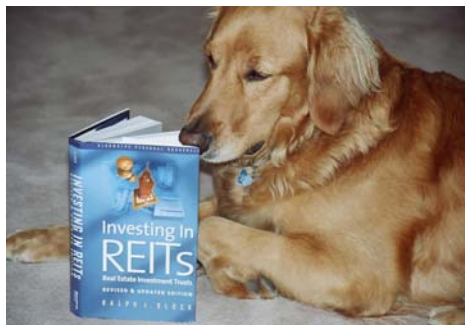


"The Essential REIT"

April 14, 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

1. The Paws That Refreshes?

Sammy and I were relaxing in the backyard on a rare warm day in Westlake Village a week ago when the subject, naturally, turned to REITs. We had a half-hour before our daily visit to Russell Park, enough time to cover some topics of particular importance to my furry friend. So, pull up a chair and listen. You won't learn anything, but perhaps you'll be entertained a bit.

Sammy: What do you make, Reitnut, of the recent trashing of REIT stocks? Some of them have been mangled as badly as my old dinosaur Nylabone. Is this the paws that refreshes, or is the fur going to continue to fly in Reitland?

Reitnut: If you had read my last "Essential REIT" of March 24 rather than chasing tennis balls, you'd have known that I expected a "price correction" (a euphemism for mild trashing) of about 5%. From March 24 through April 12 (the latest date for which FTSE NAREIT All-REIT Index information is presently available), REIT total returns were a negative 3.9%. Tack on another 1.2% trashing on Thursday, and we're right at that forecasted 5% figure. However, a very substantial number of REIT stocks are roughly 10-12% below their highs for the year, e.g., Boston Properties, Equity Res, Pro Logis, Public Storage and Simon are down 11.5%, 10.7%, 12.4%, 11.8% and 10.7% from their 52-week highs, disrespectively. So, yeah, REIT stocks have been blitzed.

The culprits of this discomfort are 3-fold. First, REIT stocks had simply gone too far, too fast, amidst a disquieting level of heavy breathing by speculators anxious to cash in on the next REIT buyout. Second, valuations were a bit stretched; even though NAV premiums never became excessive, the prospects of possibly rising cap rates were not being discounted in REIT stock prices. Third, the 10-year T-note has been misbehaving, on Thursday blowing past the psychologically important 5% level to highs not seen since June 2002.

Sammy: I note that data from Green Street Advisors – to which firm I am very much indebted due to Mr. Leupold’s strong recommendation to you five years ago to “get a Golden” – suggests that REIT stocks today trade at a *zero* NAV premium, compared with their historical average of about +7% since 1992. Does this mean anything, Reitnut?

Reitnut: It can mean any one of three things: (a) investors are expecting a rise in real estate cap rates and declines in REIT NAVs; (b) investors are requiring higher returns on their REIT investments to compensate for the risk of even higher interest rates; or (c) investors are idiots and are pricing REIT stocks too cheaply today. Or perhaps all three. Of these choices, (a) is possible, but there are no signs yet that cap rates are moving up; (b) is a bit silly, as the yield on the 10-year isn’t a lot higher than it was in late March (4.75%) when REIT stocks were screaming; and (c) is, of course, possible if one believes that markets are inefficient, but my belief is that REIT stocks aren’t cheap at the present time – fairly priced, sure, but cheap, no.

Sammy: So where does all that gibberish leave us? What’s it all about, Alfie?

Reitnut: My name’s Ralph, not Alfie. What it’s all about is that REIT stocks needed a decline in order to deflate some excessive (I won’t say irrational) exuberance. My own view is that the decline *may* have a bit further to go (who the hell can call market bottoms?), but we are closer to the end than to the beginning. The US economy is still growing, the commercial real estate space markets continue to improve, new supply of commercial real estate is modest in most markets, and retail sales seem to be holding up despite the triple-whammy of \$3 gasoline, higher home heating prices, and the demise of the Home ATM Machine. And, although it’s at least possible that 5% rates on Treasuries will negatively affect real estate cap rates, this potential negative could be offset by higher-than-expected NOI growth prospects.

Thus, if we can conclude, as I do, that commercial real estate itself isn’t overpriced (relative to other asset classes)¹, then neither are REIT stocks. Furthermore, there are as yet no signs that the Great Thirst for commercial real estate at the pension funds and other institutions has been slaked. If this is so, then the trashing of REIT stocks is probably almost over. However, I would be surprised if REIT stocks finish the year with total returns much in excess of the 7.7% (my estimate) posted as of April 13.

Sammy: Speaking of REIT buyouts, what’s your current forecast? Does the buyout phenomenon of the past 12-15 months have a long tail? Or, to put it another way, will Associated Estates be snagged at a 20% pricing premium by some bozos who’d be happy with a 4% cap rate on those irresistible AEC assets?

Reitnut: Since the beginning of 2005, according to a study compiled by Ryan, Beck, 14 deals have been announced, including 11 “going private” transactions amounting to 72% of the total deal volume.² And, as there are still boatloads of capital out there hoping to weigh anchor in Reitland, it’s very likely that it might take the fingers of both hands to count the number of deals being negotiated as I write. The next deal announcement may be only a couple of days or a couple of weeks away. According to a recent Reuters story (dated April 5), which sourced Michael Pralle, President and CEO of GE Capital Real Estate for the information, Texas Pacific Group is putting together a \$14 billion fund. How many more Texas Pacifics are there? So there still appear to be lots of Willie Suttons out there, interested in REITs’ real estate.³

Of course, rising interest rates are a negative for deals; reportedly, many of these transactions depend upon huge slugs of debt. According to the Reuters news story noted above, the CarrAmerica acquisition by Blackstone Real Estate Advisors will require “only” \$900 million in equity to finance this \$5.6 billion deal. Higher interest rates will make these kinds of highly-leveraged deals much more problematic.

Also, acquirors love to offer pricing premiums (takeunders are as popular as a lion at a wildebeest party); or, changing metaphors, buyout premiums are to executives and shareholders what Playboy is to adolescent males.

¹ I and others have written often on this topic, and so I won’t bore you further with another discussion. Suffice it to say that commercial real estate is being priced today to deliver an average IRR of something like 7%, which, on a risk-adjusted basis, compares pretty well with expected returns on stocks (7-8%) and on bonds (5-6%)

² See also “The Essential REIT,” dated February 17, 2006.

³ Willie Sutton, of course, was the infamous bank robber who, when asked why he robbed banks, wisely noted, “That’s where the money is.”

And, when REIT share prices were soaring, there was less room for these premiums – which, according to the Ryan, Beck study, amounted to 15.9% of the stock price 30 days previously. But now that REIT shares have fallen back to earth, just modestly outperforming the popular equity averages, it may again be possible to offer premiums. We shouldn't expect a flood of deals – REIT stocks are now priced closer to private market values – but there's a bit of life left in the buyout mania. So, Sammy, even while you nap, keep one eye open for that next deal. And, when it happens, watch for REIT stocks, like Lazarus, to quickly rise from the dead.

Sammy: You probably know from my antics that I am a wired dog. I've been on-line to NAREIT's website, and have learned that the apartment sector is on track this year to win Best of Show, and that the mall sector looks like it's been dragged through a muddy duck blind. Perhaps you could recap sector performance? Also, Reitnut, I know you're enough of a fool to rush in where angels like me fear to tread, so why don't you tell us if these trends will continue all year? "Biscuit, biscuit, on the wall, who's the fairest of them all?"

Reitnut: You are right, Sammy. The apartment sector has been this year's leader, with an average total return of 12.9% as of April 12. However, the office guys have done nearly as well, up 11.5%, both figures courtesy of NAREIT (NAREIT's average performance was 8.4% through that time period). And the malls, indeed, have been the laggards, up only 2.2%. Mills was the culprit, ruining things for its peers, but even the widely-respected General Growth Properties turned in a poor performance. Aside from a couple of very small sectors such as free-standing retail and manufactured home communities, the healthcare REITs also underperformed, with an average total return of just 5.5% as of that date.

My assessment is that the apartment REITs have benefited by the prospects of somewhat better than expected job growth, higher interest rates (thus putting a thorn in the side of condo marketers), and prospects of a flattening in home/condo prices, along with a failure of apartment cap rates to rise despite the apparent end of Condomania. Office REITs probably have performed as well as they have due to expectations of additional buyouts at rich premiums (*e.g.*, the CarrAmerica deal, announced in early March, boosted CRE's shares over 8% that day) and by speculation that a good chunk of Manhattan office properties are about to be bought up by Saudi Oilcrats at 4% cap rates.

The malls, of course, were hurt by a triple whammy of (a) the Mills fiasco, (b) rising interest rates, which are impacting General Growth and Macerich particularly and the entire sector to the extent that higher rates chop consumer spending, and (c) concerns about a washed-out consumer having to reduce trips to the malls due to a zero savings rate, \$3+ gasoline and other assorted ills. And, in the healthcare sector, the widely-respected Ventas took a bad stumble when its rental reset right with Kindred looked a lot less valuable due to the proposed LTAC reimbursement cutback, while investors were reminded that what the government giveth, it can also taketh away. And, of course, rising interest rates haven't exactly helped this interest-rate sensitive sector of Reitdom.

Going forward, Sammy, I think it's dangerous to assume that all these trends will continue. I believe there's a pretty good chance that interest rates will top out in the fall of this year; this would help the healthcare REITs and perhaps put a bit of pressure on the apartment and office guys if the prospects of declining interest rates are interpreted as heralding a softer economy, and less job growth. Do I have lots of confidence in this forecast? Hell, no. That's why, as a faithful reader of "Investing in REITs," you know that it's wise to be well-diversified by real estate sector.

Sammy: Arf. Don't patronize me, Reitnut. Although I haven't yet bought the 3rd edition, I do know REITs and, indeed, have been asked whether I would be willing to run money for some astute individuals. But, not being an Alpha dog, I'm not sure I would do better than a REIT index. I will leave the relative performance game to you; I am wiser than that, as I seek *absolute* returns.⁴

Next question. I have more interest in T-bones than T-notes, but what's with those rising interest rates? How much will they impact REITs and their share prices?

⁴ For an interesting discussion of absolute vs. relative returns, see one of the later chapters of Barton Biggs' new book, "Hedgehogging." I loaned it to my human brother, Steve, so I cannot specify exactly where in the book it is. Nor do I much care.

Reitnut: Certainly a yield above 5% on the 10-year isn't good news for REIT stocks. In my prior year-end forecasting, for last year and this, I expressed a view that REIT stocks wouldn't fare real well should bond yields spike, and I continue to believe that. Rising interest rates have several negative effects upon REIT stock pricing, including:

1. Some investors buy REITs for yields, and look at bonds as alternatives. If they can get much greater yields on intermediate-quality bonds, they are apt to shed REITs and buy the higher-yielding bonds.
2. Some portion of all REIT debt is variable-rate, and thus rising interest rates, at the short end of the yield curve, will impact profits. Of course, REITs with the most exposure to variable-rate debt would be affected most. And, higher interest rates at the long end of the yield curve will impact REITs when they refinance their fixed-rate debt, and even their preferreds.
3. Interest rates are an important component of cap rates. Thus higher long-term interest rates may impact real estate cap rates, which in turn could affect REIT NAVs. Lower NAVs would put pressure on REIT stock prices.

Offsetting these negatives are two significant positives. First, higher interest rates, at least at the long end of the yield curve, often (though not always) reflect a growing economy – and demand for space – which of course should benefit real estate owners by allowing them more pricing power. Thus some believe that commercial real estate values (and REIT NAVs) can be maintained even in the face of modestly higher cap rates, as the other part of the valuation equation – the expected NOI that is being capped – may be higher than expected as a result of a stronger economy. Of course, much depends upon the extent of the higher cap rates.

Second, one of the biggest issues for commercial real estate owners is the amount of new space that is being built. It's Economics 101, where rents are determined by both supply and demand. Land and construction costs have been rising faster than the snow level in Mammoth, and, now that interest rates have become a bit uncomfortable, it seems but Spockian logic to assume that these factors will reduce new development starts and thus, hopefully, create the proverbial soft landing when space markets weaken.

I am not smart enough to know how all these factors combine to determine REIT stock prices, and Chaos Theory may apply. Another wild card is psychology, *i.e.*, some investors, or hedge funds, will sell or even short REITs simply because they believe other investors will do so in response to higher interest rates, which can create its own vicious circle driven by negative psychology. Perhaps hedge funds are reciting the following jingle even as I write: "REIT stocks will fall quite far; it's time to short the I-Y-R."

I cannot predict market psychology very well, and don't know whether the "wind at our backs," *i.e.*, the ongoing demand for commercial real estate, direct or securitized, from individuals and institutional investors, will be able to offset the negative psychology of higher interest rates. But this is a short-term issue, of interest mainly to traders. The bottom line, for me, is that higher rates are probably a mild negative for REIT stocks, but not a large one – as long as rates don't blast significantly higher from present levels. And who knows whether that will happen? Wall Street is littered with the bodies of investment strategists who place great stock in interest rate forecasts.

Sammy: Speaking of interest rates, the Fed seems to be biting more than just barking these days. Isn't it time to consign Mr. Bernanke and his pack of pit bulls to the local kennel before they dig big holes in the US economy?

Reitnut: I think, Sammy, that the Fed has done a pretty good job up until now. However, I agree with you that they seem to be underestimating the potential impact upon the consumer of a higher interest rates, coupled with a weak savings rate, higher gasoline and home heating (and cooling) costs, and topping home prices. Lots of "affordable" loans have been made by lenders-with-no-conscience to marginal borrowers over the past two years, and those chickens haven't yet even begun to come home to roost. And, of course, the impact of rising interest rates doesn't bite until later.

If I were Mr. Bernanke, I would be very concerned that the Fed may have already overdone it; one more bump will be necessary to establish Ben's reputation as Inflation Fighter No. 1 (particularly considering his snide nickname of "Helicopter Ben"). But, after that, the Fed will take a wait-and-see posture. And, when they see the statistics on the US economy in June and July, they will likely contemplate *reducing* interest rates, not raising

them further. By then, the yield on the 10-year will be back down to 4.75%. So, any further rise, from here, in interest rates will contain the seeds of its own destruction, and will hasten a fall in rates later this year resulting from a weakening US economy.

Sammy: Yeah, yeah. You spin a good story, Reitnut, but I don't believe any of it. You thought that the 10-year would top out by spring, but it's still moving higher. Even a near-sighted guy like me can read the bond rate tables in the Journal (actually I can smell them). And no humanoid can consistently and accurately forecast economies or interest rates, as you admitted earlier. So why should any of your subscribers believe your forecast?

Reitnut: They shouldn't. So what? They're getting what they pay for.

Sammy: Last question. Anything new on the REIT allocation issue? You and your pals are always looking for Holy Grails (of which REIT allocation is one). I, on the other hand, look for more tangible things, such as bones and hamburgers. Who's smarter, Reitnut?

Reitnut: I will ignore, for now, your gratuitous commentary. But, to answer your question about REIT allocation: This is, of course, old ground that we've plowed extensively in newsletters past, as well as in the 3rd edition of "Investing in REITs."⁵ So, I won't bore you further. I have often maintained that, for most investors who are not looking to shoot the lights out with their investment performance, a REIT allocation of something like 20% is appropriate. However, a recommendation for an allocation that high is often laughed at by financial advisors, e.g., "Well, that's Ralph Block. We know he's nuts – or, at the least, irrationally committed to REIT investing."

Well, I have now found a new ally. A fellow that many of you have probably heard of has recently written a book on investing, entitled "Unconventional Success: A Fundamental Approach to Personal Investment" (Free Press, August 2005). In the book,⁶ the author, who is not afraid to go against the "conventional wisdom," recommends an allocation to real estate of 20%.⁷

Who is this outrageous author? Perhaps some flack hired by the board of directors of a large REIT? Nope. It is David F. Swensen, the fellow who is regarded almost as a god in the investment world for what he did with the \$15 billion Yale Endowment Fund: His performance averaged 16% annually over the past 20 years, a track record almost as good as that of W.E.B. So, needless to say, I take a great deal of comfort in the fact that Mr. Swensen and I see things similarly, at least with respect to an allocation to commercial real estate.

Sammy: You've bent my whiskers long enough, Reitnut. I've got a date at Russell Park with a good-looking dingo dog named Sydney, and I'm hoping that Snickers and my other pals will be there too. And don't forget those tennis balls. Given the performance of REIT stocks over the past two weeks, you probably also ought to look for a tree squirrel you can kick a couple of times to make you feel better (assuming you could catch it).

Reitnut: I don't kick squirrels, Sammy, but I wouldn't mind squashing a few jihadists, furry or otherwise. Now, we're outta here.

Your humble servant,
Ralph (Block)

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⁵ See Chapter 10, pp. 234-238.

⁶ Which I admit not yet having read.

⁷ He recommends 20% in "real estate" (presumably including REITs), 30% in domestic equity, 15% in foreign developed market equity, 5% in emerging market equity, and 30% in government bonds – half TIPS.

