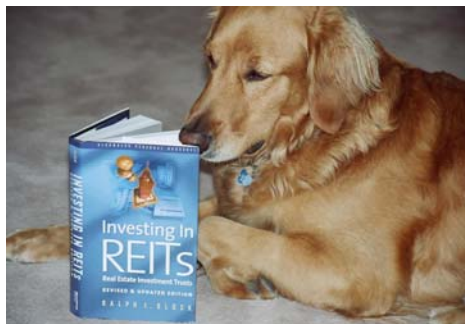


"The Essential REIT"

October 8, 2005



"If my doctor told me I only had six minutes to live, I wouldn't brood. I'd type a little faster." – Isaac Asimov

"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. Scary Times?

Having just returned from a splendid trip to Italy and other wonderful places on the Mediterranean (finishing with four days in our favorite city, Venice), and playing catch-up in my work while worrying about dry winds and forest fires, this issue of The Essential REIT will, mercifully, be one of the shortest on record. I hope to bend your ear (or, more accurately, your eye) with my normal 5-page screed on events in Reitdom within the next couple of weeks, but, for now, please indulge me in the notion that "small is beautiful." But first, a picture from...take a guess!



REIT stocks were trashed this past week. On Monday, October 3, the RMZ REIT index closed at 837.25. At Friday's close, at 799.15, the four-day loss amounted to a rather sickening 4.55%. Although REITs' year-to-date total return is still respectable, at +5.7%, and is easily outpacing other indices¹, recent trading activity is

¹ As of Friday's close, the S&P 500 (a price-only index) was off 1.3% for the year. The S&P Small Cap index was up 3.0%, and the NASDAQ was down 3.9%.

creating some discomfort. The logical – and most important – question of the day is whether this means that forward-looking equity investors are anticipating a reversal of cap rates, *i.e.*, lower private market valuations. Green Street Advisors' Craig Leupold and Mike Kirby put out a provocative note on Friday which, while non-committal, provided some anecdotal evidence suggesting that some savvy REIT executives were taking actions consistent with a peak in real estate pricing, and wondered whether the current swoon may be “a sign that REIT investors are starting to hear the same warning bells ringing.”

The answer to this question will, of course, have a significant impact upon the pricing and returns of REIT stocks over the next year or two. Should REIT NAVs decline due to a meaningful increase in market cap rates, REIT stocks will suffer, *i.e.*, we REIT investors will no longer be able to brag to our brothers-in-law about our returns. But let's be realistic and open-minded. Although the magnificent decline in cap rates may be over, they are not necessarily destined to rise – and may flat-line for quite some time. The yield on the 10-year T-note, at 4.35%, is only 10 basis points higher than where it began the year, and a huge 168 bps below its 6.03% yield at the end of 2000.

Furthermore, bond yields are as likely to come down as to go up, as not everyone believes that inflation and bond yields will move relentlessly higher. Perhaps it's a contrarian viewpoint, but listen to Andy Brenner, head of global fixed income trading at Investec, quoted in today's Barron's: “The continual hawkish statements from the Fed continue. They were wrong about deflation, and they will be wrong with the magnitude of inflation.” I tend to side with Mr. Brenner, and believe that an imminent topping out of the housing market, together with higher gasoline and home heating prices, will sufficiently dampen the US economy that inflation will no longer be an issue, and bond yields and even short-term interest rates will drift lower next year.

But don't listen to me; listen to Pimco's Bill Gross. In his October 2005 commentary,² he reviews two scenarios for the US housing market, one a soft landing and the other not so pleasant. But, he says, “In either case, however, our Fed with its new Chairman will likely be in the enviable position of lowering rates come mid-year 2006. Currently ogreish central bankers within twelve months time will thus be responsible for some rather deliberate acts of kindness: lowering yields to keep our asset-based economy alive and kicking. Whether in the fullness of time that will be judged to be kind is another question, but it appears that this overwhelming deluge of circumstance will require lower yields at least one more time.”

If long-term T-notes remain within a 4-5% band, I'd have a hard time concluding that cap rates must be driven higher (forcing valuations lower). Furthermore, the long-term forces that have propelled real estate prices higher even beyond the contribution from falling interest rates seem to remain intact, *i.e.*, investors' desire for current income, lackluster returns on equities, the need for portfolio diversification and improving real estate fundamentals.

Paul Samuelson once famously said something to the effect that “the stock market has discounted seven of the past four recessions.” The REIT market has become very volatile, and the current REIT stock decline may simply reflect the activities of hedge funds, momentum investors and others whose time horizons are shorter than a flea's eyelash. And perhaps it was no coincidence that another leading sector, oil and gas stocks, also got blown away this past week. In the current environment of ETFs and microscopic time horizons (short-term performance is, alas, the altar at which almost everyone now prays), we should never underestimate the power of the hedgies and other assorted weirdoes to drive stock prices in *any* direction for several weeks.

There's no question that today's prices for real estate and REIT stocks imply lower returns than have been enjoyed historically. But the key question is whether commercial real estate and REIT prices must be pushed substantially lower to provide acceptable risk-adjusted returns for investors. Even though Sammy may not be able to gnaw on a T-bone steak doesn't mean that he can't enjoy his kibbles, perhaps with an occasional slice of ham. This asset class is now competing for investment capital against all other asset classes, but I am far from convinced that, as long as expected returns on equities remain mired in the 7-8% zone and long bonds (even the corporate variety) don't yield more than 5-7%, required returns on real estate must increase significantly in order to remain competitive. And, with real estate space markets continuing to recover, I see no compelling need for investors to increase their assumed risk premiums for this asset class.

² <http://www.pimco.com/LeftNav/Late+Breaking+Commentary/IO/2005/IO+October+2005.htm>

Those forecasting a significant decline in commercial real estate prices, through wrong in the past, may yet prove, like broken clocks, to be right at some point. However, I am not yet willing to assume that a 4-day decline in REIT prices, along with some hand-wringing about inflation, should be accepted as an omen of a significant – or even meaningful – deterioration of commercial real estate prices in the private markets. Condos and vacation homes are one thing; commercial real estate is quite another.

I will fall on my sword (does anyone still use swords?) if I am wrong but, even then, gored and bloodied, I will cheerfully reinvest my spare cash at cheaper prices and at higher dividend yields. I will worry only when and if real estate cash flows go negative and dividend cuts become prevalent in REIT world – and, I see no evidence of that happening. Commercial real estate is a splendid long-term asset, and as long as businesses and consumers continue to need space in which to work, live and play, it will remain a compelling asset class for long-term investors, both individual and institutional, particularly those who prize stability and income.

2. A Bronx Cheer in Philly.

Now, for those who care, a few thoughts on the Brandywine – Prentiss deal. On Monday morning, October 3, office REIT Brandywine Realty (BDN) announced an acquisition deal with Prentiss Properties (PP), in which the latter will be acquired for a total consideration of \$3.3 billion, consisting of \$21.50 in cash and 0.69 shares of BDN for every share of PP. Brandywine's properties are primarily located in Philadelphia, New Jersey and D.C., while Prentiss has focused on the California, Dallas, Austin, Chicago and D.C. markets.

The rationale for the deal, according to Brandywine's press release, is that *"This merger is a transformational event for both companies, creating a significant multi-market growth platform for Brandywine. We have a longstanding respect for Prentiss Properties' senior management and the integration will strengthen our management infrastructure at both the operating and executive levels. This transaction expands the companies' tenant diversity, creates tremendous growth through our combined development pipeline and significantly broadens our capital deployment opportunities. Furthermore, this transaction also presented a unique opportunity to work with PREI to create a positive result for all three parties."*

Hmmm...Pardon me if I am less than excited. I never did own Brandywine stock, but have owned Prentiss shares for a number of years. It's hard to say what motivated Mike Prentiss and his board to sell out. First, let me say that I have been a real admirer of Mike, Tom August and their executive team. What they have lacked in property performance (some of their markets have been uglier than mutant bats) has been offset by strong capital allocation skills and honest, forthright communication with us shareholders. The merger premium over PP's prior closing stock price was modest, just 6% – and by the end of the week, the premium evaporated entirely and went negative (by 2.6%) with the trashing of BDN's stock price.

The Prentiss people have had, over the past several years, a more dour view of the office markets than other office REIT executives, so perhaps they felt that the office market recovery would be a long, uphill battle and figured that it would be advisable to collect a bunch of cash for part of their holdings and go gently into that good night. Maybe they were tired of outside investors, analysts, quarterly conference calls, independent boards, Sarbanes-Oxley and all the other trappings of public companies these days. Maybe they just wanted to spend more time with their grandchildren. Perhaps only their shrinks will know for sure. But elect to sell they did, and the merger is unlikely to be voted down (*i.e.*, there will be no Mack-Cali déjà vu). Having bought my PP shares at lower prices, I will cry all the way to the bank.

But it's the Brandywine shareholders who are crying in their beer. The deal drew a major Bronx Cheer from the company's investors, as the stock closed on September 30, before the announcement, at \$31.09, and last Friday at \$28.06; yeah, I know that REIT stocks declined last week, but Brandywine's shareholders were clobbered – the stock was down 9.7%, equal to about a year and three-quarters' worth of dividends. Are BDN's shareholders right to complain?

We won't really know for some time, but if I were a Brandywine shareholder, I'd worry about questions such as: What value, if any, is created by entering into a number of new markets? Can I realistically assume that the key Prentiss operating guys will happily continue on with the same esprit d'corps that they showed when

working at Prentiss? How much do the Brandywine guys really know about the Oakland (CA), Dallas and Texas office markets? Why will the FFO “accretion” be so modest, about 4-6 cents per share, given the substantial risks in deals of this size and complexity? Won’t the advantages of a “multi-market growth platform” be outweighed by the fact that the contribution to shareholder value from a few home-run deals in the future will be diluted by the larger size of the company?

Some pundits have suggested that this deal looks uncomfortably like the ill-fated Prentiss – Mack-Cali non-deal of several years ago, *i.e.*, “huh?” Perhaps, from the Brandywine shareholders’ viewpoint, it’s a “why?” – a solution in search of a problem. It certainly won’t be a “deal from hell” but, if I were a Brandywine shareholder, it would be difficult, at the present time, to develop a warm and fuzzy feeling about it. As Pascal once dryly noted, “All man's miseries derive from not being able to sit quietly in a room;” many of the worst deals in REIT history have been hatched out of a perceived need to “do something.” Anyway, I hope Brandywine’s management team will prove me wrong. Finally, I’ll leave you with a threat: I hope to have more to say about mergers in Reitland in an upcoming issue of The Essential REIT, as I suspect we’ll see more of ‘em.

Your humble servant,
Ralph (Block)

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