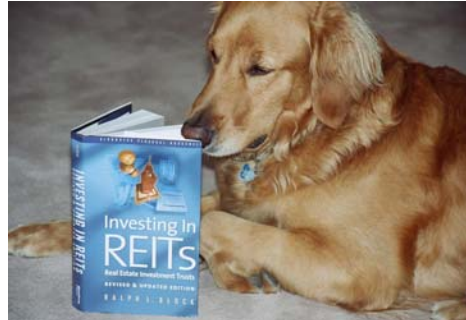


“THE ESSENTIAL REIT”

November 12, 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. A Random Walk Down REIT Street.

A month having passed since the last issue of The Essential REIT, it's a good thing I changed the title of this bizarre little publication from “REITWEEK;” otherwise, Eliot Spitzer would, by now, have hung me upside down and cut my heart out for practicing false and misleading advertising. In any event, I hope that, as many assert, “excitement” is overrated, as there's been precious little of that commodity in our world lately. During the roughly 30 days since the last issue (October 12), the RMS index is up 2.7%, but the S&P 500 (+3.7%) has outperformed it – an unusual event during most of the past five years. With little change in interest rates or economic conditions, real estate cap rates continue to play “limbo,” with everyone wondering, “How low can you go?” And this, of course, has meant that those proclaiming a market top for REIT stocks have been wiping the egg off their sad faces, while those with a mind-set for “buying the dips” have been chortling.

Elsewhere in the world, interest rates are up modestly from one month ago (primarily reflecting surprisingly good job growth numbers for October), consumers continue to view saving money as something akin to undergoing a root canal (and thus continue to shop), oil and gasoline prices have eased a bit, and the national political campaign for President, which began two weeks after President Bush was elected the first time and which lived up to the middle three of the five evils spoken of by Hobbes (solitary, poor, nasty, brutish and short), is, mercifully, over. Now all investors have to worry about is the Iraqi quagmire, a falling dollar, mushrooming twin deficits, persistently-high oil and gasoline prices, wimpish employers who lack Keynesian animal instincts, rising interest rates, a dysfunctional healthcare system and an unsolvable social security problem. I understand that bulls climb walls of worry, but this one looks like Hoover Dam.

Not being able to solve any of those problems, let's turn inward and consider a few issues of interest to us REIT investors. Perhaps it might be useful to ask some questions of that old codger lying over there on the sofa, scratching the belly of a well-known Golden Retriever.

Q. Hey, Reitnut, is it OK if I ask you a few questions?

A. Sure. There's certainly no guarantee that any of my answers will be either accurate or helpful, but fire away.

Q. *Earnings Season*. REITs' earnings season is now over; what have we learned, if anything? Were all those hours of lost sleep worth it? Did the benefits justify your surly mood over the past 2-3 weeks?

A. No. Oh, sure, we did learn a lot, but no major revelations resulted from the hours of discussions and the reams of disclosure documents. But what did you expect? An announcement that EOP's occupancy rate had spiked 500 basis points, or that Archstone's net operating income soared by 12% last quarter? This is the real estate business, lad, where trends last for years and watching grass grow is exciting by comparison.

But we did learn a few things worthwhile for investors to know. In the comments to follow, I will be generalizing, and ignoring many flagrant exceptions; but, hey, nobody pays me to write this stuff, so be generous. The apartment business is slowly but surely healing; concessions are abating, occupancy rates are firming in most markets and, in a few, owners are even getting modest rental rate increases. The agony of the past four years is ending; however, high-fives and other sorts of jubilation are still premature.

Washington DC and Southern California remain among the best markets, and the usual suspects, *e.g.*, Dallas, Denver, Houston, *et al*, remain weak. Job growth, while improving, isn't yet strong enough to offset new apartment supply and free-flowing single-family mortgages. If the results of Avalon Bay, Archstone-Smith and Essex are any indication (each of which delivered some respectable numbers), the coastal markets appear to be opening a gap on their lower barrier peers. Three big issues for apartment REIT owners: (a) are existing cap rates too low; (b) when do mortgage rates rise enough to make a difference to prospective home-buyers; and (c) will NOI growth ramp up as quickly as buyers and REIT investors seem to expect?

The office situation remains a tale of two markets, with the rich (er, less poor) getting healthier, and the poor (yeah, that fits) getting, well, perhaps not poorer, but seeing no prospects of marrying a trust-fund heiress. Unfortunately, most markets are still plagued with high vacancy rates (the average national vacancy rate is still above 16%), and roll-downs from lease rates recorded during the Dotcom Madness of five years ago will, at least over the next 18 months, continue to be painful.

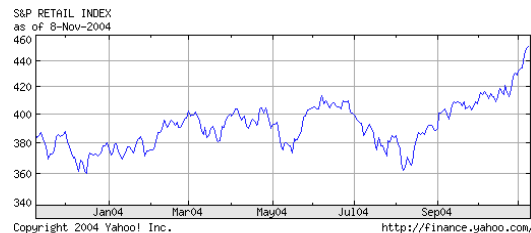
Those office owners, *e.g.*, Equity Office, saddled with heavy exposure to markets such as Atlanta, the Bay Area, Boston, Chicago, Dallas, Denver and Houston, are still scraping and clawing for every tenant, and the best that one can say about net effective rents (contract rents less TI allowances, commissions, free rent, free parking, free laundry, etc.) is that, generally speaking, they're no longer declining. Talk of "leasing velocity" isn't impressive; heck, even your humble author can lease tremendous amounts of space if nobody cares if net effective rents are a buck a foot per year.

On the other hand, owners in NYC, Washington DC and many Southern California markets, *e.g.*, SL Green, Vornado, Reckson and Kilroy, are chirping like magpies about declining vacancies and changes in tenant psychology, and even daring to suggest some increases in market rents beginning late next year in those few markets where vacancy rates are about to breach the single-digit level. Sure, there are very good management teams in place at these office REITs, but anyone who thinks that the outperformance of their stocks this year hasn't been driven principally by their relatively stronger markets is two slices short of a full loaf.

Interesting issues for office REIT owners are: (a) when, if ever, does job growth (at least for the FIREA segment of the economy) accelerate enough to absorb the excess space created by the tech and dotcom meltdown beginning in 2000; (b) do we – or don't we? – have unacknowledged excess space that will be returned to owners as leases expire over the next 24 months; and (c) when we finally get to enjoy a bit of landlord pricing power in some markets, will the developers take away the punchbowl by launching new spec projects? Unfortunately, we are beginning to see signs of this happening in the industrial property space, where builders are taking advantage of lower return requirements of institutional investors and doing

“bespoken” deals, some at sub-7% caps. What’s a poor development REIT to do? The *good* news is that cap rates are low; the *bad* news is that cap rates are low.

Moving over to the swaggering retail REITs, I’ve have seen nothing during the late earnings season to make me think that the party is over – indeed, a number of guests are still hanging, glass in hand, from the chandelier. Of course, some retailers will always be just five steps away from the Federal bankruptcy court; however, most of them appear to be in pretty good shape. The S&P Retail index (^RLX) seems to bear this out, as you can see:



Consumers continue to spend despite the abatement of cheap refi loans and the Bushian tax cuts, and job growth, while hardly robust, does seem to be a fact of life (and there are some indications that wages are beginning to grow as well, perhaps in response to declining productivity numbers – the low-hanging employees have already been plucked). Meanwhile, the retail gurus expect a 3%+ increase in Holiday Season sales this year. In short, there is ample demand for space by retailers of all shapes and sizes, and spreads between new rents and expiring rents will remain healthy, *e.g.*, spreads for mall REITs Macerich and Simon were both 19% (the former for Q3, the latter YTD). The strip center guys are doing well also, *e.g.* both Kimco and Weingarten reported same-center NOI growth of 4.5%, and Pan Pacific came in at 4.0% (though most of the peer group didn’t do quite as well).

A few key issues for retail REIT investors include: (a) what happens to consumer spending if oil, gasoline and home heating prices again act like a Golden Retriever on steroids, particularly if rising interest rates put coffin nails in home refinancings; (b) how much will FFO growth slow as portfolios approach effectively full occupancies – remember that leases don’t roll over frequently in this sector, and cash rents on new or renewed strip center leases don’t grow by more than 6-8%, while the competition for acquisitions is breathtaking; and (c) can the supermarkets withstand the challenges of Wal-Mart and other competitors, and maintain adequate profit margins? Another issue is whether retail REIT stocks underperform after a monster run of outperformance during the past few years (for speculation on this, see below).

Q. *Too Many IPOs?* Thanks, Reitnut...I think. There have been a substantial number of REIT IPOs this year. Is this a sign that REIT stocks are approaching a top?

A. I’m not terribly worried about this – at least, not yet. It is, in a sense, odd that so many of the current IPOs are REITs. This has rarely been the case. I think it is a reflection of three things: (a) REITs have outperformed all other asset classes for the past five years, so it is natural for investor demand to be strong relative to non-real estate companies (yes, Virginia, investors *do* tend to chase performance); (b) the desire for current yield is a trend that has been in effect for several years, and REITs provide that – so, again, it’s natural for this thirst to be partially slaked via the IPO market; and (c) REIT stocks are presently trading, on average, at premiums over estimated net asset values, which encourages some entrepreneurs to form real estate companies to try to take advantage of better prices on Wall Street than on Main Street.

So, it is not surprising that there are a number of new REIT IPOs. And I agree that, if unabated, this could signify trouble for REIT stocks down the road. Indeed, too much equity raising was a major contributing factor to the REIT bear markets of '98 and '99, and IPO statistics constitute a good barometer of market froth. However, the situation today isn’t terribly worrisome, as the volume of new REIT IPOs (and secondaries) as a percentage of the REIT industry’s total equity market cap is modest. Thus YTD through October 29, there were 26 REIT IPOs, generating \$8.0 billion of equity, and 68 REIT

secondaries for another \$6.3 billion. All together, that's still only \$14.3 billion, or 6.4% of REITs' \$224 billion year-end market cap for '03. It's substantial, but not worrisome. Back in 1997, there were 26 IPOs raising \$6.3 billion, plus 227 secondaries raising an additional \$20 billion, for a total of \$26.3 billion. That was a shocking 30% of REITs' total equity market cap at the end of 1996 (\$88.8 billion).¹

So, do I worry? Not yet, given the relatively small amount of equity capital being raised via IPOs and secondaries vs. the total size of the REIT industry. I am also encouraged by the fact that the NAV premiums for REIT stocks are still in the 10-12% zone, a far cry from the danger levels of 30% that we saw in 1997. There is also an argument, which may be valid, that those buying REIT stocks today tend to have longer time horizons than those who bought in 1997. Finally, the current crop of REIT IPOs is not trading at premiums in the after-market and, indeed, some have been priced at below the estimated price range. This is hardly the stuff of irrational exuberance. But is the REIT IPO trend something to watch closely? Is a frog's ear water-resistant?

Q. Of SOX and REIT Stocks. How are REIT organizations handling the Sarbanes-Oxley (SOX) cost issue? Does the recent wave of REIT mergers and acquisitions have anything to do with SOX and its consequences?

A. There is a "law of unintended consequences," which apparently asserts that no planned change, in any sector of human endeavor, can be effectuated without causing some adverse and unintended consequences. Another way to put it is, "It seemed like a good idea at the time." Perhaps indexing social security payments to inflation is one good example. And we know, of course, that when politicians decide to "fix" a problem – whether real or imagined – there will be a price to pay that goes beyond what was intended by a "benevolent" Congress. All right, enough of philosophy. Whatever good the SOX legislation has done, or will do, it will also create some unintended problems (or "issues").

One such problem is that, due to the enormous compliance costs – during the conference calls we have heard estimates ranging from \$500K to well over \$1MM per year (and these estimates generally exclude internal costs, *i.e.*, time spent by in-house legal, financial and accounting personnel) – smaller companies will have a profitability disadvantage vis-à-vis their larger peers. Compare mega-retail REIT Simon with \$225-million market cap Cedar Shopping Centers. A \$500K increase in G&A costs, due to SOX compliance, would increase Cedar's G&A (vs. 2003) by almost 16%, and cost its shareholders \$.14 per share (these are my back-of-the-envelope numbers from perusing Cedar's financial statements, not Cedar's projections).

But an increase of \$1.0MM in G&A expense at Simon, due to SOX compliance costs, would boost G&A there by only 6.7% (and by only 1% if we include "home and regional office costs" as part of SPG's entire G&A package). In any event, this is only 0.4 cents per share.² While it is certainly true that smaller companies are likely to spend less total dollars on SOX compliance, the larger REITs will be better able to absorb these costs on a percentage basis.

Perhaps a larger and more important issue is whether SOX will be, for many executives, the straw that breaks the camel's back. Some will label my personal background as sordid,³ as I practiced corporate and securities law for many years. (Just kidding – *most* lawyers are decent, hard-working folks). In any event, I got the opportunity to work with many executives of public companies over a period of 27 years. And, based upon my experiences, I can say with some confidence that many (perhaps most) executives, while understanding the need for good governance and compliance, believe that the time and money spent on such issues is more than a bit excessive. And it's not just the exorbitant cost and the drain on valuable management time that's a major issue; for some unfathomable reason, most executives would rather not

¹ Source: NAREIT's website, www.nareit.com. I heartily recommend that all Reitsters check out this updated, spiffy and very useful source of information.

² On Simon's Q3 conference call, David Simon noted that Chelsea's SOX costs were running at about \$500,000, or one-half of Simon's, even though Simon was four times the size of Chelsea.

³ Defined in some dictionaries as "morally degraded, and in others as "foul and repulsive."

spend time at Raiford or Attica due to a SOX violation. And they have come to believe that there's a Spitzer and a plaintiff's lawyer lurking around every bend.

So the real question is whether this issue may be a contributing factor to an increased willingness among some executives and controlling shareholders to entertain a buyout offer from a larger firm. Put yourself in the place of a REIT CEO who owns lots of stock. You can get an offer today at a price that's probably higher than your stock has ever traded, and can boast to your kids and grandchildren that you retired at the top of your game. You can take home bundles of cash (or stock that can be sold without analysts whining and institutional investors carping about insider stock sales), and buy a second home in the Poconos and a villa in the Italian Riviera. Or, if you're a workaholic and don't want to enjoy a leisure life, you can easily snag \$75MM or \$100MM that will undoubtedly be offered to you by exuberant institutional real estate investors and earn a six- or even seven-figure income that you can use for walkin'-around money.

Look, I don't know if SOX will really lead to more M&A in the REIT industry. But it may certainly be a factor in the minds of some REIT executives when considering the future – and the quality of their lives. So, while I would never buy *any* stock on the theory that it soon will go to the altar with Daddy Warbucks, I do believe that SOX issues may help to modestly increase M&A activity in Reitville.

Q. **“The Trade.”** Reitnut, where are we with respect to “The Trade?” You recall, I'm sure, that Green Street Advisors and others have been speculating for some time on the possibility that a number of performance-minded REIT investors will decide to dump their retail stocks and load up the truck with apartment REITs. Is now that time?

A. “The Trade” is a great discussion point, but nothing's ever that easy in the real world. The argument runs something like this: Apartment REITs have been clobbered by low interest rates (which encourage borrowing to buy single-family homes and building by spec developers), and by non-existent to sluggish job growth. Retail REITs, however, have benefited by flush consumers and healthy retailers, encouraged by those same low interest rates, as well as plenty of re-fi opportunities and lower tax rates. So, when the economics flip over, *i.e.*, when job growth finally accelerates, interest rates rise, demand for houses wanes due to higher mortgage rates, and new apartment supply is cut back as a result of higher development costs (including rising interest rates) and perhaps a firming of cap rates, then apartment owners' prospects will be a lot rosier vis-à-vis retail real estate owners – the latter's advantages will wane or even be eliminated.

OK, so where are we now? We have interest rates rising moderately, but not much at all at the long end. On the last day of last year, the 10-year T-note yielded 4.26%. As I write, after an increase of a quarter-point over the past few weeks, the yield is 4.25%. So, are interest rates rising? We had a very good month for job growth, in October. Is that a blip, or the beginning of a ramp-up that will drive demand for apartment units by new renters? Will rising mortgage rates price would-be owners out of the market, thus turning the tide for apartment owners? Will these owners soon enjoy something akin to the halcyon days of the '90s, when NOI growth of 6% was almost a slam-dunk? Or will NOI growth rebound to just 2-3% annually – and stay there? Has the cycle governing the demand for single-family home ownership taken on a different and more disturbing shape? Do the remarkably low cap rates that stun our senses today already discount these better times ahead for apartment owners?

The bottom line, for me, is that what we already know about the apartment story is also known by everyone else, and what we don't yet know is unknowable. So if you (a) think you are smarter than everyone else, (b) enjoy acting like a cowboy with your or others' money, willing to “bet 'em high and sleep in the streets,” or (c) just plain feel lucky, go ahead and sell all your retail REITs and load up on the apartment owners. And pray like you've never prayed before. Don't get me wrong; I do agree that prospects for the apartment owners are improving, and I have added shares of these companies to my personal portfolio. But I'm a belt and suspenders kind of guy.

A final point. Although it's certainly true that prospects look a lot better for apartment owners next year than they've been in quite some time – and can no longer be called the poor cousins of the retail guys – it appears to me that the market has already discounted much, or even all, of this. Through November 9, retail REITs' YTD total return (per NAREIT) averaged 28.2%; the apartment sector has generated an

average YTD total return of 23.5%; that's hardly chopped liver, and many apartment REIT stocks have performed a lot better than many retail REITs. Macro calls are never easy or obvious, except with hindsight. As for me, I will remain diversified.

Best regards,
Ralph (Block)

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