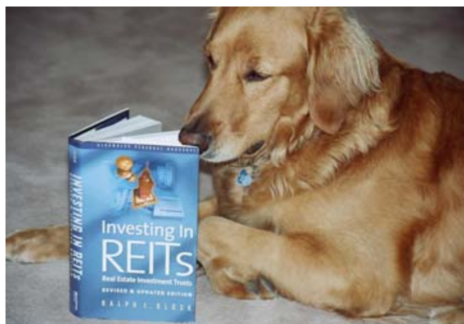
"The Essential REIT"

August 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. Reitnut's Foolish Attempt to Answer Unanswerable Questions.

Where have we been, where are we now, and where are we headed? Barron's likes to ask famous investors these important questions. Although your humble author isn't *entirely* unknown in Reitville, and Barron's *did* do a story on my partner, Bill Schaff, and me several years ago, I have as much chance of being interviewed by Barron's as does Elmer Wimpstone, a small (5'2") investment advisor working out of his barn not far from Dubuque. Accordingly, I will (reluctantly) interview myself in a foolhardy attempt to answer unanswerable questions.

Q. Earnings Season – Cap Rates. Reitnut, REITs' Q2 earnings season is over. What have you learned (beyond the obvious fact that one unfortunate side effect of the Sarbanes-Oxley medicine is severe compressionitis of reporting dates)? Please start with cap rates; are the boo-bird cyclicalists wrong again?

A. There has been a kind of Tale of Two Cities with respect to caps. Now that levered initial returns won't be any better than what might be obtained by putting up all cash, we have seen some pricing pressure on those assets that are favored by the debt-dependent buyers. Furthermore, prevailing interest rates are much more determinative of cap rates of bond-like properties without much NOI growth potential. So the low-growth and B-/C+ assets in secondary and tertiary locations have been experiencing a bit of price erosion.

But high-quality assets in good markets with reasonable NOI growth expectations are still in as much demand as ever, particularly from institutional buyers with satchels of money who are – quite properly -- expanding their real estate allocations. Accordingly, most REIT NAVs are firm and modestly rising, which will support REIT stock prices. And private equity capital continues to be deployed into commercial real estate, so expect yet more privatizations. Just as Willie Sutton sought out banks because "that's where the money is," REIT organizations are where the properties are. Many of the beneficiaries of this "going private" trend will be reputation-challenged REITs, some of which have been serial value-destroyers whose stocks trade at significant NAV discounts. This year a number of wart-infested REITfrogs are morphing into handsome princes.

Q. Space Markets. And what about the space markets?

A. More good news here, too. As a gross generalization, most markets are clearly in recovery mode, with good positive absorption. We are seeing occupancy rates and market rents rising steadily for virtually all asset types and,

while office tenant improvement allowances remain stubbornly high, concessions are abating. Apartment owners continue to push rents, which are rising by 5-8% over last year – although comps will get tougher in the second half, and expense growth is still uncomfortably high. Condo converters have picked up their marbles and gone home; condo-crazed speculators are hurting, some tossing their erstwhile treasures onto the rental markets, but the increased supply isn't likely to be a problem in the vast majority of markets unless job growth screeches to a halt.

Some office markets are doing *very* well, *e.g*., Manhattan is about as good as it gets, while others are just now lifting off the bottom. Long leases, however, will prevent higher market rents from showing up in operating results for at least another year. The industrial markets are recovering nicely, with NOI growth now turning positive for the first time in several years. We are, of course, waiting for consumers to cease all shopping, remaining at home and watching "I Love Lucy" re-runs, but so far reports of the death of the American Shopper are greatly exaggerated.[1] As long as we avoid recession, retailers will take a few quarters of slow spending in stride, and continue to seek revenue-goosing space in America's best shopping venues. But, for obvious reasons, I continue to expect that properties serving the higher-end shopper will outpace their more bargain-oriented peers.

The growth story for upper-upscale and luxury hotel owners, in particular, remains intact; there is very little new supply, group and business bookings are very strong, and even the leisure traveler hasn't cut back much. Airline load factors are the best in many years, and something much worse than last week's U.K. arrests of a gang of Islamofascist jihadists would have to happen here to knock the props out from under this favorable trend. Self-storage owners continue to do well despite the prevalence of increasingly-cautious consumers, and healthcare owners are enjoying stable occupancy rates and tenant coverage ratios (and their stocks will perform better now that interest rates are topping out).

Of course, as the US economy is in a weakening mode, we'll have to watch the numbers closely for signs of something worse than a soft landing. If, as I suspect, GDP growth slows to something like 2 – 2.5% for the next few quarters (a "mid-cycle pause"?), all will be well.

Q. Recession. Let's talk about that a bit more, Reitnut. Isn't there an increasing danger of recession?

A. Ah, there's always *something* to worry about; Alfred E. Neumann had it wrong. We all know those jokes about economists, and what happens when you lay them end to end. However, I have been fortunate in getting access to information from ISI Group, headed up by Ed Hyman and Nancy Lazar. Having read their stuff, I have found them to be as good as any in their profession, recognizing of course the inherent near-futility of economic forecasting. They recently held a conference call, in which Ed Hyman opined that the odds of recession remain small.

This was based upon the following: Fed tightening has been pro-active, not reactive; the interest rate curve has not been severely inverted; corporate balance sheets are strong; we've experienced only modest increases in the ECI (employment cost index); consumer balance sheets are OK, with net worth up 8% year-over-year (this factor has been very weak prior to previous recessions); global interest rates – which ISI thinks more important than domestic interest rates – are up only slightly (albeit rising); there is little evidence thus far of an imbedded wage-price spiral; and foreign economies are in pretty good shape.

I am, of course, no economist, but it seems to me that the biggest risks are significant further boosts in European and Asian interest rates, a quickening of increases in the ECI, and a bone-rattling crash of the housing market. And a recession, of course, would destroy space demand and slash NOI growth expectations, and thus provide the major risk to REIT stocks (as well as the entire equities markets). I wish I could be more helpful, but saying more would be like my trying to play Beethoven's Violin Concerto in D major; some things are best left unsaid and undone.

Q. Topping Interest Rates. Let's stay with the macro stuff for just a bit longer. The Fed, seemingly, has paused in its interest rate goosing strategy – although it has threatened to boost rates further if the economy doesn't continue to slow and/or inflation doesn't abate. Assuming the Fed has got it right, where does that leave REIT stocks?

A. A modestly-growing economy is quite good for commercial real estate owners. Interest-rate driven upward pressure on real estate cap rates will abate, and new supply, from developments, will be less of a risk (at least for those developments that require substantial pre-leasing). Capital intensive companies such as REIT organizations

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[1] The July sales report was pretty good, exceeding everyone's expectations, and Target, Penny's and Kohl's issued very positive outlooks late last week.

will enjoy cheaper financing, which will offset, to some extent, a moderation in rental rate increases and occupancy gains. Expense growth will ebb to acceptable levels.

And, perhaps most important, bond yields will decline, while profit growth rates and profit margins in Corporate America would moderate. Accordingly, these asset classes would provide less competition to commercial real estate from the point of view of expected investment returns. Other than recession, the biggest risk to REIT stock prices is the expectation of better risk-adjusted returns elsewhere. REITs (and commercial real estate) are now playing in the Big Leagues, and capital will ebb and flow on the basis of expected risk-adjusted returns. Bottom line: REIT stocks look particularly attractive in a slow-growth environment.

Q. Risk! Reitnut, some have complained that we now face more uncertainties than ever. We've got to contend with heightened geopolitical risks, *e.g*., Iran, North Korea (weirdoes with nukes), Iraq, Hezbollah, and a whole parade of hate-filled crazies and horrific scenarios; inflationary pressures that are making some of us a bit uncomfortable; interest rates that, perhaps, are too high for consumers to handle; oil prices that seem to spiral ever upward; political squabbles in which politicians from both parties have become meaner than junkyard dogs; stubbornly high budgetary and trade deficits; and a single-family home market that may become uglier than a Tasmanian devil on a bad hair day. How do these worries affect pricing for REITs and commercial real estate?

A. They sure don't do it any good. Risk, along with growth prospects, interest rates and scores of other variables, is always a significant factor in the pricing of any investment,. To the extent that perceived risk increases, the price at which an investment will trade must come down, all else being equal (of course, it never is). And I suspect that the weakness in REIT stocks that we've suffered in recent trading sessions has much to do with increasing "risk premia" (as the academics and quant jocks might phrase it). Note that REITs rallied today, with the cease fire in Lebanon.

However, I also think that owners of commercial real estate and REIT shares are more insulated from these risks than other investors. They have, at the least, the protections afforded by long-term leases, along with modest growth expectations – which, if dashed, won't affect pricing as much as in the equities market, where a 3% shortfall from consensus earnings estimates can slice two years of expected returns off a stock position. And, "space" owners, if not overly leveraged, also have a bit of protection from economic shocks; after all, we all need to live somewhere, shutting down offices and warehouses is one of the last cuts that businesses will make, and shoppers do need to buy stuff – at least the necessities of life (which these days might consist of sparkling water and styling gel, rather than cigarettes and sealing wax).

Thus owners of commercial real estate and REIT shares certainly won't be immune to the nasty effects of increasing risk perceptions, but I suspect that they will be able to weather these storms better than owners of other asset classes. The equity markets don't handle increasing risk perception terribly well, especially in an era where the patient investor is as rare as a William Buckley-type conservative at U.C. Berkeley. Even the bond markets can get pretty ugly when increasing risk perceptions cause widening spreads over US Treasuries. All things considered, aside from T-bills, I'd rather be overweight in commercial real estate when macro risks rise to uncomfortable levels.

Q. Blue-Chip Embarrassment. Reitnut, I know your job title at Phocas Financial is "REIT Investment Strategist," and that, accordingly, you grope with nebulous "big picture" stuff. (Whether you are good at it is another question altogether). But what can you tell me about a REIT-specific event that recently happened in Reitville: A blue-chip REIT, General Growth Properties ("GGP"), missed its numbers badly last week – this happens rarely to quality companies of this type – and two (perhaps momentum-oriented?) sell-side firms immediately cut their investment ratings on GGP. What gives?

A. It was, indeed, a bizarre event. Keep in mind that General Growth has always been one of the most highly-regarded REITs in the industry, certainly in the retail sector, and its investment returns over the years have been awesome. Its average annual total return for the 10 years ending last year was an incredible 27.9%[2], which not only greatly surpassed the 9.1% return of the S&P 500, but also clobbered the average annual returns of the Morgan Stanley REIT index of 14.3% and the NAREIT Mall index (ex-GGP) of 20.2%. And little has changed, in management or otherwise, to require us to look at GGP with a newly-jaundiced eye.

What *did* happen was that the REIT acquired Rouse in November 2004, and took on lots of debt, including huge amounts of variable-rate debt, to finance it. This caused GGP's quarterly operating results to become very interest rate sensitive. It also acquired, in the Rouse deal, community development and land sales businesses whose cash

[2] See page 4 of General Growth's 2005 Annual Report.

flows can be as lumpy as a very elderly toad. These variables bit General Growth in the butt in Q2, as a 40 bps increase in interest rates and lower cash flows from these related businesses trashed FFO estimates (the shortfall was 12 cents per share, about 2/3 of this from the land sales business).

And, of course, those who are wont to shoot first and ask questions later were screaming "sell" at their brokers when trading began the following morning. Aided by the (mindless, IMO) quick-trigger reactions of the two sell-side firms[3], the stock fell 3% that day, protracting the price weakness of GGP that began in January.

But the irony of the situation is that, operationally, General Growth delivered a pretty good quarter. Occupancy rose 50 bps (unlike the declines at peers Simon and Macerich) and management expects year-end occupancy to be in line with 2005; same-center NOI increased by a huge 8% (even after adjustment for non-cash credits and termination fees); and same-tenant sales rose 2.7% (total same-*center* sales were up by 6%). So, despite hand-wringing about the death of the American consumer, business is good at GGP's malls, and development and redevelopment projects continue to create value for shareholders.

Even better news was General Growth's progress in paring down short-term variable-rate debt. CFO Bernie Freibaum stated that Q2 marked the zenith of GGP's exposure to rising interest rates. Management expects only modest increases in interest expense going forward, and "after Q3, increases in short-term interest rates will be just noise," having no material impact upon operating results. Admittedly, the land sales business is both significant to General Growth and is fraught with uncertainties these days – but is still only a modest part of its estimated NAV.[4]

This will be a year that GGP management would love to forget. The Q2 earnings miss came only a couple of quarters following its discovery of weaknesses in its financial controls, courtesy of the Rouse acquisition. It is not accustomed to being embarrassed like this, nor having its stock perform so poorly vs. its peers. But General Growth is pretty much the same company it always was (just somewhat larger and more powerful), and management not only takes much pride in its reputation, but owns a ton of stock (the Bucksbaum family owns 20.8% of the outstanding stock, while Mr. Freibaum owns over 5.8 million shares (both per the 2006 proxy statement).

Estimated AFFO growth in each of 2007 and 2008 exceeds 10%. And, shockingly, the stock closed on Friday at an NAV discount, assuming Green Street's estimates are correct, of over 25% (no, that's *not* a typographical error). Yes, I know that John Bucksbaum wants the company to be valued as a business, not a "collection of assets." But even he must be ready to barf his guts out when looking at that 25% NAV discount, based upon the $43.55 closing stock price on Friday. Those investors with a time horizon that exceeds three months may want to ask themselves why they shouldn't back up the truck.[5]

Q. Pension Fund Enigma. We're running out of time (er, space), Reitnut, and I have two more questions. Do you think you can ditch your tiresome habit of responding to every question with an essay, and provide just a few sentences? You must imagine yourself an 18th century English solicitor, who charges fees based upon the number of words in his pleadings. In 100 words or less, why are institutions such as pension funds climbing over each others' backs to enter into joint ventures with high-quality, well-managed REITs *but won't invest in their shares?*

A. You must've read Mike Kirby's most recent "Heard on the Beach." In it, the highly-respected top dog at Green Street Advisors referred to an IREI Plan Sponsor Survey that noted that "US REITs will be accorded only 5% of the $59 billion of plan sponsor capital flows into real estate this year" (the rest going into direct investment of various types). I have seen similar IREI surveys previously, and have always wondered – as Mike has – why institutions invest so little of their commercial real estate allocations in REIT shares.

"Inadequate liquidity" and a "lack of track record" were perfectly good rationalizations – but only up until the past few years. No longer will they suffice. Scores of high-quality REIT stocks are today very liquid, and these REITs have performed extremely well through an entire real estate space market cycle. And, at least as important, the management teams have shown that they understand, more than ever before, their cost of capital and other responsibilities of running a public company. REITs are no longer public versions of private fiefdoms. So why just 5%? Never have advised a pension fund or its trustees, I cannot say. However, I will hazard a few guesses.

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[3] Wachovia and Goldman Sachs, to name names.
[4] 5% of it, per a Green Street Advisors report, dated August 7, 2006.
[5] Disclosure: I have personally been buying GGP stock over the past couple of months, including as recently as August 10.

Perhaps they don't know how to categorize REIT stocks; are they "equities" or "real estate?" But that debate was resolved long ago;[6] we now know that REITs are more real estate than equities. However, turf wars and petty jealousies may still loom large. There may be conflicts of interest among advisors, *i.e.,* managing commercial real estate for a pension fund is more lucrative than managing a REIT portfolio for it. Perhaps outside consultants still do not understand REITs, and fear that the volatility of their stocks makes them a different animal than direct real estate. This may be true in the short term, but certainly not so over a period of a few years – and aren't these funds supposed to be long-term investors? Mike has suggested to me, in an e-mail exchange, that perhaps NAREIT might want to make an effort to educate pension fund chief investment officers. Particularly during a period in which REIT stocks have been trading at par with their Net Asset Values,[7] the timing is perfect.

Q. Total Returns. Jeez, that was 368 words; I asked for 100. You're hopeless. All right, last question: What is your total return expectation for REIT stocks over the next few years, and how do you get there?

A. C'mon. I could write a 5,000-word article for Journal of Portfolio Management on that topic (except I'm woefully incapable of speaking the lingo and doing the Boolean algebra that would be required). But I'll make this quick. REITs won't be able to rack up the 15% total returns they've done over the past 30 and 10 year periods, nor even the 12% of the past 20 years. The Big Repricing of the past 6 ½ years has seen to that. Nevertheless, REIT returns will continue to be comparable to those of equities going forward, as they have for long time periods in the past – *and with relatively low correlations.*

Today equity REITs yield 4.2%, on average, and will grow their NAVs by 4-5% in a typical year; adding them together, which I think is a fair exercise, we get 8-9% total returns for your decent quality REIT. How do I get 4-5% NAV growth? NOI growth, levered with 50% debt, will get us *close to* 4% through an entire space market cycle. Add another half to one percent from the deployment of retained earnings and generation of JV and other fee income, and we approach almost 5% average annual NAV accretion. Absent a huge increase in cap rates (which I don't expect), that's a pretty good formula for 8-9% average annual total returns.

Q. Thanks, Reitnut. How is Sammy doing? You didn't mention him in this issue of The Essential REIT.

A. He's doing great. We're planning a short trip up to Shell Beach next month to relax and see the grand-kids, and the inn is dog-friendly. He's honing his fishing skills.

Your humble servant,
Ralph (Block)

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[6] I refer you again to that what-should-be-famous article by Mr. Pagliari and friends in Journal of Portfolio Management.
[7] Green Street estimates that the average NAV premium since 1993 is 6.7%. Today, by my reckoning, it is about 1%.