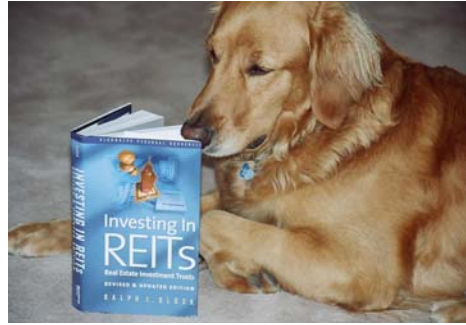


“The Essential REIT”

February 17, 2006



“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. Deal-a-Week.

a. No Rest for Weary Investment Bankers. Every morning at about 5:30 a.m. Sammy walks outside to do his business and to bark at perceived dangers. Similarly, every morning, upon cracking open the newspaper or turning on our computer, we are greeted with yet another buy-out offer for a REIT organization. If this is Wednesday, it must be an office REIT; Fridays are apartment buyout days. I sometimes wonder if the size of the REIT industry will shrink rather than grow – not because of a rise in cap rates or a decline in REIT stock prices, but simply because there will be fewer REITs.

Let's meander back to June, 2005, when the buyout tsunami began to quickly rise.¹ DRA Advisors then made an offer to acquire CRT Properties, a rather obscure office REIT, at a \$1.8 billion price tag. In the very same month, a private equity partnership sponsored by ING Clarion offered to buy apartment REIT Gables Residential for \$2.8 billion (at, I might add, a 14% premium to the prior closing stock price). One of the few “public-to-public” deals in the past six months also was announced in June (June is historically a good wedding month), when Pro Logis and Catellus agreed to tie the knot in a deal valued at \$4.9 billion, generating a 16% premium for Catellus' happy shareholders.

Then, after a brief summer hiatus (perhaps induced by investment bankers squandering their gigantic fees in Newport or Cape Cod), DRA Advisors returned to the well again in September, offering to snap up auto dealer REIT Capital Automotive for \$3.4 billion, a nice 9% premium over the prior market price of “CARS.” The following month saw another public-to-public deal, when Brandywine, seeking a new “growth platform” (whatever *that* is), agreed to buy Prentiss Properties for \$3.3 billion. This deal didn't involve a large premium (only 6%); perhaps Mike Prentiss was simply tired of paying homage to the SOX gods. Even here,

¹ According to “REIT View – Winter 2006,” published by Transwestern Securities Management, “17 large M&A deals worth an estimated \$26.6 billion were announced in 2005, ...including 11 deals worth \$16.7 billion” in public company buyouts.

however, an institution was behind the scenes, as PRIA would participate in the deal. Also in October, a Morgan Stanley property fund, perhaps regretting that it missed out on Gables, offered to buy Amli Residential for \$2.1 billion – and paid a whopping 21% premium to capture its prey. And Morgan Stanley has yet more firepower, as we'll see below.

Two months later, in December, after what was probably the longest courtship in REIT history (except, of course for the Public Storage/Shurgard never-ending saga), Arden Realty CEO Richard Ziman announced that he had brought home the bacon (well, perhaps *bacon* isn't the right word here) to his shareholders, agreeing to be acquired by GE Real Estate for \$4.8 billion. Determining the premium that GE agreed to pay for Arden is rather difficult, given the fact that Arden was rumored to be for sale almost since the Michael Jackson trial, such rumors having driven its stock price higher ahead of the announcement. However, if we use a pre-rumor price, the premium was in the neighborhood of 15-20%. Also in December (are we having fun yet?), CalEast Industrial Investors (an entity in which institutional giants CalPers and LaSalle have a major interest) agreed to buy industrial REIT Centerpoint Properties for \$3.4 billion (a 9% premium).

But perhaps the Mother of All Buyouts (in interest, if not in size) began last December, when Town & Country, an apartment REIT owning assets that some might generously label "acceptable", agreed to sell out to a Morgan Stanley Real Estate syndicate for \$33.90 per share, a 13.8% premium over TCT's prior closing price. This was perceived as a pretty good deal for TCT's shareholders, as it bore a respectable 5% premium over Green Street Advisors' \$32.25 NAV estimate. But wait! That was far from the end of the Town & Country story. Two other groups found Miss TCT so incredibly beautiful (despite the fact that her assets are long in the tooth and of mediocre quality) that they just *had* to bid for the hand of this fair lady.

So, in January, Oriole Partnership LLC, comprised of Essex Properties,² two UBS entities and AEW, made a topping offer, at \$36 (all cash, of course). But even this substantially enhanced offer didn't discourage the lady's other ardent suitors. After receiving a higher bid from another guy out of left field, Berkshire Property Advisors, and following another couple of rounds of frenzied bidding, it now appears that Miss TCT has chosen to marry several men, including Morgan Stanley Real Estate, Onex Real Estate and Sawyer Realty, which banded together in a group named "Magazine Acquisition" (hey, fellas, this is a real estate firm you're buying, not a publishing house).

It's been a great week for TCT's shareholders, as this Magazine will be the best one they ever subscribed to – they will put \$40.20 per share into their pockets at the closing. The premium over TCT's \$29.79 closing price before the courtship began is too large to contemplate without embarrassment (oh, all right, if you insist – it's 35%). "Big Spender" Daddy Magazine must've really been in love; his winning bid exceeded his original offer by 18.6%. Beauty must, truly, be in the eye of the beholder.

Those Reitsters who thought that the Town & Country episode had to be the crowning and concluding chapter in the Great REIT Acquisition Frenzy were disappointed when, on February 10, after the close, Bedford Properties (an office/industrial property owner plying the sleepy backwaters of Reitville) agreed to be taken over by LBA Realty at a 10% premium over BED's prior closing stock price. Is Bedford the last of 'em? According to veteran REIT observer Barry Vinocur, friendly investment bankers continue to work on yet more deals. Those who believe that Bedford is the final chapter are dining with several tines short of a fork.

b. What's It All About (Alfie)? "Why all the deals?" you might ask. "Why" indeed. Although I confess to having been surprised by the sheer volume of transactions announced in just over six months, as well as the hefty premiums being paid, it's not difficult to figure out why investment bankers cannot even find the time to take their suits in for pressing these days (although, with the money they're making, they ought to just toss 'em after a week of wear and buy new ones).

² I am still trying to figure out why Essex, with all its assets located in California and the Pacific Northwest, would bid for apartment assets located in Maryland, Virginia, Pennsylvania, North Carolina and Florida – and engage in a bidding war for them. Could management fees be that lucrative? Perhaps irreplaceable Elvis Presley memorabilia are hidden in the closets.

There are at least three reasons for all this hoopla. First and foremost, institutional investors, particularly pension and endowment funds with long-term benefit payment obligations, have finally woken up to the fact that they need to own lots more of a very attractive asset class – commercial real estate. These long-term investments provide high and predictable current returns, less volatility than the equities markets (and with less risk), increasing cash flows over time (unlike bonds), and low correlations with other asset classes.

Too, there is more transparency and liquidity in commercial real estate today than ever before, and – most importantly – these institutions are grossly underweight (did I really write that?) in these assets and want to – and need to – build allocations, eventually perhaps up to 15% of their portfolios. Willie Sutton, when asked why he robbed banks, responded: “*That’s where the money is.*” Well, REITs are where large portfolios of commercial real estate can easily be found and acquired. It’s almost that simple.

But demand for commercial real estate alone cannot explain the buyout frenzy. So we need to look at two other issues. One is that a number of REIT executives are willing to sell out at the present time. Many of them are becoming weary from a combination of headaches that come with managing a public company. Sarbanes-Oxley scares the bejeepers out of them (perhaps rightly so), sell-side and buy-side analysts annoy the hell out of them, and the ample capital they could snarf up as private entrepreneurs, along with very big paydays, attracts the greed in them. So if these founder-executives can sell their companies at very attractive prices, pay tribute to Uncle Sam and then continue to do business as private entrepreneurs accountable only to their partners and creditors, well, they’re likely to be amenable to going out in a blaze of glory, *e.g.*, Mr. Ziman.

A related reason for the zeal to sell out pertains to many executives’ view of the commercial real estate world these days. Most of these guys are wizened veterans of the real estate wars, and do not worship at the Church of Secularly Low Cap Rates. If Johnnie CEO thinks he can again buy a quality office building at an 8% cap rate a couple of years hence, then selling his REIT’s entire portfolio at a 5-6% cap is a no-brainer. I personally believe that cap rates will fluctuate within a band whose tops and bottoms will be significantly lower than they’ve been in the past, but certainly not all REIT executives and Boards of Directors believe this. Many will thus be quite willing to take the money and run.

A third reason for the proliferation of these deals is that REIT investors have been systematically underpricing REIT stocks. During the past three years there have been more reports from REIT analysts and financial writers bemoaning the “excessive” pricing of REIT stocks than the number of individual kibbles in Sammy’s 35-pound bag of Nature’s Balance. Let’s be honest. Even Green Street, the best and foremost practitioner of NAV analysis, has been behind the curve on cap rates and thus NAVs, and virtually all sell-siders have been even further beyond the pale.³ We need look only at the Town & Country bidding war, involving some very smart real estate professionals, to remind us of this.

The bottom line: If commercial real estate is being underpriced in the public markets in the form of discounted REIT stocks, institutional buyers will swoop down and arbitrage the gap between public and private valuations. One can dispute this point only by claiming that DRA Advisors, CalPers, LaSalle, Morgan Stanley, General Electric, AEW, Essex and the other buyers noted earlier in this newsletter are moronic bozos – and that’s a very hard allegation to maintain with a straight face.

c. Cloudy Crystal Ball. All right, that’s my assessment of the current situation. Where do we go from here? Is the vast majority of deals behind us, or have we just scratched the surface? Will the REIT industry shrink back to its \$32 billion market cap at the end of 1993? I don’t expect a Big Shrink. But we *are* likely to experience a continuing stream of these buyout deals, ending only when present circumstances change in a material way. Let’s take a fresh look.

³ They have been behind the curve for one obvious reason: REIT investors and analysts are a pretty conservative bunch, and have long memories. They believe that valuations revert to the mean, and in many cases they are embarrassed by their prosperity of recent years. Thus they have been reluctant to assign ever-lower cap rates to quality commercial real estate, even though that’s what’s been happening in the vast private markets.

At the present, I see no evidence that institutional investors' thirst for commercial real estate has been assuaged; indeed, cap rates, to the extent they are an indicator of such demand, continue to drift lower across many markets and property types *despite rising short-term interest rates*, and remain historically low. In response to the question, "Is there any slowdown in institutional investors' appetite for real estate ownership?" asked at the recent Kimco conference call, Milton Cooper, whose views one ignores at his peril, responded, "No, not at all." This refrain has been repeated by other REIT execs. So the demand side of the equation remains alive and well. Meanwhile, there seems to be no shortage of REIT executives who continue to ponder greener pastures in the private domain.

Is it likely that other investment alternatives will offer better risk-adjusted returns, thus causing the supply of capital flowing into commercial real estate to abate? Not right now. The stock market remains squirrely – and not particularly cheap. Stocks are priced to provide 8% returns – not bad, but hardly compelling enough to derail the interest in real estate. Yields in the bond market remain modest (at 4.6% on Treasuries, for maturities all the way from 3 months to 30 years), and inflation may become a major concern for the bondies (as it is to our new Fed Chairman). Furthermore, the need to fund retirement obligations continues to weigh on trustees, as evidenced by recent actions taken by IBM and others to begin to rein in long-term pension payouts. Commercial real estate – unlike bonds – offers the prospects of increasing fund flows that may be necessary for the payment of ever-increasing pension fund obligations.

As for public/private arbitrage, REIT stocks have not soared in response to the wave of buyout offers at prices well above (and at implied cap rates well below) anyone's expectations. The NAREIT equity price-only index rose just 2.9% from July 31, 2005 through January 31, 2006; furthermore, until this year, investors have pretty much ignored the apartment REITs despite the premiums offered for Gables, Amli and Town & Country. (In 2006, investors – or speculators – have become enamored of such apartment REIT buyout candidates as Aimco, Associated, Home and Mid-American, pushing their prices to levels where institutions may no longer be interested in offering premiums⁴).

What might cause the buyout wave to dissipate? Assuming that we don't run out of executives and Board members willing to sell, the only catalysts for abatement would be either excessive pricing of REIT stocks or commercial real estate, on an absolute basis or in relationship to other asset classes, or an external shock such as a spiking of interest rates, a major negative geopolitical event or a looming recession. But, as we cannot, by definition, foresee the unforeseeable, let's take a quick look at one central element that, by becoming excessive, could cause interest to dry up – valuations.

Surely, you may say, prices are really getting out of whack. Milton Cooper suggested that his "best assets" (at neighborhood shopping center REIT Kimco) would trade today at cap rates ranging from "the low fives to the low sixes." A package of less than showcase assets at TCT is being fought over by sane adults at economic cap rates south of 5%. Arden's assets, in the less frenzied office sector, carried an implied cap rate of 6% to the buyers, but Trizec Hahn's first-year return on the slightly better assets it intends to acquire from Arden/GE is expected to be in the mid-5s. Even Bedford's mixed bag of assets (including offices, R&D, flex and industrial space) is being valued by LBA, according to Green Street guesstimates, at an economic cap rate of somewhere in the mid-5s.

d. "What Are They Thinking?" Are the prices now being offered so high that further buyout offers at ever-higher prices make as much sense as Dick Cheney entering the 2006 NRA Long Range Rifle Championships?⁵ Will the takeover frenzy simply die of exhaustion due to excessively low cap rates? I cannot speak, of course, for these institutional investors or pension funds, but it's not obvious to me, in a world where intermediate-grade bonds yield 6% and stocks will return 8%, that investing in commercial real estate at an expected IRR of 7% is cause for a frontal lobotomy. This would be midway between the expected returns on bonds and equities, and amounts to a risk premium of roughly 250 basis points over the yield on riskless T-notes (long or short). Is a risk premium of 250 bps for commercial real estate outrageous? No – and certainly not in a low-return world, particularly when we are at the bottom of the cycle for most

⁴ Year to date through February 16, the stocks of AIV, AEC, HME and MAA have soared 14.3%, 17.8%, 20.3% and 10.9%, respectively.

⁵ <http://www.nra.org/Article.aspx?id=3696> But what do I know? I haven't shot a rifle since ROTC class at UCLA in 1964.

property types and risk levels are lower due to more available information and greater market depth and liquidity.

But will GE Real Estate and Trizec get their 7% IRRs by milking and/or improving Arden's assets? How about those Magazine guys – how can they get a 7% IRR out of Town & Country when their going-in effective yield will be something like 4.8%? Can LBA Realty squeeze another 150 bps per year in growth from the Bedford portfolio, above and beyond current cash yields? I don't know the answers to these questions (and perhaps nobody else does either – except, of course, for Jim Cramer). Some argue that, when capital expenditures and other non-property expenses are taken into account, commercial real estate owners never really get returns beyond their initial acquisition yields. This may be true; however, this principal may apply to *nominal* – not economic – cap rates, and may assume acquisitions in the middle, not the early phases, of a real estate cycle.

I can easily envision some increment of long-term growth beyond the initial stabilized investment yields from many of these buyout deals. Take Trizec's expected 5.5% initial return on some of the Arden assets; there is probably enough juice there, perhaps in the form of prospective rental rate increases as these office markets continue to firm, that will enable the buyer to generate an IRR of 7%. And perhaps Morgan Stanley, *et al.* can generate a similar IRR from Town & Country's assets.

Nevertheless, these buyers – no matter how smart they think they are – shouldn't be kidding themselves (or their clients). Nobody buying assets at current prices and cap rates should be expecting 10% IRRs on their investments, even with debt leverage.⁶ Is this a problem? Not necessarily – not when returns from other asset classes remain stuck in the 6-8% range and the world is awash with capital (or, as Reagan Pratt so well put it, "...global capital markets [are] a place where capital is quite literally whizzing around in search of basis points"). Expecting a free lunch in the investment world is almost as ridiculous as expecting Teddy Kennedy to vote for a tax cut – or President Bush to veto one.

So as long as we continue to live in an investment world of modest expectations where a 7% IRR on commercial real estate is acceptable to many, I don't think that institutional investors are going to stop snooping around REIT world in their quest for more properties – even when their initial yields, after cap ex, may be hovering in the 4 ½ to 5 ½ percent zone. But I may have a different opinion next week.

2. REIT Café.

Finally, I'd certainly be remiss if I didn't remind you of a wonderful new website, "**REIT Café.**" Launched about two months ago by veteran Reitster Anatole Pevnev, this website is a great source of information on the entire REIT industry. Anatole – who is both bright and personable – has structured his website to focus heavily on Podcasts, which allow REIT investors to listen to interviews with various REIT mafiosi, including REIT executives, REIT portfolio managers, REIT analysts, and lots of other real estate folks. Go to <http://www.reitcafe.com/REITcafe.html> and browse around. Click on "Podcasts," and then "Guest List" and "Upcoming Guests." REIT Café is also making replays of some REIT conference calls available, and is working on compiling NAV estimates from various sell-side firms. Try it – you'll love it!

Your humble servant,
Ralph (Block)

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⁶ An obvious exception would be the likes of AMB, Kimco, Pro Logis, or Regency, which can generate higher than market returns by virtue of their ability to generate management and incentive fees through JVs.