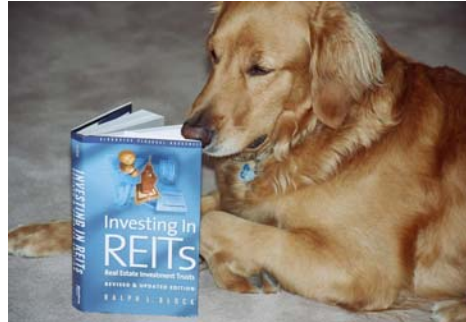


“THE ESSENTIAL REIT”

December 29, 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. 2005: Projections and Reflections.

Please refrain from tossing durian rinds at me as I dare to make a few forecasts for 2005. I am deluding neither my readers, nor myself, as we all know that forecasts, particularly the e-mail variety, aren't worth the paper on which they're printed. Even the best of them can be read, laughed at and then safely forgotten, and mine are, of course, no exception. But they may have a bit of socially redeeming value. If a forecast is based upon logical assumptions, we can keep those in mind while watching for bolts out of the blue that, by definition, are unforeseeable and thus not part of the equation; it is these surprises that make fools of forecasters (on both the upside and the downside).

OK, enough “CYA” preliminaries. The balance of this issue of The Essential REIT will attempt to persuade you, among other things, that REIT stocks should be able to deliver another respectable performance year in '05, albeit nowhere near the type we've been chortling over during '03 and '04. I'll make use of portions of the “poem” from the last issue, and try to explain the assumptions behind my apparent (or perhaps real) madness.

Our targets all are blown away,
Old records down the drain;
REIT stocks have kicked some major butt,
The shorts scream out in pain.

Like mighty airborne Supermen,
(Disguised as mild Clark Kent),

REITs five-year romp was off the charts –
Averaging twenty percent.

But trees grow not into the sky,
And stocks revert to the mean;
So will '05 become an ugly year,
In which Reitsters cease to preen?

Yes, 2004 was a dynamite year, particularly as it followed an even better one in '03; we would be guilty of the sin of hubris if we did not expect REIT stock performance to revert to the mean – perhaps soon. But, at the risk of sounding like a former president, what does “mean” mean? The average over the past 10 years

of 15.1%? No, certainly not – too high. How about 10%, a nice round number and perhaps the long-term return goal of many who invest in REIT stocks? Or perhaps something less than that, given today’s low interest rates and above-norm valuations? I have read all sorts of forecasts for 2005, covering a range wide enough to drive a Hummer through, *i.e.*, from screams to “short REIT stocks,” to dire warnings of a real downer of a year (off 20%) to proclamations of another splendid year, *e.g.*, something in the mid-teens. Then, of course, you have your middle-of-the-roaders, *e.g.*, Merrill Lynch, suggesting 5-10% returns in ‘05. Which of these pundits are more likely to be right?

Fundamental Spockian logic suggests that some or all of the basic forces driving the 5-year bull market in real estate and REITs need to vaporize before we experience a meltdown in prices. These forces are numerous, and include the growing importance of yield, low yields on bonds and other relatively low-risk investments, enough risk-aversion on the part of great swaths of investors to goad them to favor the predictability and stability of RE and REIT cash flows, a scarcity of cheap stocks out there in the great World of Equities, and substantial investor underweighting in the real estate asset class.¹ If most of these trends remain in place, those who argue for a major trashing of either real estate or REIT shares are trying to put together a 500-piece jigsaw puzzle with 418 pieces.

But what about valuations? Is real estate, or are REIT shares, so horribly overvalued that they may tumble simply from their own weight like a flabby 350-pound man trying to insert himself into a canoe? Sure, stocks may trade at excessive prices for quite some time (remember the Dotcom Era of the late ‘90s) but, to my knowledge, nobody has repealed the law of gravity – which eventually causes overpriced chickens to come home to roost. The valuation issue is what I had in mind when I wrote the following stanzas:

By hoary yields and multiples standards,
REIT stocks appear quite pricey;
But comparisons with NAVs
Show values far less dicey.

So private market pricing is
A key to this complex puzzle;
Are pension funds now satisfied,
Or do they voraciously still guzzle?

Are prevailing market cap rates
Unrealistically rich and low?
Will they turn back up perversely,
Striking our REITs a painful blow?

REIT multiples are high; indeed, they are higher than they’ve ever been. But this is a misleading issue; high multiples disclose only a very small part of the valuation story. Indeed, as REIT stocks tend to move with estimated REIT NAVs,² it’s only natural that low cap rates should cause REIT stock prices to trade at higher multiples of free cash flow. Stocks also tend to trade at high multiples of trough earnings and, indeed, that is what REIT stocks are doing. But a more relevant question is, “Are REIT stocks trading at *excessive* premiums over estimated NAVs?” That, I believe, was one of the precipitating factors in the evil REIT bear market of 1998-1999, which was preceded by excessive valuations from an NAV perspective, *i.e.*, the *average* NAV premium hit 33% at the peak.

But today we’re not seeing those types of excesses. The most reliable sources (in my opinion) suggest that the typical REIT stock today trades at an NAV premium of about 14%, which isn’t too crazy when compared with the average premium in the Modern REIT Era of about 7%. Furthermore, it’s clear to veteran REIT investors that the quality and management depth of today’s REITs are better than ever (and

¹ *E.g.*, REIT stocks have barely scratched the surface of that leviathan 401k market, which is a natural for REIT investing.

² Green Street Advisors has done a study of this, showing that REIT stock prices tend, over time, to perform in line with increases or decreases in NAV estimates.

corporate governance “issues” are dissipating rapidly), and their stocks are much more liquid. So, a modestly larger than historical NAV premium shouldn’t make us double over with laughter or sneer with derision. It is certainly true that investors should be reluctant to pay a hefty NAV premium for most REITs at the present time, as it’s easier for pigs to root out truffles than it is for management teams to uncover really good real estate values. But, unlike Sammy’s snoring, an average 14% NAV premium doesn’t cause me to lose sleep at night.

But what about cap rates? Are they “too low?” Many argue that, when caps rise (this is, they say, merely a question of “when,” not “if”), REIT NAVs will certainly fall, as NOI growth won’t be sufficient to offset a large increase in cap rates. But first let’s address the preliminary question: “Are *existing* cap rates in the private markets too low?” I don’t think so. Green Street has done some very interesting work on this topic in recent months, and they have determined that cap rates tend to correlate nicely with interest rates on BAA-rated long-term bonds. Recent spreads of real estate cap rates vs. such bonds are a bit skinny but (except in the apartment sector) not very much out of line when compared with historic spreads, *i.e.*, something like 75-80 bps over BAA bonds, compared with a longer term average of about 100 bps.

Today’s cap rates therefore aren’t egregiously low when set against the backdrop of prevailing interest rates; so, as long as the latter remain somewhat stable, no one is going to convince me that cap rates are in bubble territory – not even close.

But let’s get back to the question of what happens to RE and REIT prices when interest rate *do* move back up; won’t that crater REIT valuations and their stock prices? Here we delve into the issue of whether today’s low cap rates are a symptom of something new cast upon the land, or just a function of today’s low interest rates. The issue is vital for understanding RE and REIT values, as a 75-100 bps increase in long-term interest rates would substantially decrease prices in our favorite asset class if the low cap rate phenomenon is merely cyclical in nature and explained by puny interest rates. Thus:

“It’s never, ever different this time,”
Dour cyclicalists intone;
“When interest rates begin to rise,
The low cap story’s blown.”

“But wait,” say smiley secularists,
“Our world’s more warm and sunny;
Allocations still are much too light –
Just follow well the money.”

Both sides of this argument have points in their favor. Interest rates have always been a key driver of cap rates in the real estate market, as well as multiples in the equities market (indeed, real estate cap rates are but real estate’s (reversed) version of equities’ price/earnings ratios). So, we delude ourselves if we think that rising interest rates won’t exert *some* upward pressure on caps (and downward pressure on pricing). And yet, we’d also be foolish curmudgeons not to recognize the recent investor sentiment that places real estate investments in higher esteem than has been the case during much of the last 10-15 years. And, if we recognize this apparent reality, we must conclude that “secular” issues may offset a large part of any negative effects on pricing resulting from an increase in interest rates. So, as I put it last time,

You may label me a wussy waffler,
My view’s betwixt those two;
Rising rates can be a pain,
But pricing’s a complex stew.

But wait! Even if cap rates rise but little with interest rates, that doesn’t mean that REIT stocks won’t get beat up in the short term. REITs trade as equities, and equity investors are notorious for shooting first and asking questions later. This is particularly so when an asset class develops a following among the momentum crowd, perhaps goaded even further by the hedgies, those trendy investment darlings who are anxious to dump an entire portfolio in the time required to tie one’s shoes. If they catch a whiff of rising interest rates – and, emulating Keynes, if they believe that *others* will sell REIT stocks in such event – they won’t waste any time dumping every REIT stock they own. And, thanks to ETFs, they can do so even without waiting for an uptick. We can’t say we’ve not been warned; we’ve seen this happen in April-May and, to a lesser extent, more recently. Thus:

Yet hedgies and their fellow traders
Can morph quickly into bears –
When long rates start to escalate,
They'll barf out all their shares.

Our REITs, of course, are divinely blessed
With sweet cash flow stability;
But the traders in control today
Spawn frightful volatility.

Thus, even though the secularists may be right, *i.e.*, cap rates may remain fairly stable even in the face of modestly rising interest rates, that doesn't mean that REIT stocks won't be slammed for a few months as a result of traders' nefarious activities, causing NAV premiums to narrow for a spell.

Will interest rates rise in '05? Quoth Dr. Seuss, "I do not know, I cannot say." The 10-year has had ample opportunity to fall apart over the past nine months, due to the trashing of the dollar, rising budget deficits, and steady Fed tightening, but is hanging in there like an ageing Mafia don. I personally think that long-term interest rates are more likely to rise than to fall, but see no reason why there should be more than 50-75 bps of exposure. Anyway, forecasting interest rates is less productive of my time than tossing tennis balls to Sammy.

Some have argued that the active REIT IPO market we've seen this year is a sign of a top in REIT shares. The facts, both quantitative and qualitative, don't bear this out. Certainly IPO volume is up substantially from recent years; through November 30, according to NAREIT, a total of 26 REIT IPOs raised an aggregate of \$8.0 billion. That's a larger number of deals than in any year since 1997, and the dollar volume even surpasses that year. However, as a percentage of the REIT industry's equity market cap, it's not particularly worrisome. Furthermore, the type of pricing frenzy we saw in '97 and even into '98 is clearly absent this time, as IPO issues have been opening for trading within a dollar of where they priced:

Do rising volumes of IPOs
Mean a REIT bull market peak?
Though aggressive pricing is the norm,
Aftermarkets have been weak.

Another interesting phenomenon is that, despite a 5-year bull market, we're not seeing much irrational exuberance on the part of investors, analysts or REIT executives. Indeed, most of the sell-siders have cut their ratings on the REIT industry from buy to hold (or worse) about 200 RMS points ago, while investors (both institutional and individual) continue to talk about "lightening up," "taking profits," "rebalancing" – all euphemisms for selling REIT stocks. This, of course, is healthy, as caution is rarely seen at market tops:

There's no portentous feeding frenzy
That's easy to discern;
At NAREIT's conference in LA
Our countenances were stern.

The sell-side guys all sport big claws,
"Reduce your REITs," they say;
Irrational exuberance
Seems many months away.

Now let's talk for a few minutes about sectors. First, an overview:

Now let's review the sectors –
Which performs the best?
That, good sir, is a loser's game,
A Holy Grail quest.

Avaricious merchant builders
Are becoming downright giddy.

Let's label most of the office REITs
Soporific Ambien Hounds;
Occupancy gains will be offset
With nasty rental roll-downs.

Apartment owners finally emerge
From a pit both cold and deep;
But if more jobs are not created,
Cash flow growth won't leap.

The picture's brighter for industrial REITs,
But, oh, what a heart-rending pity –

If gasoline spikes and home prices fall
I'll look like an abject fool;
But I'm inclined to tell the retail boys,
"Party on, dudes – it's cool."

Investing in REIT stocks by making macro calls on which sectors will perform best over the next year or two is a bit like trying to make a living at the track. Or, as Oscar Wilde said of second marriages, the “triumph of hope over experience.”³ That said, most investors expect that their forecasters will go out on a limb so that they will be able to chortle mightily when it gets chopped off by the shears of unforeseeable events. But I will bravely (though briefly) climb out onto that fragile limb.

The apartment sector experienced a transition year in '04. Occupancy rates firmed, concessions have been abating and market rents have flattened. However, low cap rates for these assets and perhaps overly rosy forecasts for NOI and FFO growth for next year make it unlikely that this sector of Reitdom will be a standout. Forecast: Market performers. Be very selective, *e.g.*, AVB or ASN.

Retail delivered excellent results again this year, and has been the only sector to enjoy substantial NOI and FFO growth for the last few years. There are few supply issues, particularly with respect to malls. But consumers appear to have become increasingly cautious, and this Holiday Season hasn't seen them pour money into those “must-have” toys despite the blandishments of the advertisers. The end of the tax cuts and abatement of home refinancings, coupled with very modest wage growth, higher energy prices and absurdly low savings rates, could mean that demand for retail space by retailers will abate next year. And, there could be an increase in retailer bankruptcies. A rise in short-term interest rates may affect AFFO growth at some of the mall REITs, in particular. Nevertheless, I'll go with the flow, and forecast: Slight outperformance.

The office sector is like the proverbial battleship – very slow to turn around. Disappointing job growth thus far, businesses' willingness to make do with existing staffs and the ever-increasing drive towards higher productivity mean that absorption will remain below historical norms. Yes, the worst is over for office owners, but 2005 will be another sluggish year for cash flow growth as modest occupancy gains (perhaps 100-150 bps) will be offset by another year of rental rate roll-downs as leases signed in '99-'00 will continue to haunt office owners when renewed or re-leased. Forecast: Yet another year of underperformance, albeit slight due to better relative valuations.

The industrial space is similar to offices, but never runs to such extremes in either direction; less dependency on job growth also helps. Better market conditions, however, will meet head-on with increasing supply, and so NOI growth will be mired in the 1-2% range. AFFO growth must come from external sources and, fortunately, some of the best and brightest REIT executives live in this sector and have been able to generate substantial external growth, such as by “going foreign.” However, much of this superior growth is already in the stock prices. Forecast: Market performers.

Lodging stocks have perked up substantially over the past 12 months, and 2005 should be another very good year for this volatile sector. Stronger results will be driven by a slowly improving economy, a lack of meaningful new hotel supply and, perhaps not yet fully discounted by investors, the positive effects of a weak dollar – which will encourage visits by foreigners (despite their disdain for US foreign policy) and more domestic travel by US citizens. And businesses, too, will open their purse strings a bit; they may not hire much, but will be forced to expand their travel budgets in an ever-competitive economy. Here there be dragons, however, which include potentially negative geopolitical events. Forecast: Modest outperformers.

And all of the foregoing is worth a hamburger wrapper at McDonald's. All right, let's get to the bottom line. What's in store for us REIT investors next year? Here's a quick summary of my forecast and basic assumptions:

³ Most of us have forgotten the entire quote: “Marriage is the triumph of imagination over intelligence. Second marriage is the triumph of hope over experience.”

Assume just minor cap rate moves,
Modest tweaks to NAVs;
And that investors still love dividend yields –
Thus no change to REITs' P/Es.

Let's posit 4 percent AFFO growth –
I hope you don't dissent –

Tack on a 5% dividend yield,
Our returns could be 9 percent.

What's the joker in the deck
That could really foul our year?
If the 10-year crosses five percent
We'll be crying in our beer.

Of course, it ain't that simple. There are probably 15-20 variables that will affect REIT prices and performance next year. However, if we expect the major positive trends we enjoyed during the past several years to remain in effect, it's difficult to see a significant trashing of REIT shares, *i.e.*, the wind will be at our backs. But, by the same token, many investors are getting nosebleed at the present altitude and will be quick to lighten up upon further levitation in the stocks. Furthermore, while I don't believe that REIT stocks are terribly expensive, neither are they cheap. Thus any additional buying power that would drive REIT stock prices higher will be met with selling by those who've enjoyed the largesse of REIT investing over the past several years. So, by default, REIT prices should be able to maintain current P/AFFO multiples and NAV premiums, but expansion is not likely. Should multiples and premiums remain steady, and if these pricing parameters are adjusted for a conservative AFFO and/or NAV growth rate of 4.5%, then this, plus a dividend yield of 4.6%, will get us to that 9% total return. It could be a very boring year.

The "joker in the deck," of course, is interest rates. Rising rates are likely to negatively impact REIT stock prices for three reasons: (1) hedge funds and traders will quickly short REIT stocks (or liquidate positions) upon any sign of a meaningful upturn in long-term rates, and this selling will generate negative momentum – which, unfortunately, does tend to move markets in the short term; (2) bond yields will increase, providing more competition for REIT stocks among the Yield Crowd – thus REIT stock yields will have to increase to remain competitive with bonds; and (3) REITs' future cash flows will be worth less on a net present value basis when discounted at a higher rate of interest.

Furthermore, there is ample evidence that rising rates have not been good for REIT stock prices (nor have they been good for much of anything in the investment world, except for T-bill owners). So, let's not kid ourselves; regardless of what (if anything) happens to cap rates in a rising interest rate environment, we should expect some real damage to REIT stocks if the 10-year T-note yield rises towards the 5% level (indeed, it need not even get that high to cause some to develop itchy trigger fingers).⁴ And that, I would argue, is the major monkey wrench that could be tossed into my forecast. Events of lesser probability include economic recession, capital leaving for a red-hot stock market, reduced allocations to real estate (and REITs) by major institutions, or major negative geopolitical events. But Equity REIT stocks suffered negative total returns in only six of the past 33 years,⁵ so the odds of a "red year" aren't substantial.

So, there's my forecast for 2005. But is it worth anything more than the powder to blow it to hell?

Do I strongly believe in this forecast?
Can we take it to the bank?
Sit down, son, and brace yourself,
I'll be humble, fair and frank.

Every year in the investment world,
Come demons from hellish portals;
They love to ruin the best-laid plans
Of us poor and chastened mortals.

So nail down your REIT allocations,
Decide what is right for you;

⁴ As I write, the 10-year is yielding 4.2%.

⁵ The losers: 1973 (-15.5%); 1974 (-21.4%); 1987 (-3.6%); 1990 (-15.3%); 1998 (-17.5%); and 1999 (-4.6%).

Understand well this asset class,
And plod on with a long-term view.

I hope all of you have enjoyed a wonderful Chanukah and/or Christmas, and would like to wish you and your loved ones a healthy and splendid New Year!

Best regards,
Ralph (Block)

Disclosure: I and/or the firm(s) to which I provide services may from time to time have long or short positions in some or all of the stocks (if any) mentioned above. Further, this "newsletter" is not intended as a recommendation for the purchase or sale of any particular security and is not intended to be investment advice – or any other advice for that matter. The statements made in this newsletter are my own personal opinions, and do not represent the views of any other person, real or fictitious, or even the views of Sammy, my Golden Retriever. © 2004 Ralph L. Block