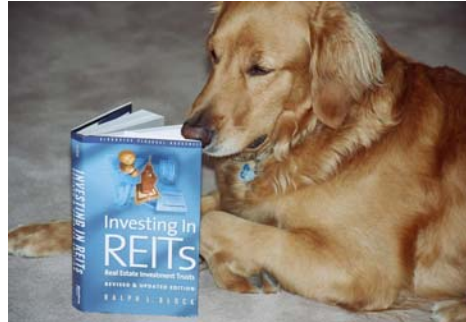


"The Essential REIT"

December 22, 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. Reflections and Projections.

Preliminary note – "Investing in REITs": Please forgive this quasi-advertisement...I learned from Bloomberg Press last week that copies of the new Third Edition of "Investing in REITs" will be available in bookstores and e-commerce merchants (e.g., Amazon, Barnesandnoble *et al*) by mid-January. I believe the new book is an improvement over prior editions (what else did you expect me to say?) and covers lessons learned over the past few years; if you liked the prior editions, you'll love the new one; if you hated it, well, go suck on a frog.

a. A 2005 Report Card. Those of us who are dumb enough to make market forecasts often compound their stupidity by taking a peek at their forecasts a year later – usually a very humbling process. Truth to tell, however, I didn't do too badly this year, so I am less embarrassed this time around. Let's take a look at my "bold" predictions from last year,¹ and have a few laughs.

"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. 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."

Commentary. Obviously, the limb that I crawled out onto when making this forecast was made of sturdy stuff, and this morning I bask in the satisfaction of knowing that it wasn't sawed off from under me. The trend towards lower cap rates maintained momentum this year, and there has been no lessening in the bucketsful of money being thrown

¹ As contained in The Essential REIT, dated December 29, 2004.

at commercial real estate – despite significantly higher interest rates on the short end of the yield curve. Chalk up a another victory for the Secularists.

“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.”

Commentary. That assumption – that cap rates were *not* too low at the end of 2004 – seems to have been accepted by investors, as evidenced by cap rate and REIT stock behavior this year. Of course, cap rates haven’t yet been “stress-tested” by a rate north of 5% on the long bond; the yield on the 10-year is, as I write, only about 25 bps above where it finished 2004, thanks to “The Pump” so ably explained by bond guru Bill Gross. Although there are a few signs that bond spreads have begun to widen a bit, this new trend, such as it is, appears to be as wimpy as a shy cocker spaniel. We should become more concerned, however, if the spread on Baa-rated long bonds widens further vs. the 10-year T-note (the current spread is about 175-200 bps), as that would likely negatively impact cap rates. It is certainly true that REIT AFFO yields and real estate cap rates are much lower today vs. yields on Baa-rated long bonds than has been the case historically, but this is explainable by where we are in the real estate space cycle, the modest amount of new commercial real estate construction, rising replacement costs, and the redressing of the sin of excessive historical underweighting of commercial real estate by investors large and small.

“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.”

Commentary. I was a bit too conservative here; as noted, the yield on the 10-year has risen just 25 bps since the end of 2004 (although the increase in Baa bond yields has been modestly above that). But I do think that firm to slightly-lower cap rates, as well as the performance of REIT stocks in 2005, have been helped by a less-than-expected increase in the yield on the 10-year (yet again). Mr. Greenspan and crew must be ready to bang their heads against the wall due to the behavior of the 10-year. If they are to pop the housing bubble (assuming they want to), they will need to keep boosting short-term rates and hope the yield curve doesn’t go negative.

“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.”

Commentary. Dire warnings from sell-side analysts and negative articles about “real estate bubbles” in the financial press have provided tailwinds for REIT investors. Keep those bearish commentaries coming!

“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. 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.”

Commentary. Sector calls are, indeed, treacherous; that is one reason why I make them only in the privacy of my own bedroom. Simply put, I don’t let them interfere with my REIT stock selections. So, here, I confess to having made less than prescient forecasts on which real estate sectors would perform best in 2005. Let’s take a quick look.

Apartments: “...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.” Apartment stocks did better than I thought they would. Through December 20, the NAREIT

Equity REIT index delivered a total return of 11.7%, but the apartment guys beat that by 310 bps, at 14.8%. They were helped by the buyouts of Amli, Gables and Town & Country (and a Post Properties rumor, like a bad penny, continues to circulate), stronger than expected NOI growth, persistently low cap rates, reductions in stock due to Condomania, and housing affordability that seems to decline as quickly as Michael Jackson's net worth.

Retail: "...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... Nevertheless, I'll go with the flow, and forecast: Slight outperformance." This wasn't a horrible forecast, as the combined performance of malls and strip center REITs pretty much equaled that of the NAREIT index – but they failed, as a group, to outperform. Chalk it up to investor concerns over retail sales growth due to high gasoline and home heating prices, an impending decline in the girth of the Home Refinancing Piggy Bank and a perceived consumer "malaise."

Office: "...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." I was, again, off target, but not by much. The office sector, at +11.5%, was also very much in line with the averages. Perhaps their climb out of the cellar can be attributed to a clear stabilization in most US office markets, and even some nascent signs of rental rate increases (and lower concessions) in the stronger markets, coupled with continuing low levels of new construction.

Industrial: "...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." I was a bit too conservative in this forecast. The industrial sector managed another year of good performance, up 13.3%, perhaps due to the same reasons helping the office sector; companies are, at last, committing to new space, and foreign users are offering some interesting investment opportunities to those venturesome enough to pursue them, e.g., Pro Logis and AMB Properties.

Lodging: "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." This forecast – let's not sugar-coat it – was an abject failure. Lodging stocks eked out a kiss-your-sister 7.7% total return through December 20; while RevPar growth continued to accelerate, investors fretted about rising operating costs, queasy consumers and, possibly, a weaker economy in 2006. I believe, however (as I will explore below) that the sun will shine brighter next year for hotel REIT owners.

Now, to the bottom line...

"...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."

Commentary. Despite some occasional knuckle-biting moments this year, REIT stocks did *not* get trashed. In fact, they significantly exceeded most expectations; NAV premiums sucked back a bit, but a further compression in cap rates increased NAVs enough to more than offset this. At December 20, their total return, per NAREIT (equity REITs only) was +11.7%. This exceeded my 9% expectation, but I suspect that most of my prognosticating compatriots will be tripping all over themselves making excuses – they forecasted much lower returns.

“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). 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 year, so the odds of a “red year” aren’t substantial.”

Commentary. Despite rising oil prices, hefty increases in short-term interest rates, and uncomfortable hints of higher inflation, the yield on the 10-year never got close to that scary 5% figure, and this was one reason why REIT stocks performed as well as they did this past year. Other reasons: lackluster returns on non-REIT equities, continuing inflows of capital into directly-owned commercial real estate, and several REIT buy-outs. The purveyors of gloom, *i.e.*, most self-appointed “pundits” who whined about REIT stocks being “too high” or commercial real estate prices being “bubbly,” had a bad-hair year. But the bears will someday no longer need to hide in caves. Perhaps in ’07 or ’08?

b. Managing 2006 Expectations. All right, enough of 2005. Can we frustrate the Bears once again? Any forecast is only as good as the assumptions used to create it. If they go awry, so will the prognostications. So, let me start with a few assumptions, followed by their possible impact upon REIT share pricing in ’06.

Although consumer spending won’t be weak enough to satisfy the curmudgeons (who believe that erstwhile free-spending Americans will suddenly decide to vegetate in front of their TV sets and never venture to the local mall), the spending slowdown we are likely to see this Holiday Season will extend well into ’06. Gasoline and home heating price increases will keep the consumer in a cautious mode and modestly crimp his spending power, and the endless political bickering in Washington, goosed by troublesome news in the world and high profile lay-offs among heavy manufacturers such as the zombie car companies, won’t help. And low savings rates provide little margin of error; bankruptcies will increase. But the principal driver of subdued consumer spending will be the damage done to the Home ATM Machine, *i.e.*, cash-out refinancings resulting from a topping out of home prices and tighter lending standards.² *Net Result:* Modest negative for those REITs that are dependent upon consumer spending.

Due to what I think will be a slowing economy next year, impacted by a weaker consumer, the delayed – but real – effects of much higher borrowing costs, and political uncertainties, interest rates will peak in the Spring, and then flatten for the balance of the year. The Fed may even think about a more “accommodative” policy in the second half of ’06. Core inflation won’t go into hyper-drive, fluctuating at or around 2% (the core personal consumption price index (PCE), which excludes oil and food, rose at an annual rate of 1.7% in Q2 and only 1.4% in Q3). *Net Result:* Flattish interest rates will more than offset a modestly weaker economy to produce a slight positive for REIT stocks.

Job growth will remain positive, but won’t be sufficient to produce an elevated level of demand for real estate space. But the supply of new projects will remain modest, “thanks” to the difficulty of forecasting reasonable returns on invested capital due to construction costs that are rising faster than China’s thirst for oil. Employee and energy costs will outpace the rate of core inflation, putting modest pressure on NOI growth. *Net Result:* Slight positive, as low supply will more than compensate for sluggish employment growth, keeping absorption firm.

The secular forces that have helped to drive cap rates to today’s low levels will remain alive and well. However, there is some risk that caps will rise 25-35 bps, on average, as perceived risk will increase with higher cap ex and more lessee defaults, and as NOI growth from higher occupancy abates (as we know, cap rates tend to rise when risk increases or prospective returns moderate). Bond spreads will widen a bit. REIT NAVs will be flat to just slightly down, as NOI growth will not be sufficient to offset modestly rising cap rates. *Net Result:* Capital inflows won’t offset a bit of downward pressure on property prices, so grade the pricing factor modestly negative.

The U.S. stock market will perform somewhat better than in 2005, due to reasonable valuations and modest margin expansion. Export growth will improve, driving better sales growth. This stronger performance, along with rebalancing in early 2006, will suck funds out of REIT stocks, as some investors – particularly the large base of

² On Tuesday the Fed and related agencies proposed a meaningful tightening in mortgage lending standards which, if implemented, could have a dampening effect on the housing market. See <http://www.latimes.com/business/la-fi-mortgage21dec21.1.7375704.story?coll=la-headlines-business>

cross-over investors – chase performance. Furthermore, low dividend yields on equity REITs will result in further contractions in REIT mutual fund inflows. *Net Result:* REIT fund flows will be a modest negative next year.

REIT FFOs and AFFOs will improve further in 2006 as space markets continue to improve and rental rate roll-downs burn off, but the modest pressure on REIT NAVs suggested earlier will offset this positive. There will be four or five additional buyouts of REIT organizations, but these events, as we saw with Centerpoint, will have only a fleetingly positive effect on prices. The second half of '06 will be better than the first half.

Tacking all of these assumptions together (perhaps one or two of them may even be close to reality), we are likely to end the year with capital appreciation for the average REIT stock of a modest 3.5%. Couple that with an average dividend yield of 4.5%, and, if my math isn't too far off the mark, ***we will finish the year with an 8% total return.*** After winning the past six performance derbies, I suppose it's time to let the other guys win one. Your tech-heavy brother-in-law will finally be able to take the bag off his head next year.

Finally, I will put my fat neck on the chopping block with a guess on the best- and worst-performing sectors for next year. The cellar dwellers will be the office and self-storage REITs. Those hoping for a strong rebound in the average office market will be disappointed, due to a slowing economy and continuing cautiousness by businesses. Office AFFO growth (outside of unusually endowed specimens such as ARE, KRC, SLG and, perhaps, VNO) will be mired in the 1-2% range, and NAVs will decline very modestly. The self-storage sector kicked everyone's butt in '05 (+28.3% at December 20), but they will revert to the mean next year, as occupancy and NOI growth will moderate, due to a more cautious and less-flush consumer.

The best sectors? Hotel REIT owners will finally be able to bask in the glow of outperformance, particularly the upper-upscale and luxury inns located in the best markets. There is virtually no new supply out there, and room demand will be surprisingly robust (despite a moderation in overall consumer spending); RevPar will grow in the high single-digits, and margins will improve further. Dividend growth will be impressive. Some consumers will travel less, but the ageing boomers won't be denied their fun-seeking. AFFO growth will range from 25% to 40%.

And, finally, a last-shall-be-first call: The second-best performers will be the lowly healthcare REITs, who will kick sand in the faces of the higher-profile bullies in Reitdom. Delivering only marginal 2.0% total returns through December 20 (thanks to their high dividend yields), they will benefit from a topping in interest rates, along with more visibility on the reimbursement front. ALFs and ILFs will perform particularly well, as occupancy rates in those types of properties will climb. These REIT stocks will be good total return candidates in an otherwise quiet year for equity REITs.

And if you believe *any* of the foregoing I can sell you a fine Nehru jacket, which you can show off on special occasions, for only \$2,000. Or, perhaps, a pair of pre-owned Gucci jeans for just \$3,000?

Best wishes for a splendid Holiday Season and a healthy, fulfilling and profitable New Year. Sammy has asked me to remind you that 2006 will be the ***Year of the Dog!***³

Your humble servant,
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 Phocas Financial any other person, real or fictitious, or even the views of Sammy, my Golden Retriever. © 2005 Ralph L. Block

³ <http://www.c-c-c.org/chineseculture/zodiac/dog.html>