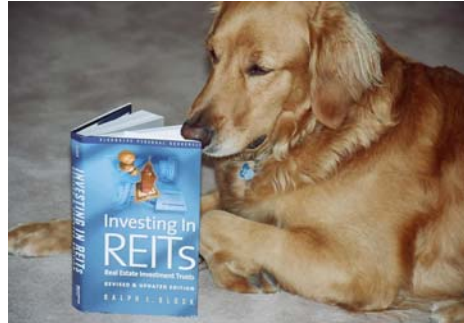


# “The Essential REIT”

September 29, 2006



*“Be who you are and say what you feel, because those who mind don't matter and those who matter don't mind.” – Dr. Seuss*

*“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. Marching to Their Own Drummer (Again).

REITs and their stocks, like the gremlins and lokis of old fairy tales, seem to enjoy doing the unexpected. For example, REITs have become Corporate America's leaders in responsible citizenship. Who'd have thunk it a few years ago, when everyone knew that too many REIT executives were crazy cowboys with itchy trigger fingers and little regard for the niceties of corporate governance? Who'd have guessed that a large number of REIT organizations would develop strategies enabling them to reduce – and in some cases even eliminate – their dependency upon the capital markets to generate external growth? And would anyone have dared to predict that REIT stocks would kick sand in the S&P bully's face for the past six years (now going on seven)?

New evidence of the contrariness of REITs and REIT investing can be witnessed in the Initial Public Offering (IPO) arena.<sup>1</sup> Wized investors know, sometimes from bitter experience, that when an asset class (or even a segment of a larger group) does extraordinarily well for a substantial period of time, we invariably witness the oft-demeaning spectacle of millions of new trend followers jumping on the bandwagon. In no other of life's endeavors does success breed excess more regularly than in the investment world. Accordingly, to meet the needs of these voracious new “investors,” new supply is created in vast quantities by financial opportunists who are always willing to give the public what it thinks it wants.

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<sup>1</sup> I am indebted to both “missash” and Ron Donohue, who post regularly on The Motley Fool's REIT message board, for suggesting this topic and for providing some stimulating thoughts.

Accordingly, we become inundated with floods of IPOs in which public investors are given the “opportunity” to take advantage of these newest new things. Think of the dotcom era, where every college kid with an idea could bang on the door of his local venture capitalist, get his idea funded and then taken public (no pun intended) six months later. And there are many other examples of this craziness, including the South Sea Bubble of centuries ago, the foreign stock and bond mania of 1993 (when closed-end “country funds” traded at 30% NAV premiums), railroad bonds over one hundred years ago, Milken-inspired junk bonds in the 1980s and, most recently, O&G and related commodities ETFs and mutual funds. This phenomenon has occurred with amazing regularity for hundreds of years, and has inspired one of my favorite quotations which is reproduced in the footnote below.<sup>2</sup>

REIT stocks have been amazing performers for well over six years. Check out the following table:

	<b>FTSE ALL-REIT INDEX</b>	<b>S&amp;P 500 INDEX</b>
2000	25.9%	-9.1%
2001	15.5%	-11.9%
2002	5.2%	-22.1%
2003	38.5%	28.7%
2004	30.4%	10.9%
2005	8.3%	4.9%
2006 (through 8-31-06)	20.1%	5.8%

Over the past 10 years, the average annual return for REIT stocks was 14.62%, compared with 8.91% for the S&P 500 index; the return on the Russell 2000 index was 9.39% over that time period.

So, based upon the immutable Law of Investment Greed, we would expect that, as in many prior years of REIT history following extraordinary performance, we’d be witnessing a large number of REIT IPOs this year. But here’s the surprise:

	<b>Number of IPOs</b>	<b>\$ Volume of IPOs</b>
2004	29	\$7.98 billion
2005	11	\$3.79 billion
2006 (through 8-31-06)	2	\$267 million

At the current pace, new REITs will raise only \$400MM in IPOs this year – only 5% of the IPO dollars raised just two years ago. Thus we see an incredible shrinkage in IPOs, following an extraordinary period of outperformance by REIT stocks. What’s going on here? Have the laws of investment avarice been repealed? I will offer some thoughts below, for what they might be worth.

Most owners of commercial real estate today simply don’t *need* to be public to be successful. Debt capital is widely available, and at very low spreads over US treasuries; anybody with a decent office building or strip shopping center occupied by solid tenants can take his (or her) friendly banker out to lunch and walk away with enough capital to buy a stable of Bentleys. This is a very different situation from that which prevailed in the early 1990s, at the dawn of the “modern REIT era,” when even the most savvy and experienced real estate guys could turn a pit bull into a prairie dog faster than they could get a real estate loan from any purported lender.

What’s also different now is that institutional investors are almost begging to put capital to work in real estate in order to fill expanded allocations; today’s joint ventures provide both private and public real estate

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<sup>2</sup> “There must certainly be a vast Fund of Stupidity in Human Nature, else Men would not be caught as they are, a thousand times over, by the same Snare; and while they yet remember their past Misfortunes, go on to court and encourage the Causes to which they were owing, and which will again produce them.” – Cato’s Letters, January 1721

owners (and developers) with plenty of opportunities. While it helps to be a Kimco or a Regency, being a public company isn't essential to attract JV capital. And even pure equity capital, which private companies often have more difficulty accessing, isn't hugely valuable when commercial real estate bargains are as scarce as \$300,000 homes in Southern California. To put it simply, using public capital markets to launch huge acquisition pipelines just doesn't create any value today.

Another factor deterring REIT IPOs is that, unlike many periods in REITs' history, there is no private-public valuation arbitrage to capture. Indeed, as evidenced by the wave of private equity buyouts over the past 18 months, real estate has been selling more cheaply on Wall Street than on Main Street. Wealth can't be created overnight via taking a portfolio of commercial real estate public.

It may also be argued that retail investors haven't been beating down the doors of their brokerage firms to buy REIT stocks. According to National Real Estate Investor,<sup>3</sup> "after accelerating each year since 2001, the flow of investment capital into REIT mutual funds slowed precipitously in 2005. Although positive, the \$1.8 billion inflow total for 2005 marked a 76% reduction from the record \$6.9 billion that entered the sector in 2004, according to AMG Data Services." Inflows have perked up this year; Jon Litt of Citigroup reports that, as of August 18, real estate funds (excluding ETFs) have received (per AMG Data) inflows of \$2.2 billion, equal to a pace of about \$3.5 billion for all of this year. Nevertheless, REITs' stunning performance has surprisingly been met with yawns from the smaller investor, who may have become discouraged by today's 4% average dividend yield. To the extent that retail demand has historically been an important IPO driver, this element has been conspicuous by its absence.

Another factor that may explain the dearth of REIT IPOs is that, over the past few years, real estate organizations have had ample opportunities to become public companies; those who haven't taken the plunge either aren't of sufficient quality, experience or size to do so or have simply opted out of the public domain. The costs and aggravations of being public, particularly in this Sarbanes-Oxley era, shouldn't be underestimated. As shocking as it may seem, some real estate professionals look forward to attending "investor days" with the enthusiasm with which they greet a root canal, and are less than delighted in having to justify their actions to analysts and investors every quarter. Nor do they like seeing their compensation packages scrutinized like a bottle of Clairol at the local airport.

So might the REIT industry, despite its renowned success over the years, actually shrink in size? Not likely. The market capitalization of our little corner of the investment world will ebb and flow over time, and I've become skeptical of those who claim that 70% of the commercial real estate in America will be in public hands by, well, name a date. Certainly the exponential growth in our industry that we witnessed in 1993-1994, fueled by a tremendous wave of REIT IPOs, is a relic of history. Furthermore, for the last decade it's not been difficult to snag one's required returns by owning commercial real estate directly. And today, as noted, the private-public arbitrage is gone, while capital is freely available to private owners.

Nevertheless, there will again be periods in which public markets will exert a stronger attraction (although we won't again enjoy 35% NAV premiums, at least not in my lifetime). And, even more importantly, there *are* clear advantages to being a public company, even for real estate organizations. This is particularly true for the more entrepreneurial companies that want to operate like growing businesses. Public companies certainly find it easy and convenient to provide equity incentives to capable and ambitious executives (as Milton Cooper has explained in the Kimco 2005 Annual Report to Shareholders<sup>4</sup>) and, of course, being public makes it much easier for heritage executives to hand over the reins to the younger guys.

While the pace of REIT industry expansion will be uneven, and will depend upon a myriad of factors influencing the public markets and investors' shifting preferences, over time our industry will indeed grow. This, of course, is a very good thing, as new blood is necessary to prevent sclerosis. Meanwhile, we can feel a bit more comfortable due to the conspicuous absence of that type of investment euphoria which feels good for a while but invariably leads to very bad hangovers.

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<sup>3</sup> "A Lazy River of Funds," January 26, 2006.

<sup>4</sup> See his discussion of the Kimco employee wealth created by the company's use of equity incentive, p. 7.

## 2. Musings on REITs and Interest Rates (Again).

It is often assumed that REIT stocks are interest-rate sensitive. Some regard them as bond-proxies, without significant growth prospects, and many buy them for their relatively high dividend yields. Furthermore, REIT organizations, which own assets with very stable but slow-growing cash flows, are voracious borrowers – for them, carrying substantial debt is both logical and normal. Some of this debt is at variable interest rates, generally tied to Libor. Furthermore, cap rates applicable to the assets they own are significantly influenced by prevailing interest rates; rising interest rates would thus negatively impact REIT NAVs. Accordingly, conventional wisdom holds that rising interest rates are like nasty trolls to REIT investors, who are likely to suffer when these critters emerge from under their bridges.

So, that's the theory. But the reality is somewhat more complicated. According to NAREIT data,<sup>5</sup> the 10-year historical correlation of the FTSE NAREIT Equity Index to the Merrill Lynch Government/Corporate bond index is just 0.04, and the 20-year correlation is only 0.19. But let's ignore long-term interest rates; surely REIT stocks must be sensitive to *short-term* interest rates. Hmm...REIT stocks can hardly be said to have fallen apart over the past two years, during which time the Fed boosted short-term interest rates 17 times (commencing June 2004).

Are REIT stocks' supposed sensitivity to interest rates, then, just another of the myths that have bedeviled REIT investors for so many years? We must, of course, be careful about using historical statistics to predict the future. Sure, they're helpful, but we've never been able to blindly use prior relationships and correlations to make us money in the investment world – which changes almost as fast as Sammy's quiet demeanor when a squirrel runs across his path. Too many of yesterday's performance numbers, relationships and correlations are the consequences of facts that just won't exist tomorrow.

So let's ignore those NAREIT correlations (and the failure of REIT stocks to crash and burn while the Fed was playing Scrooge), and try to apply some ol' fashioned Spockian logic. The first thing to note is that REIT stocks, particularly in recent years, have been moving very much in line with REITs' NAV estimates. As NAVs have increased, so have the prices of REIT stocks. NAV premiums and discounts have also narrowed, as REIT stocks have been tethered to their NAVs (not a bad thing, of course, in this environment).

If this relationship holds, perhaps REIT stocks will be priced, more than ever before, on the basis of transactions and valuations in the vast private commercial real estate markets. And this is logical: As the size of REIT organizations grows over time, their valuations will be increasingly tied to the valuations of their large portfolios of existing assets, and a few gee-whiz developments or acquisitions will barely budge the valuation needle. And, as cap rates have remained low (and valuations strong) despite the interest rate gyrations of the past two years, perhaps the right question to ask isn't whether *REIT stocks* are interest rate sensitive, but rather whether *commercial real estate* is.

Many have assumed this to be so; indeed, a favorite analyst question on recent REIT conference calls has been, "Have you seen cap rates rise in response to the increase in short-term interest rates?" Or, as they might have put it more bluntly, "Aren't rising interest rates trashing your real estate values?" So far in this cycle they have not. But can cap rates remain firm when interest rates rise? This may be a moot point today, given the behavior of the credit markets over the past month, but it remains a real longer-term issue.

Think of real estate cap rates as we think of multiples of earnings for non-REIT equities. Many real estate buyers apply a cap rate to current or 12-month forward anticipated cash flows, just as equity investors frequently apply a multiple to current or projected corporate earnings (or, similarly, both may apply an appropriate discount rate to all future income). And multiples of cash flows or earnings that buyers are willing to pay for a particular investment at any particular time will vary with many factors. What are these

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<sup>5</sup> See NAREIT's ChartBook, dated July 2006, p. 9.

factors? Interest rates are certainly one of them, and a very important one. But investments other than US Treasuries are priced on the basis of considerations in addition to interest rates and rate forecasts.

Expected rates of growth in earnings or free cash flows have always been a key issue in the valuation of investment assets. Investors' willingness to pay more for every dollar of today's free cash flow is based, in part, upon their growth projections; the greater the expected rate of growth, the more they will pay for a current dollar of earnings. Google sells at 41x projected 2006 earnings (a 2.4% "cap rate"), due to very strong growth expectations. Equity investors learned this reality before they learned to say "Warren Buffett." In our world, investors are willing to pay a cap rate of 4.5%, or 22x this year's cash flow, for a Manhattan office building because they expect cash flow will rise rapidly as existing leases roll at higher rents. Or, to put it another way, investors tend to look at prospective IRRs, rather than first year returns. Interest rates will impact required IRRs, of course, but can frequently be offset by higher growth assumptions – often rising interest rates are symptomatic of stronger economies.

Perceived *risk* to existing and prospective cash flows or to intrinsic values is another key aspect to the pricing of an investment asset. Risk is a bad-ass dude who can threaten us in many ways. Investors must continually worry about dangers to existing and projected cash flows from their investments, perhaps from a weakening US economy and job growth (which can translate into a reduction in demand for space), an uncomfortable increase in new development starts in the locations in which our assets sit, or screw-ups on the part of our management teams.

And, of course, there is always the risk of accelerating rates of inflation (which would reduce *real* returns), perhaps due to fiscal or monetary mismanagement on the part of our government officials ("say it ain't so, Ben"), a weak dollar, or other factors beyond our control. The greater the perceived risks to valuations and cash flows, the higher the cap rate (or the lower the earnings multiple) we'll be willing to pay for an investment, and the higher the discount rate we'll apply to future cash flows.

If the gods who determine real estate valuations agree with my belief that interest rates are not the sole drivers of cap rates, we could even see cap rates *increase* while interest rates drop, perhaps in response to weaker than expected economic conditions. Indeed, the biggest risk to real estate cap rates over the next few quarters could very well be disappointingly weak economic growth, which would reduce the growth assumptions inherent in today's commercial real estate valuations – and cause buyers to demand more of their required returns up front in the form of higher cap rates.

All else being equal, of course, higher interest rates will tend to decrease the value of commercial real estate – and REIT stocks. But "all else" is never equal. We must look beyond interest rates when making projections of how real estate will be valued over the next 12-24 months. Yes, REITs and real estate are interest rate sensitive investments (like bonds and other equities); but *to what extent* is the most important question – and the most difficult to answer. Perhaps Sammy knows.

Best regards,  
Ralph (Block)

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