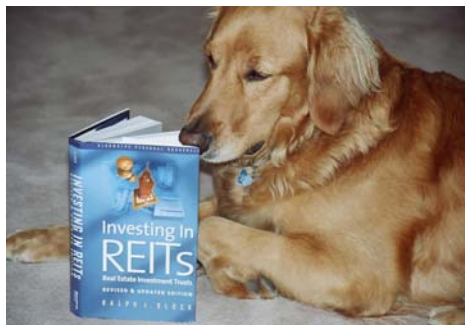


"The Essential REIT"

March 23, 2006



"The best way to become acquainted with a subject is to write a book about it." – Benjamin Disraeli

"An author is a fool who, not content with boring those he lives with, insists on boring future generations." – Charles de Montesquieu

"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

[Preliminary Note]. I'm not naïve enough to think that any of you wait around for the next issue of The Essential REIT like a computer geek waiting for his next issue of PC World magazine; furthermore, on a scale of excitement, this lowly newsletter ranks a notch or two below watching snow melt on the driveway. Nevertheless, some of you may be wondering why this issue has arrived in your in-box about five weeks after the last one. Well, I could offer up a number of excuses, ranging from the late (and never-ending) Q4 REIT earnings season, to my need to do a number of radio shows at Bloomberg's request to help launch the new 3rd edition of "Investing in REITs," to my grandson Jake having deleted it from my computer (the first two of which are valid).

But the *real* reason is that it's tough these days to think of new – and hopefully insightful – REITy things to write about. Our stocks are performing pretty well, real estate markets are improving with every passing month, capital continues to flow into commercial real estate, and almost every day brings news of yet another buyout offer at ever-lower cap rates. There isn't a lot to worry about except Iranian nuclear bomb capabilities and other dreadful things we can do little about, and most of what needs to be said about REIT investing in 2006 has already been said. In this environment, it's almost as difficult coming up with something original and really worthwhile to talk about as it is for Sammy to learn to play Bridge. So, with that caveat, I'll offer a few thoughts originating from this fuzzy head of mine.

1. Complacency? Perhaps Even Giddiness?

Those of us who've been investing in REITs for some time (heck, even those who began this year) can perhaps be forgiven for being a bit giddy. REIT stocks have kicked butt and taken names ever since early 2000 (with just a few stumbles along the way), and your typical equity REIT is up 13.7% in total return,¹ even before the end of the first calendar quarter. (My forecasted total return for this entire year was 8-9%).

¹ As of the close on Wednesday.

Although the vast "space markets" out there are performing a lot better (occupancy rates continue to rise and many real estate owners are now enjoying a bit of pricing power), REIT share prices are being driven this year not by fundamental factors but by the voracious appetites of institutional investors, often manifested in the form of buy-out offers even for REITs holding middling assets. The prices being offered in these deals are demonstrating that sell-side (and perhaps even buy-side) NAV estimates remain too low.²

All right, let's assume that REIT stocks have been "too cheap" compared with commercial real estate, and that the market is now adjusting to this reality. But let's step back for a moment and consider whether there may nevertheless be a few near-term danger signs lurking out there.

On purely a valuation basis, I can justify today's private market real estate pricing, where the buyer of a quality real estate asset can realistically expect an unlevered internal rate of return (IRR) of about 7%, based on a nominal cap rate of something like 6%, modest increases in net operating income, and after incurring normal recurring capital expenditures which never show up in nominal market cap rates. This is a much more modest return than has been the case for many years, but compares reasonably well with a realistic return expectation on equities of about 7-9% annually, particularly when adjusted for risk, and vs. the returns on intermediate-grade long-term bonds (about 6.25%), with less risk but no upside.

Accordingly, I don't think that commercial real estate is valued too richly today and, as REIT stocks now trade at an average NAV premium of about 8% (pretty much in line with the average over the past dozen years), REIT stocks aren't terribly "expensive" vs. commercial real estate. But I *am* concerned about a few incipient signs of investor giddiness that have surfaced recently. Consider:

a. Jim Cramer is a bright – and colorful – guy, and certainly boasts a legion of fans. But because he is just plain wrong on many of his calls (and is no REIT expert), it was a bit unnerving that his recent “buy” recommendation on Education Realty Trust (EDR) caused the stock to rocket 8.1% on the date of his recommendation. That's close to the return that most investor in EDR expected *for the entire year*. Do I detect a whiff of irrational exuberance?

b. There is speculation in Reitdom of a type we haven't seen in quite some time. Buy-out candidates such as Associated and Aimco have outperformed most of their more widely-respected brethren, *e.g.*, Archstone and Equity Residential, even though there is no solid information that would point to the former being acquired. When Felcor announced that it wouldn't be attending the Solomon Smith Barney CEO's conference two weeks ago, its stock shot up almost 5% -- purely on speculation that it was negotiating some kind of deal. If this isn't a sign of froth, then Pat Buchanan isn't a social conservative.

c. Where are all the articles in Barron's, Forbes, Money, Kiplinger's, *et al.*, which claim that REITs are overvalued and that investors should bail? Where are all the "sell" or "underweight" recommendations from the sell-siders? We have been bombarded with these poorly-reasoned screeds throughout 2004 and 2005, but the present environment is notable by their absence. Have the bears capitulated? Has the “wall of worry” been surmounted? Overconfidence and complacency are tricky elves that enjoy tripping up bull markets.

d. How much of the institutional capital that's been given to middlemen such as Morgan Stanley *et al* with orders to "go out and buy us a REIT" derives from long-term strategic objectives, and how much is due to the fear of being the last kid on the block to be fully invested in commercial real estate? These money flows, as we know, can dissipate at any time, particularly when, as now, capital is being flung all over the globe in search of the highest returns – often based upon very short-term time horizons.

e. In case nobody has noticed, interest rates have been moving up on the long end of the yield curve, not just the short end. The yield on the 10-year T-note recently hit its highest level since about 20 months ago, before pulling back a bit in recent days. Some REITs are seeing their bottom lines shrink with higher interest rates, and the value of commercial real estate as an asset class is at some risk when rates (particularly on the long end of the yield curve) rise significantly. So far, we've not seen any firming of cap rates in the private markets, but it

² The offer for Carr America, however, was only 4% above Green Street's NAV estimate.

stretches the imagination to think that caps won't be negatively affected if long-term rates continue to grind higher and move above 5%.

The bottom line, for me, is that I see increasing short-term risk in the REIT market, and wouldn't at all be surprised to see a correction of 5-8% or so begin at any time.³ Longer-term, I am as bullish as ever on REIT stocks, and believe that we are just in the 3rd inning of a new ballgame which is transforming the way in which investors – both institutional and individual – view commercial real estate (and REITs) as investments. So the wind is still at our backs. However, in case any of you long-term investors care, I think the risk of a short-term pricing squall is higher now than it's been in quite some time – perhaps we are in the midst of one as I put the finishing touches on this issue of the newsletter.

But let's keep our perspective. Some uncomfortable near-term stock price performance, perhaps shaking out the traders, momentum investors and hedgies, will be a significant positive for REIT investors, as it would kill off the modest amount of speculative fervor I observe at the present time, and would remind all of us that there is market risk in any asset class other than 3-month T-bills. And, of course, it would provide the REIT Faithful with better returns on our new investment dollars. Indeed, I would be more concerned should REIT prices spiral higher over the next few weeks in the absence of any fundamental change in the prospects for commercial real estate or changes in interest rates.

I need not admonish you, of course, to take all of the foregoing jabbering with lots of grains of salt. There are many things I cannot do well (such as carpentry or teaching Sammy to give up a fetched tennis ball), and I have never claimed to be a successful market timer. So, even if I am right about my caution about next few weeks, the odds still favor continuing good returns for REIT investors – particularly those wise enough to look beyond the very near term.

2. Revisiting the Value Creation Conundrum.

The words “value creation” have been used so often that they've become almost trite. Nevertheless, just as “Freedom” is also a word that's used often but never ceases to lose its importance, we should never get tired of thinking about the creation of shareholder value by REIT organizations. I wouldn't go so far as to suggest that creating value is as important to REIT shareholders as campaign donations are to politicians; after all, even if a REIT management team creates no incremental value for its shareholders, they still have their indirect ownership in the REIT's assets, which provide stable and predictable cash flows – particularly if those assets perform reasonably well.

However, value creation by a REIT's management team – extending beyond the value of what's implicit in the REIT's existing assets – is truly important. And, I venture to suggest, most members of the Ancient and Hoary REIT Investment Club (of which I include myself as a member), who have been doing battle with the investment dragons for decades, would no doubt agree. But let's back up a bit. Just what IS value creation in a REIT? Put simply, it is the ability to create some increment of value for the REIT's shareholders that goes above and beyond the value inherent in the REIT's existing investment properties. In other words, management can sometimes create something of value to enhance the worth of the REIT beyond managing the existing asset base. I'll summarize a few value-creating businesses and strategies in a few minutes, but first, we need to ask, “Why is value creation important?”

For institutional investors, at least, it justifies owning REIT stocks rather than direct commercial real estate – although a number of other factors may also make REIT investments more attractive than direct investments to these heavy hitters, such as more liquidity, and the ability to obtain greater investment diversification by sector, geographically and by management style. Value creation can also provide a valuable offset to any potential loss of value in a REIT's assets due to weakening real estate markets or rising cap rates, *i.e.*, the value of a REIT whose management team can consistently exploit unusual opportunities isn't anchored exclusively to same-store NOI growth or cap rates, and isn't as sensitive to real estate cycles. And, significant value creation over time

³ This paragraph was written last week, just prior to REIT stocks being trashed 3% on Monday and Tuesday, so perhaps much of the correction I speak of has already occurred.

allows for more rapid growth in dividends and free cash flows, which of course benefits long-term investors both directly and through higher stock trading multiples and greater NAV premiums.

Those REITs whose management teams have been able to create significant value over the years have seen their shares trade at sizeable NAV premiums and, most importantly, have provided above-average returns to their loyal investors. Think Kimco; one may question the appropriate size of KIM's NAV premium, but nobody can dispute the fact that it *deserves* to trade at a rich price relative to its peers. Kimco's stock has greatly outperformed most others in Reitdom over a long period of time, and the principal reason for this is that Kimco's management team has been able to create lots of value for shareholders over the years, and is expected to continue to do so.

At times it's almost as easy for a REIT management team to create shareholder value as it is for Sammy to take naps. At other times it's very difficult. And this ease or difficulty can correspond to each form of value creation. For example, in the early 1990s it was easy for a REIT to create value for shareholders; all that was necessary was having access to loads of equity capital, enabling the REIT to snarf up all the real estate it could get ahold of. We are 180 degrees away from that situation today, as it's almost impossible to create shareholder value by merely buying commercial real estate. Development, at certain times and in certain sectors (if done right – “don't try this at home”), can enrich a REIT's shareholders with substantial value creation, but at other times development is simply a foolhardy exercise in futility.

And there are, of course, other ways to create value for the REIT's shareholders beyond the obvious methods. A few REITs have been very good at finding and exploiting unusual real estate opportunities, such as Kimco and Vornado – but, in accordance with the “no free lunch” principle, unusually good prospective returns normally come with higher risk, and shareholders will sadly remember the first few years of Vornado's cold storage business. Sometimes it's even possible to create value by doing a bang-up job with the balance sheet, *e.g.*, by selling equity at a high price or buying in stock at prices well below NAV, harvesting appreciated assets at appropriate times, or even managing debt particularly well. And, of course, some REITs have been very successful at organizing and running non-REIT businesses; Archstone-Smith's Ameriton subsidiary, which builds and trades apartment communities, is just one example.

But now, thanks to the global thirst for commercial real estate, there is yet another excellent way for some REITs to create value, which is only now becoming recognized for the potential bonanza that it could become – Asset Management. If I – and my fellow travelers along the “secular change” highway – are right in thinking that we are still in the early stages of a long-term trend in which institutional investors will be substantially increasing their investments in commercial real estate, co-investing with these institutions and managing the investment fund's properties will be one helluva business and a great way to create value for the REIT's shareholders. Why?

Let's assume that institutional investors will want to own a lot more commercial real estate. They can – and they will – go out and buy it, but this can be a costly and cumbersome way to boost their investment in commercial real estate. Isn't it often better and smarter for an institutional investor to “outsource” an increasing commitment to real estate as an asset class? The advantages include:

(a) it enables them to get the “best in the business,” *i.e.*, the leading REIT management teams, to select and manage their newly-acquired assets; (b) by requiring the REIT that manages the fund to co-invest, it causes the REIT to have its own skin in the game and aligns the interests of the partners; (c) it eliminates the need for staffs of high-powered (and expensive) employees; (d) the investment may sometimes be structured to provide some degree of liquidity; (e) the investor will frequently be able to acquire high quality, newly-developed assets, perhaps via a right of first refusal, *e.g.*, as in the case of AMB's and PLD's new developments; (f) the fund investors should be able to benefit from the REIT general partner's extensive tenant relationships, particularly in the retail and industrial sectors; and (g) owning assets through funds managed by large, quality REIT organizations is simply a cost-effective way to own commercial real estate.

And, for particular REITs, becoming the general partner in such a fund can be the next best thing to a free lunch – and will create substantial value for the shareholders. Taking only a portion of – and reducing the dollar amount invested in – new properties minimizes the REIT's need to raise equity capital, which is often very

costly. A strong fund business will enable a REIT to expand its presence in attractive markets, strengthening relationships with existing tenants and forming new ones.

Furthermore, the stream of management fees that are earned boosts revenues and investment returns, as many REITs have been demonstrating, and prospective incentive fees can add up to some real money over time. And, although investors are just now beginning to realize it, many of these revenue streams are safer than even rental revenue streams – as the highly respected Milton Cooper, Kimco’s CEO, noted recently, the investors must pay management costs before taking any property cash flow distributions.

Of course, not all REITs can successfully build and maintain a significant investment management business. Some sectors are more conducive to this business model than others; in the retail sector, for example, strong tenant relationships are particularly important, which provides significant inducement for a large investor to team up with a REIT that enjoys this attribute. Industrial properties, where many large space users can be persuaded, due to existing relationships, to sign new leases with the REIT on properties in select locations around the globe, and self-storage properties, where greater size and brand-name recognition are very important, are two other sectors which seem to be ripe for a fast-growing asset management business.

It is only now that REIT investors are coming around to appreciate this asset management business model, and they are beginning to accord premium prices to the REITs that can do it successfully. The cash flow streams from these asset management businesses are being given higher multiples by REIT analysts, e.g., 16x rather than 8x.⁴ And so an increasing number of REITs are now realizing that this is a business they want to get into. Some of today’s major players include AMB Properties, Acadia Realty, Developers Diversified, Kimco (which was one of the first entrants with its “KIR” venture), Pro Logis and Regency Centers. New asset manager wannabees include Federal,⁵ Health Care Properties, Parkway, Reckson and Weingarten, among others.

This business, like virtually all others today, will be highly competitive; while it will often be relationship-driven, the investment managers must perform, and money will leave a poorly performing manager – or even one that’s insensitive to its clients’ needs – faster than investors liquidate a tech stock that’s missed its numbers by a few cents. But those REITs that can develop this kind of business successfully will be creating significant amounts of value for their shareholders. Mr. Cooper, without a doubt one of the wisest REIT executives in the industry, has recently stated that he hopes to build Kimco’s assets under management by a factor of 10x its present level, to as much as \$75 billion over the next five years.

Investors will be missing a big piece of the performance puzzle if they fail to account for the values that can be created by a strong REIT management team with an excellent track record and a commitment to the investment management business. Fueled by a continuing desire of institutional investors to boost their commercial real estate portfolio allocations, the rate of earnings growth for these REITs could be significantly above what’s possible by merely owning real estate. Perhaps the hefty NAV premiums that are being awarded by investors to some of these “asset manager” REITs are not so absurd after all.

Your humble servant,
Ralph (Block)

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⁴Because some asset management businesses provide much more stable revenue flows than others, the valuations of these businesses must take these differences into account.

⁵ Actually, Federal has been in this business since July 2004, when it inked a JV deal with ING Clarion, but the venture has been dormant until recently due to low market cap rates.