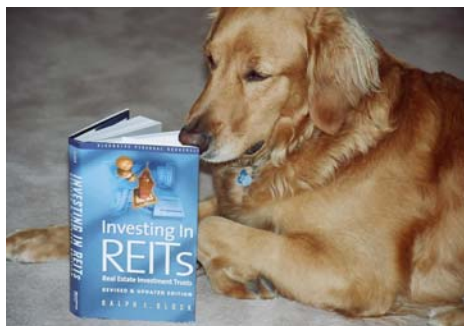
"The Essential REIT"

November 30, 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. Real Estate + Value Creation = REIT.

a. Philosophical Issues. We sometimes lose sight of the fact that our REITs are odd ducks, *i.e*., they are "hybrids" – a hybrid is defined as "something of mixed origin or composition." They own, acquire, manage and sometimes develop and sell commercial real estate, but most of them are also active, operating businesses and their shares trade like stocks of other public companies. Those who view REITs solely as "real estate" and, conversely, those who ignore their asset-centric nature are, like Sammy attempting to hump the sofa pillow, doomed to eternal frustration. Let's be honest: REIT stocks don't act like commercial real estate (in the short-run), nor do they act like other equities – and their price movements are poorly correlated with either. If it doesn't look, walk or quack like a duck, then it might be a penguin.

The challenge of approaching REITs from both sides of the igloo is magnified by virtue of the fact that a REIT's real estate values are largely determined by market forces, while a REIT's enterprise value also reflects its management's ability to continually create extra value for shareholders above and beyond its real estate value, and/or its propensity to make mistakes that trash the value of the company.

Most professional REIT investors are pretty good at understanding private real estate markets, and know what makes them tick. They may not always be able to accurately forecast office market conditions in Atlanta or San Diego next year, but they're pretty good at discerning all that's known about our major real estate markets at any given point in time; God knows there's enough available data out there, from Reis, CBRE, Torto, Real Capital Analytics and others. But perhaps an insufficient amount of attention has been given to the *other* side of REITs – value creation and destruction. So, with your kind permission, I will focus this issue of The Essential REIT upon that illusive (and often subjective) topic.

First, a few preliminary thoughts. For years, REIT investors have observed that those REITs that are capable of creating substantial extra value for their shareholders tend to trade at significant NAV premiums, while

those that have become known as serial value-destroyers have traded at serious discounts. Of course, the premiums and discounts will vary from time to time, based upon valuations of REIT stocks generally, *e.g.*, when the average REIT stock trades at a modest premium, Kimco's shares will trade at a much larger one, and when NAV discounts are prevalent, KIM stock may trade at only a marginal NAV premium.

Second, our ability to measure and quantify a REIT's value-creating abilities (or its more sinister opposite) is greatly restricted by our inability to peer accurately into the future. Staying with Kimco for the moment, it is very difficult to ascertain exactly how much value "Uncle Milt" and his crew is generating for us needy shareholders by virtue of their "opportunistic basket" of investments. These value-creating enterprises are often transactional-related, and thus are unpredictable and – horror of horrors to investors – "lumpy!"

So some investors simply take the position that, "if you can't measure it, it doesn't exist," while others grope to ascribe some increment of value to value-creating activities. Those who refuse to take value-creation or destruction into account when valuing REIT stocks are playing with three cards short of a full deck. Yes, these "x-factors" are hard to value. But those investors who ignore the value of Archstone's Ameriton business, while admittedly hard to quantify, are doing themselves no favors. How can we ignore the value of Pro Logis' development/JV business? AMB's extensive network of institutional investment partners? Avalon Bay's shadow development pipeline? Or even the strength, depth and wisdom of Boston Properties' management team as a whole?

We live in an era rich with data, and the Internet renders it only a mouse-click away. Furthermore, computer power is awesome, and spreadsheets are the life-blood of the research analyst's world. So investors are naturally uncomfortable attempting to value stocks partially on the basis of factors that they cannot quantify. And yet, quarks and electrons exist even though we cannot see them, and value-creating skills also exist even though they are not easily quantifiable. Mr. Cooper is a really nice guy, but Kimco's stock doesn't continually trade at NAV premiums because of that.

b. Indicia of Value Creation. Let's look at some ways that REIT management teams have been able to create value for shareholders over the years – beyond the values inherent in the real estate. Sound acquisition and deal-making skills are perhaps the most obvious. There are times in which almost any acquisition is likely to create long-term value for shareholders. This was the case in the early 1990s when owning commercial real estate was deemed as safe as playing in the mountains near San Diego with an oxy-acetylene torch; as a result, values plummeted, and investors could buy at 10% cap rates and at 40% of replacement value. Creating value via acquisitions was as challenging as teaching a kangaroo to hop. However, most of the time, certainly including the present, an acquisition at market price will normally create zero value for shareholders and makes true value-creating opportunities less valuable due to the REIT's increased size and bulk.

And yet, even what appears to be a garden-variety acquisition can create significant value. Examples of this might include off-market deals driven by special relationships, transactions structured to be very tax-friendly to the sellers, "hairy" properties that are poorly leased or that have significant lease expiration risk, assets that come with adjacent developable land or with redevelopment or re-tenanting potential, or even an asset owned by a seller who has badly miscalculated future market value, *e.g.*, S.L. Green's acquisition of 1515 Broadway in Manhattan, which has more than doubled in value (on an unlevered basis) in just over three years. Even acquiring a bunch of hotels from an owner who is hot to manage them for a number of years, as Sunstone has done recently, can create value. Thus not all acquisitions are created equal; some will create value, most are neutral, and some can even destroy value.

In a larger sense, of course, acquisitions are only one species of deal-making skill. Although the number of great deal-makers can be counted on the fingers of one hand, these people do exist, and we should look for, and give credit to, "opportunistic" REIT executives who've been successful. They will occasionally err (who's perfect?), but will sometimes hit a few out of the park. Steve Roth, of course, must be included (*e.g.*, Alexander's, Mendik, the "Marts"), as must Milton Cooper (*e.g.*, Venture Stores, among many others). How can we value these deal-making skills? Alas – with great difficulty. But value them we must.

Wrapping up this category, I will also suggest that, as Kenny Rogers once noted, knowing when to hold 'em and when to fold 'em can be extremely important. Now that selling an asset is no longer viewed by REIT executives as tantamount to selling one's first-born child, judicious asset sales *can* create value for shareholders. This is often difficult to ascertain at the time – who really knows where cap rates are headed? But can anyone doubt that sales of apartment communities to Crazy Condo Converters, as Archstone-Smith and Avalon Bay (and others) have done recently at cap rates beginning with a "3", have created value for their shareholders?

Development, of course, is the next broad value-creating category. Of course, here as elsewhere, risk must be carefully considered. As we all know, development entails construction cost and timing risk, lease-up risk and financing risk (as well as cap rate, *i.e*., "spread," risk). Land must be acquired at the right price, and entitlements must be cadged from quirky planning commissions. This is an endeavor where the following warning applies: "Don't try this at home." Now we are witnessing overseas development by some REITs, which adds yet another layer of risk to the equation. In other words, investors need to be very careful when ascertaining whether a REIT's development strategy is creating – or destroying – shareholder value.

Nevertheless, a well-conceived, well-timed and well-executed development strategy can justify a significant NAV premium, and many REITs have been successful in their development strategies. Examples include AVB and ASN in apartments, BXP, CUZ, DRE and perhaps KRC in offices, CNT and PLD (and, now, hopefully, AMB) in industrial, and GGP, REG and SPG in retail. Perhaps Ms. Chelsea was the most successful retail developer of all-time (now she's married to Mr. Simon). (I love it when a mall is developed and leased at an 11% initial yield). Before we leave this topic, I'd be remiss if I didn't note in passing one the very best value-creating strategies of all time, at least on a risk-adjusted basis – redevelopment. A good redevelopment strategy can generate double-digit yields, with very modest risk, and is perfect for REIT investors. Yes, I acknowledge being a REIT Weirdo, but my eyes glaze over when I see a REIT do successful redevelopments. A few good examples of successful redevelopers include Acadia, Alexandria, Federal and Macerich.

Another category where value can be created is in non-real estate ownership businesses. These can be reflected in development-for-fee enterprises, creation of property management fee streams (as in joint ventures with institutional investors), or the creation of strategic alliances to foster brand-name recognition (Simon Brand Ventures). Structured financing and preferred equity investing, while risky, can be a successful business if operated by the right people. Kimco, by itself, can provide a full laundry list of the possibilities here. These businesses are usually conducted in taxable REIT subsidiaries, so investors should measure *after-tax* returns. Of course, lots of value can be destroyed if bad businesses are pursued by bad actors, so caution is warranted; however, the value of a long-lived stream of fees shouldn't be under-estimated.

And, of course, we also need to keep a close eye on a REIT management's capital allocation skills. This is a very broad category, but has a significant impact on the extent to which a REIT stock "should" trade at a premium to its NAV. Obviously, we want to own REITs where management has done a great job of allocating capital, and should be willing to pay a premium for these skills. "Capital allocation," admittedly a squishy concept, includes (in my mind, at least) conservative and effective balance sheet management (including judicious and timely use of debt and equity), volumes and types of acquisitions, developments and asset sales, and stock repurchases and issuances. Some examples: ASN's opportunistic stock buybacks, GGP's capture of asset refinancing opportunities, PSA's heavy use of heads-we-win, tails-you-lose preferred stock, AVB's asset sales to condo converters, and CNT's and CUZ' asset recycling.

Another area to keep an eye on is tenant relationships. All else being equal, the real estate owner that enjoys a great long-term relationship with a large base of quality tenants will be more competitive, and make better deals, than one that doesn't. Kimco impressed me, way back in the early '90s, with its wide array of tenant relationships, and I have since learned to appreciate the importance of tenant relationships even more. Although it's still a bit early to determine how much tenant relationships contribute to the bottom line of office owners (perhaps not much), ARE has proven their value, at least in its niche of the office market. And certainly these relationships have proven very important for industrial and warehouse space owners, particularly with respect to development opportunities.

Retail is an obvious sector where tenant relationships are crucial, as we know from following the likes of General Growth, Kimco, Regency, Simon, Weingarten and others. How can we, as investors, place some extra value on a REIT that enjoys strong tenant relationships? I find it difficult to do so, and puzzle about how to capture this competitive advantage in my REIT valuation spreadsheet; however, it certainly plays an important, albeit subjective, role in my stock selection process. (I'd probably flunk out of Harvard Business School).

Finally, an intangible overlay. Years ago, Green Street Advisors coined the term "local sharpshooter" to refer to a REIT that is focused upon one property type in a fairly narrow geographical area of the U.S. And, the firm considered the extent to which a REIT was a "local sharpshooter" in its determination of its "warranted" stock value at any point in time. Today, much has changed, and most REITs have gone far and wide in their property-owning strategies. A number of years ago, Weingarten owned assets only in Houston; today it owns assets in 20 states across the southern U.S. Kimco, as good a company as it is, can hardly claim to be a local sharpshooter. Equity Residential, a darned good apartment REIT, owns properties in 32 states.

And yet, I have found that local sharpshooters can indeed create extra value for shareholders – but that a REIT need not be focused on a single market to fit neatly into that category. Indeed, Boston Properties is, in my opinion, a local sharpshooter in four markets (NYC, DC, Boston and SF). Again, while I cannot quantify the value of a REIT's local market expertise, in some sectors of Reitdom, such as offices and apartments, significant local expertise and "presence" can make a real difference with respect to value creation over long periods of time.

b. Value Destruction. In consideration of my readers' available time, and in order to avoid inflicting too much pain upon them, I will just summarize a few value-destroying activities sometimes perpetuated by some REITs. Like their "good twin," value creation, these tendencies are important and should be taken into consideration when valuing the shares of REITs. What do these nefarious activities consist of? Let's consider some examples.

Watch out for a growth for growth's sake mentality, either via a buy-anything-now acquisition "pipeline" or acquisitions of other REITs or large property portfolios. Sometimes a REIT can generate a better long-term growth rate with a "strategic" acquisition, but investors should be skeptical. It's no coincidence that the shares of Pro Logis and Brandywine have performed below par this year, following their Catellus and Prentiss announcements; merger premiums almost always redound to the benefit of the acquired company's shareholders, and there will always be integration risk. The burden should be on a management team to show that a large acquisition deal is likely to create value for its shareholders, rather than the shareholders of the seller or acquiree. The graveyards of Reitville are littered with the bodies of REITs that grew merely to get larger, and yesterday's "accretive acquisition" is today's "advantageous disposition of non-strategic assets."

Many value-destruction activities are merely the reverse of the value-creating strategies described above. For example, poorly-conceived and badly-executed development efforts (and lack of sufficient spreads between development and acquisition yields), or a lack of discipline in development (perhaps Mills and, a few years ago, Prime Retail, are examples of this). And, of course, many REITs have lacked the discipline to focus on their core competencies, having tried to morph into Growth Stocks, *e.g.*, Crescent, Meditrust and others in the mid-1990s. As wisely noted by a character in an old Clint Eastwood movie, "A man's gotta know his limitations." Same with REITs.

Then, of course, there's balance sheet mismanagement and poor allocation of capital. Take a look at the sad saga of Patriot American Hospitality[1] and you'll know how bad things can get when management loses balance sheet discipline. Meditrust, a healthcare REIT that tried to leverage its "paired-share" advantage into

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[1] For a good write-up on what "PAH" did to its shareholders, and how it did so, take a look at http://www.fool.com/DTrouble/1998/DTrouble981208.htm

golf courses and hotels, is another unfortunate example of capital misallocation. Other typical sins include over-leveraging a balance sheet (or placing too much reliance upon short-term debt), issuing shares at NAV discounts (without using the proceeds to buy at even greater discounts from fair market value), and mismanaging the dividend policy. These kinds of problems can cause shareholders to live in a House of Pain for quite some time.

Some additional, albeit more intangible, acts of destruction include poor corporate governance, *e.g*., conflicts of interest, excessive and indiscriminate use of "weapons of mass entrenchment" such as poison pills and staggered boards of directors, excessive compensation to a small number of executives (perhaps based upon nothing more than increases in the REIT's stock price), and accounting problems such as experienced by Highwoods, Shurgard and Sun. Also, shareholder value has been sometimes compromised by a "failure to communicate" with shareholders.

Many REITs have, unfortunately, turned the Milton Cooper doctrine on its head by overpromising and underperforming, *e.g*., ARC, among others. This is often a problem that we encounter when companies launch IPOs; lots of promises are made by real estate guys who sometimes have difficulty understanding, or coping with, the demands of fickle equity investors; or, they may simply assume that everything will go according to plan. It rarely does. Investors aren't patient with executives who make rosy forecasts and come up with excuses when they cannot meet them. That's value destruction!

c. Caveats and Conclusions. Although it may be difficult to value these types of acts, choices and decisions by public REITs, it's not impossible. There are a number of ways to do this. In NAV-based models, assign incrementally higher warranted NAV premiums to those REITs that are likely to continue to create value for shareholders, and vice-versa. In AFFO multiple models, simply assign higher multiples to those REITs that are perceived as being capable of growing faster via value-creating activities; assign low multiples to serial value destroyers. In discounted cash flow or dividend growth models, adjust prospective AFFO growth rates in the "out years" to account for better- or worse-than-expected growth rates, or perhaps assign smaller or larger discount rates – after all, consistent value creation can offset a lot of inherent risk, and prospective value destruction increases it.[2] Of course, there are many other variables that must be plugged into each of the valuation models, but, in my opinion, it's not wise to ignore value creation – or its opposite – even though these elements are difficult to quantify.

Finally, all of you know this, but we need to be careful about assigning huge warranted NAV premiums even to those REITs that have created the most value in the past and are likely to do so in the future. Intel has always been a fine company, but it doesn't warrant a PE ratio of 50x; Centerpoint and Cousins have created lots of value for REIT investors, but rarely, if ever, warrant NAV premiums of 35%. A related issue, of course, is the investor's time horizon and return requirement. Very high NAV premiums often indicate very substantial prospective value creation, but it may take years for such value to actually be realized – and any potential future value should be discounted to the present date. It's difficult for me to justify *any* REIT trading at a 3% implied cap rate, even for a veritable value-creation machine. But perhaps I'm just an old curmudgeon.

I'm afraid I have raised more questions than I have answered. Whoever said investing was easy?

Your humble servant,
Ralph (Block)

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[2] Would you use, for example, the same discount rate for Mills as for Simon?