, no assurance that these trends will continue. All forecasts are suspect – which provides both the fun and the frustration of successful investing.

Off Topic. Here are two quotes from Friday's newspapers that brought me smiles: (1) remarking on the modest snap-back in retail sales reported for July, "Consumers are back. Actually, they never went anywhere" (Joel Naroff, Naroff Economic Advisors); and (2) Commenting upon earnings surprises at Hewlett-Packard and other technology companies, "Technology is becoming a cyclical sector" (Apjit Walia, RBC Capital Markets). Silly me; I had always thought that tech companies report ever-increasing earnings each and every year.

Best regards,
Ralph (Block)

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