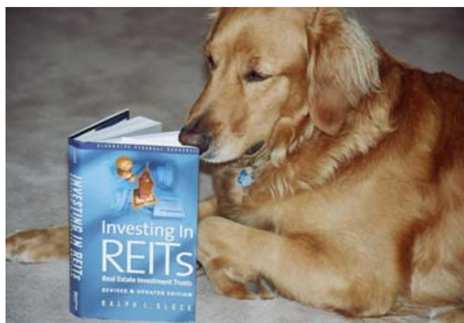
“The Essential REIT”

June 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

1. Mauled!

“The last shall be first!” And vice-versa. Reversion to the mean is one of the iron laws of investing. Thus it shouldn’t surprise us when a favored stock or group of stocks suddenly underperforms after a magnificent run, perhaps due to changing “fundamentals” or shifting investment fashions. On occasion the period of underperformance seems to last nearly as long as the term of an unpopular U.S. president (Clinton or Bush, take your pick), while at others it’s merely a pause that refreshes.

Those thoughts occurred to me recently after looking at the performance of the mall sector in REITdom thus far in 2006. After performing like the Green Bay Packers under Vince Lombardi from 2001 through 2005[1], the sector, this year, has been as sluggish as an exercised-challenged fat man after eating a plate of Tommyburgers. Year to date through June 20, the average mall REIT has turned in a total return of -.03%, vs. +8.32% for the NAREIT equity index. That performance is, of course, skewed by Mills, the juvenile delinquent of the group (down over 30%), but even its better quality and less troubled peers haven’t performed very well, *e.g.*, Simon Property was up just 6% at the same date (on a total return basis). This year investors have fallen in love with apartment and office REITs, while the entire retail sector (+2.25%) has been a laggard.

For some thoughts on the prospects for the mall sector, in particular, let’s listen in on a heated conversation between two long-time REIT denizens, Ursa Mallbear and Stella Bullymall. As their names imply, Ms. Mallbear has been absent from this sector for some time, while Ms. Bullymall continues to drool (do bulls drool?) and snort over its future prospects.

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[1] The mall sector outperformed the NAREIT Equity REIT index by approximately 1800, 2100, 1500, 1300 and 400 basis points, respectively, in each of those years.

Mallbear: Investors are rightfully stomping on the mall sector. Consumers, while perhaps not ready to stay at home every day watching "Lucy" re-runs, are in deep trouble. High gasoline prices, spiking home heating and cooling costs, the demise of homes-as-ATM-machines, and negative wealth effects from falling home prices are, like Harry Potter's dementors, sucking the happiness out of consumers. They have little discretionary income to squander, and it'll be very difficult for mall retailers to pry dollars out of their pockets. Meanwhile, mall owners won't be able to get much blood out of retailer-turnips.

Bullymall: First, mall REITs' less than scintillating performance this year is due more to the heavy bets being placed on apartment and office REITs than to forecasts of trouble ahead for mall owners; and, if we take out Mills' dismal performance, the remaining mall REITs haven't lagged too badly. Second, if the poor relative performance is due to worried investors, they have overreacted. Look at the real world. The mall business is quite healthy. Occupancy rates remain very high, bankruptcy-related closures are near historic lows, NOI growth is still in line with historic norms (a bit over 3%), and spreads on re-leasing are very close to their averages over the past few years. Investors are within their rights to worry – indeed, investors should *always* worry – but if it's fear that's causing them to sell mall REITs, such fear is misplaced and doesn't correspond with today's realities.

Mallbear: That's backward-looking analysis, Stella. Markets look ahead, not backwards, and retail REITs' best days are behind them. Don't invest on today's numbers; think 2007.

Bullymall: OK, let's do that. Employment and salary growth will slow a bit but remain positive. Even if the likes of Wal-Mart and Target should suffer because their shoppers struggle to fill their gas tanks, most mall REITs cater to relatively affluent shoppers, and there are still plenty of money-earning consumers. Gasoline prices, albeit at high levels, have been flat recently, and this moderating trend should continue. In any event, gasoline consumption is a relatively small component of most families' monthly expenditures. Although the housing market could get out of hand, all available evidence suggests that we are headed for a soft landing.

Yes, consumer spending will certainly slow in the months ahead but will remain positive and, so far, retailers aren't praying to the porcelain god. Retailers, when signing leases, look 3-5 years out; perceived near-term slowdowns don't much affect their leasing plans. And there are few new malls being built, so retailers won't stint on taking space at quality malls, nor will they balk (more than usual) about rents – and mall REITs have more negotiating clout these days. The recent ICSC convention was hardly a harbinger of gloom and doom.

Mallbear: Ah, but the *trends* are weakening. Re-leasing spreads are now below the long-term averages (albeit slightly), and interest rates, which affect virtually all consumers and many mall REITs laden with slugs of variable rate debt, are moving relentlessly higher. The major department stores continue to consolidate, leaving lots of space to backfill. And, of course, we are over-stored in America.

Bullymall: If consumer sales are slowing, they are doing so from very high levels. Retailers are creating new shopping concepts, which are drawing the fickle but persistent consumer. "Over-stored?" We've heard that for the past 10 years; you can go broke in a hurry by underestimating the American consumer's staying power. And don't forget that malls continue to reinvent themselves; now, it's restaurants that are drawing the crowds, while mixed-use opportunities abound.

Perhaps retail property performance will no longer kick butt relative to other real estate sectors, but NOI and AFFO growth will remain very respectable. Reitnut thinks that average AFFO growth for the mall REITs will be modest this year, due to higher interest rates, but that AFFO growth will exceed 8% in '07 and '08, thanks to solid internal NOI growth and contributions from developments and redevelopments. And look at mall REITs' valuations! The average mall REIT, per Green Street data, traded at a 14% NAV discount at the end of last month.

Mallbear: Valuation, schmaluation. Nobody cares about valuations these days. Look at the lousy momentum, fella! But even if valuation is relevant, you should understand that what appears cheap will

become expensive in REIT world should cap rates rise – especially with the higher than average leverage deployed by mall REITs.

Bullymall: So far, the only upward pressure we've seen on cap rates from higher interest rates is for lesser-quality strip centers in mediocre locations; these have been the sand-boxes in which the leveraged buyer crowds have been playing. We are not seeing increases in cap rates among the types of assets owned by the major mall REITs. Furthermore, existing cap rates are not outrageously low; Green Street uses an average nominal cap rate, in determining the NAVs of the mall REITs they follow, of a little over 6% (about a 5.5% economic cap rate).

With internal growth prospects reasonably decent, thanks to embedded NOI growth running at something over 3%, it's clear that mall properties are being valued reasonably, and there is no reason for mall cap rates to spike. Need I remind you, Ursa, that yields on the 10-year still hover in the low 5% range. A final point: as there are very few large and productive malls up for sale, they have a bit of scarcity value that will tend to keep cap rates – and thus REIT NAVs – firm. So if you see a quality mall REIT trading at a sizeable NAV discount, it's worth a second – and third – look.

Mallbear: Humph! Investors are telling us *something* and, as Reitnut has fretted about often, it's never wise to toss the one-fingered salute at Mr. Market.

Bullymall: True. But markets often overreact. As long as we're on the subject of market lore, don't forget what Paul Samuelson said about markets and recessions.[2] Look, pal, I can't tell you when mall REIT stocks will crawl out of their doghouses and begin to cavort around the yard, but I can tell you with confidence that there's real value in them today. Oh, but how silly of me; they don't have momentum, so a Mr. Magoo like you won't be interested in them.

Mallbear: Oh, all right, let's play your stupid game. Which mall REITs do you particularly like these days?

Bullymall: I'm like a gold bug in Fort Knox! Except for Mills, which I wouldn't be seen with in polite company, I like just about all of 'em. But the most interesting mall REIT at the present time is General Growth Properties (GGP).

Mallbear: GGP? Arggh! Surely you jest! That company is in debt up to its eyeballs, much of which is at variable-rate. Rising interest rates are eviscerating this REIT, and the stock has been roadkill this year, down 7.6% in price from the end of last year through June 20 (when it closed at $43.43). Don't touch it, Stella; it's radioactive waste!

Bullymall: When will you ever learn, Ursa? This poor stock performance is one of the principal reasons why GGP is so cheap. As of June 20's close, it sold at an incredible 23% discount to Green Street's NAV estimate. And it's multiple, at under 19x estimated 2006 AFFO, is well below its peers Macerich, Simon and Taubman, all of which trade at over 20x. Sure, a modest P/AFFO haircut is appropriate, due to GGP's higher debt leverage and variable-rate debt. But today's massive NAV discount is crazier than Iran's President.

Mallbear: Are you forgetting that GGP overpaid for Rouse? Chickens like that have a habit of coming home to roost. And, their community development business inherited from Rouse is not only complex, but also very risky. We all know what's going to happen to *that* business, and it ain't pretty.

Bullymall: As for overpaying for Rouse, that point remains debatable. Analysts have estimated that GGP paid a cap rate for Rouse of between 5% and 5.5%. Although this looks a bit expensive, this deal was *not* done as a property or portfolio acquisition, but as a strategic move. GGP's management believes that owning the Rouse assets will make all its portfolio properties more productive, enhance growth

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[2] Mr. Samuelson's famous quote is that "The stock market has predicted nine of the past five recessions."

opportunities, and will augment GGP's negotiating strength with retailers. It's much too soon to render a verdict.

And keep in mind that this company is entitled to the benefit of the doubt. Look at its track record; it has been the best-performing mall REIT for the 5-year period ending May 30, 2006 (according to Bloomberg). And, its longer term track record is even more impressive. For the 10 years ending December 2005, its average annualized total return was 27.9%, compared with 14.3% for the Morgan Stanley REIT index and 20.2% for the NAREIT mall sector (excluding GGP). In the 13 years since General Growth has been public, its dividend has increased 13-fold, from $.493 to $1.64. Sure, investors always ask, "What have you done for me lately." However, it seems to me that these guys are entitled to a little more respect.

As for a "complexity discount," well, perhaps you have a point. However, most of the better REITs today are becoming more complex, as REITs have had to go further afield in the current environment to create value for their shareholders. But, aside from land sales, which continue to be respectable, the business is pretty straightforward; they own, manage and develop shopping malls and related retail centers. And Q1 2006 NOI from the company's community development business was only 7.4% of company-wide NOI. Although it may be more difficult to forecast quarterly FFO to the penny, understanding General Growth ain't rocket science. Look at the forest, Ursa, and don't try to climb up a few individual trees.

Mallbear: But what about those debt levels? Management has really goosed the risk in this stock!

Bullymall: Only if, like tech junkies, you fret about missing quarterly numbers by a few cents. Sure, GGP's short-term FFO and AFFO will be somewhat dependent upon interest rates, and rising rates have impacted cash flow growth a bit this year. But is that why we invest? I thought investing was about finding great companies, whose stocks are trading at attractive prices, and which are able to create substantial value and deliver outstanding returns to their investors over 5- and 10-year periods. And as for GGP's current debt load, it ain't all that bad. Debt leverage, at March 31, was about 60% of estimated asset value (vs. 53% for the mall sector of REITdom), and variable rate debt was 14.6% of the current value of the company's assets (vs. 9.7% for the average mall REIT).[3]

Mallbear: Ah, but its dividend is puny, at 3.8%. Given the higher risks, GGP's stock ought to provide a dividend yield at least in line with the REIT averages, say, 4.3%.

Bullymall: Why? Perhaps the risk is a bit higher, due to the greater debt (and variable-rate debt), but this company owns major malls, where performance over many years has been very stable. But, even more important, GGP pays out a relatively small portion of its free cash flow in dividends, and thus has room for ample increases (as has been the case historically). If it paid out 90% of its estimated 2006 AFFO, the dividend would be $2.07, and the dividend yield would be almost 4.8%. Today's payout ratio is only 71% of this year's estimated AFFO.

Mallbear: What's the company's asset quality?

Bullymall: Glad you asked. Quite good. The average GGP mall is rated A- or B+ in quality. Average occupancy was 91% at March 31, and occupancy over time has been very stable. Average tenant sales are $444 sq.ft. Average household income in its trade areas is modestly higher than both Simon and Macerich (though less than Taubman). These are very good assets, and the portfolio is well diversified across the U.S.

Mallbear: What kind of AFFO growth prospects lie ahead?

Bullymall: Hmmm…Ursa, have I convinced you to take a good look at this company? OK, AFFO growth will be modest this year, perhaps 5-7%, as rising interest rates will pinch near-term growth. However, if one believes Green Street estimates – and there are no better analysts out there – AFFO will grow in the double-digits in 2007 and 2008.

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[3] Figures from Green Street Advisors at May 31, 2006.

How will they do this? My belief, Ursa, is that internal, NOI growth will remain respectable despite the slowdown in consumer spending (keep in mind that internal growth is largely based upon occupancy rates and rental re-leasing spreads, not near-term same-store tenant sales). Perhaps more important, this company has a very solid development and redevelopment pipeline, amounting to over $1.27 billion as of March 31, not including eight new projects in pre-development. Even if these AFFO growth estimates are a bit too optimistic, this company is still a growth machine (or at least as good a one as can be found in this asset class).

Mallbear: I'll bet insiders have been selling.

Bullymall: Just the opposite. The highly respected GGP CFO, Bernie Freibaum, bought 10,500 shares on May 17 at $43.93, another 9,500 shares on May 18 at $43.91, 1,300 more shares the next day at $43.10, and 20,000 shares as recently as June 14 at $42.70 – 42.80, while director Adam Metz bought 6,000 shares at $44 May 18. These were open market purchases, not option exercises. Mr. Freibaum's total investment amounted to $1,789,000; even for a man of his stature, this ain't chump change. Insiders, taken together, own approximately 18% of GGP's outstanding stock.

Mallbear: What are the major risks looking forward?

Bullymall: Depends upon your time horizon. Certainly rising interest rates have negatively impacted GGP's consensus FFO estimates, and current estimates could still be too high, given the relentless upward pressure on rates caused by an "inflation-worried" Fed Chairman Bernanke trying to right himself after a rocky start. GGP's FFO is, indeed, sensitive to short-term interest rates. If you're a trader, go ahead – check each Fed member's eye twitches and hand gestures on a daily basis, and make yourself crazy. In the short term, GGP's stock will be tethered to interest rate movements. Personally, however, I couldn't care less if GGP's FFO fails to meets consensus this quarter or next if the culprit is rising interest rates. Furthermore, we are closer to the end than to the beginning of this short-term interest rate cycle.

But I do care about longer term risks. It seems to me that the largest medium-term risk is a housing crash or a major terrorist attack in the US that could precipitate a recession. That would certainly dent cash flow growth for at least a year or two. Or, spiking long-term interest rates – something significantly higher than 6% on the 10-year. Or a major rise in mall cap rates, perhaps induced by a sudden hatred for commercial real estate as an asset class. But outside of those dire events – of which the chances are slim – I don't see much risk in GGP's stock, particularly if one is old-fashioned enough to be willing to hold it for 3-5 years.

Mallbear: But what will it do over the next month?

Bullymall: It will fluctuate. Go away. Find yourself a short pier and take a long walk.

Disclosure*: Your humble author owns a sizeable slug of GGP stock, and has been adding to it recently. Ms. Mallbear has made some good points – and the stock may not perform particularly well over the near term. However, my personal belief is that those who own the stock today will be very happy with its performance a year hence.*

Your humble servant,
Ralph (Block)

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