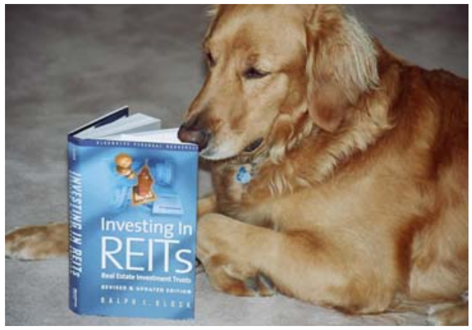
"The Essential REIT"

February 2, 2007



"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. A Rising Tide Lifts All REITs.

A friend of mine – who's a household name in the REIT industry[1] – sent me a e-mail after reading the last "Essential REIT" newsletter. He said that although my forecast for an 8% total return for REIT stocks in 2007 was "as good a number as any other," he proffered a bet of a lunch that REIT returns would be greater than 8% *at mid-year*. His logic was that Blackstone was reportedly seeking to raise another *$10-12 billion* in new funds that could be deployed into yet more REIT take-overs.

Well, as of January 31, the NAREIT equity index had scored a total return of 8.4%; even if REIT stocks remain flatter than an amoeba's belly for the next five months, my wallet will become a bit lighter. I guess I should be happy that we won't then be in the midst of truffle season.[2] Anyway, we've reached my entire 2007 total return objectives in just one month. Why? The flood-tide of capital being channeled into commercial real estate continues unabated; the recent bidding contest for Equity Office Properties (EOP), a mixed bag of generally decent office assets, is merely symptomatic of this trend. And, because there is so much anxious cash waiting on the sidelines, large packages of properties such as the EOP portfolio – due to the Willie Sutton syndrome – are going for very fancy prices. REITs are obvious beneficiaries.

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[1] I figure nobody can accuse me of being a name-dropper if I don't drop any names.
[2] From the New York Sun, October 4, 2006: "The newest wrinkle in this year's truffle season — a traditional three-month annual dining experience that kicks off in October and runs to around Christmas — is the debut of a $200 baked potato at the Four Seasons restaurant that's sprinkled with white truffles." See http://www.nysun.com/article/40836 Thanks to "Ralph of the East" for sending me this vital information.

All of this free-flowing capital is, of course, merely part of a broader and more interesting trend in global investment markets. There is tremendous liquidity in the world today, and capital is sloshing around everywhere; perhaps we'll soon be able to trade Tibetan yak futures and Haitian gourdes[3]. This condition has been aided and abetted by low volatility; we've all seen statements noting that the last time the Dow Jones declined 2% in a single day was in 2001 or some such year long ago when nobody even knew who Lindsay Lohan was (I still don't). Low volatility begets high investor confidence, which in turn begets strong capital flows into all asset classes – including commercial real estate and its cousins. And this environment brings a greater tolerance for risk – in other words, required risk-adjusted returns tend to melt.

But of course it's easy to understand why this felicitous situation exists today. Aside from the geopolitical and related problems in the Middle East (which unfortunately will be with us for quite some time), the global economy looks pretty good these days – indeed, it can be argued that Goldilocks and her "not too hot, not too cold" economy has migrated to almost all developed and developing countries, and only the residents of places unfortunate enough to be governed by whackos such as Hugo Chavez, Kim Jong and Mahmoud Ahmadinejad have much to complain about.

Interest rates are at reasonable levels, and are expected to remain stable for the balance of the year (only those homeowners whose ARMs are exposed have any real interest rate worries); oil, gasoline, and natural gas prices have come down (though they bounced back somewhat this week), and inflation is heading in the right direction; GDP growth is running at 3 – 3.5% (not too hot, not too cold), as home prices appear to be making a soft landing; employment growth is chugging along, and employment costs are rising but not at a worrisome rate; profit growth is abating but will still be reasonable this year; and the only hidden bombs out there seem to be limited to the caves and bodies of terrorists. In short, it's hard to see what can upset the low-volatility, high-confidence applecart.

Of course, investment valhallas are never forever, and coaches do eventually turn into pumpkins – for reasons that nobody can think of ahead of time. Exogenous shocks are, by definition, unanticipated and unpredictable. What could cause the markets to come unglued this year? I don't know; maybe China goes to war with Taiwan, or there's yet another major upheaval in Russia. Maybe Venezuela declares war on the U.S. Or Bill Gates marries Paris Hilton? Any such event (well, perhaps not the Gates thing) would cause liquidity to contract, the private equity scene to implode, equities to fade and commercial real estate and REIT prices to get whacked. And everyone will then be sitting around Joe's Bar wondering why Manhattan office buildings traded at 4% cap rates, someone would offer $56 for Equity Office and Avalon Bay's dividend yield could be well below 2.5%.

So what do we do now? It depends upon one's time horizon and risk comfort level. There is no question that REIT stocks – as well as all other asset classes – are priced for perfection today. However, they are not *overpriced* if one assumes that the current business, financial and investment environment can be maintained for several more years. So if one is conservative by nature, inclined to believe that "s**t happens" eventually, it would seem to make sense to raise some cash by tapering back not just REIT positions, but other equities as well – especially when we can get 5% in a money market fund.

On the other hand, those with truly a long-term perspective and who are not afraid to endure a period of pain when markets become less hospitable (as they no doubt will) may want to fasten their seat belts, moderate their return expectations over the next couple of years and, if they are fortunate, reap returns somewhat better than money-market yields. Personally, I have always been an investment optimist, but I presently hold a bit more cash than is usual for me. In short, I am still a bull, but a nervous one.

2. MAC: A Microcosm of the REIT World?

All right, enough "big picture" stuff. Here's an idea. Why don't we try to form a picture of the attractiveness of REIT stocks at their current prices by looking at one particular REIT of investment grade

[3] Yes, the currency of Haiti really is the gourde. See http://www.gocurrency.com/countries/haiti.htm

quality, perhaps one that's not the biggest kid on the block nor the smallest. A REIT that has a good reputation, but that's not written about every day like Vornado or Simon. And that owns property in a sector that hasn't been roiled by private equity gunslingers, nor in one, such as apartments, that's expected to generate huge NOI growth – which makes valuation analysis highly sensitive to growth rate assumptions. Why don't we discuss a mall REIT?

Macerich (MAC), a long-time favorite of mine, meets these criteria. It does only modest amounts of ground-up development, and hasn't aggressively pursued an intensive JV strategy like AMB, Kimco, Regency, and many others. Management is widely-respected, but doesn't get a lot of press. It's a blue-chip REIT with a lower profile. And it's headquartered in Santa Monica, California, only 35 miles from my home (but perhaps over an hour away on days when the Freeway from Hell (the #405) is converting staid commuters into raging road-warriors).

Macerich owns, manages, develops and redevelops quality shopping malls. It owns properties throughout the U.S., but is more heavily focused on California, Arizona, Mid-Atlantic and Northeast locations. The malls are above average in quality, say A- to B+, with sales of $436 sq./ft. at the end of Q3 '06. Occupancy was 93% at such date, and this figure has been as consistent as a lobbyist's smile over the past few years; the malls were 92% filled at the end of 2004, and swung between 92.1% and 93.5% since then.

Same-property NOI growth has also been consistent, ranging from a high of 4.1% in Q1 of last year to lows of 2.7% in both Q2 and Q3. In 2005, same-property NOI growth was 3.1%. In other words, boringly good. MAC's 5-year track record has, according to Green Street (based upon Bloomberg data as of December 4, 2006), been slightly better than its mall peers; at a 35% average annual total return, it matched that of Simon, was modestly behind General Growth and Tanger, but ahead of Taubman, CBL, Pennsylvania and, of course, lowly Mills.

Macerich, without a doubt, is a very good REIT. But let's now take a look at its business strategy to get a deeper understanding of the company. There aren't many great new mall development opportunities in the United States, and MAC isn't heavily focused on new development. It does have the ability to do "Greenfield developments," thanks to its Westcor acquisition in 2002, and it has done them successfully in Arizona. But Macerich's claim to fame is its redevelopment skills. The REIT has been able to acquire tired or undermanaged malls and significantly improve their profitability and productivity.

A redevelopment of the Queens Center in Queens, NY, for approximately $275MM, at an estimated stabilized return of 11-12%, is probably the best example of MAC's redevelopment prowess. But they have also done many others, at healthy rates of return, and have several opportunities in the hopper at the present time. These include projects at Tyson's Corner, Boulder (CO), Biltmore Fashion Park (Phoenix), Santa Monica, and, in my own backyard, The Oaks in Thousand Oaks, CA. Given their high returns on invested capital, especially relative to today's cap rates, Macerich is creating substantial value for shareholders via the redevelopment strategy, and with only modest risk.

The mall business today remains very good, particularly for those owners whose assets serve upper middle-class markets, *e.g.*, Coach is cruising while Wal-Mart is bruisin'.

Despite all the hand-wringing about high gasoline prices and falling home values, the indefatigable American consumer continues to spend; Holiday sales last year were reasonably decent, again confounding the skeptics. Re-leasing spreads of 15-25% are the order of the day for quality mall owners, and this is pushing same-property NOI growth to over 3%. Macerich's AFFO growth was dragged down by rising interest rates last year, but its balance sheet is better now, with variable rate debt at only 9% of total capitalization at the end of Q3; total debt + preferred leverage is at a reasonable 52%. Accordingly, increasing NOI growth from existing properties and contributions from redeveloped assets will be reflected at the bottom line. Per share AFFO should increase by over 10% this year and in 2008.

More relevant data… The stock's dividend yield is 2.86%, which is low. However, the payout ratio is just 76%, and MAC has been increasing its dividend every year. Mace Siegel, the company's founder and Chairman of the Board, owns over $300MM of stock, including OP units (4.9% of the outstanding stock), and CEO Art Coppola owns 3.7% of the outstanding shares. Accordingly, the alignment of interest between management and public shareholders is obvious.

Let's now hone in on our task at hand by assessing the valuation of the company's stock. As Ben Graham (or one of those ancient investors) reminded us, the very best company can be a rank speculation if its stock is priced too dearly. At a recent price of $95, the stock would appear to be expensive. With an estimated AFFO, per Green Street, of $3.58 this year, the multiple is 26.5x. While not excessive relative to other REIT stocks today, it's not cheap vs. high-quality S&P 500 company stocks that sell at 18-20x '07 earnings.

But is it meaningful to compare REITs' P/AFFO ratios to non-REITs' P/E ratios? AFFO is a rough approximation of free cash flow, while the "E" in P/E measures GAAP earnings. One must convert a non-REIT's earnings per share to free cash flow to make a rational comparison, and there are just too many variances in S&P 500 companies to enable us to compare free cash flows between a REIT such as Macerich and a "typical" S&P 500 company. Let's look at a different measurement – net asset value (NAV).

The most recent estimate of Macerich's NAV by Green Street (the leading buy-side REIT research firm) is at $85. This is based upon many variables, but the firm values MAC's assets at an average nominal cap rate of 6.0% (and an economic cap rate of 5.3%[4]). So the NAV premium, at $95, would be 11.8% (which compares with an average REIT industry premium of about 7% since 1993). It seems to me that a 12% NAV premium is not unreasonable for the stock of this well-managed company – a company with good growth prospects, a sound, consistent and low-risk business strategy, and a reasonable balance sheet.

But let's take one further step. Perhaps the 6.0% and 5.3% cap rates used by Green Street, while reflecting market transactions, are too conservative – and few quality malls have been sold recently. Wouldn't a mall buyer in today's environment accept an economic cap rate of 5% if it wanted to buy MAC's assets? After all, these are irreplaceable properties in very good markets, with substantial embedded NOI growth. Tenants

[4] I believe it was Green Street itself that coined the terms "nominal cap rate" and "economic cap rate." The difference between the two is that the latter takes recurring capital expenditures into account when determining a first year return to a property buyer.

are clambering for space in MAC's malls, and long-term leases provide substantial downside risk. Using Green Street's impressive interactive NAV calculation model, and plugging in 5.0% rather than 5.3% for MAC's economic cap rate, we find that MAC's NAV would be $95.38. Thus with slightly more optimistic cap rate assumptions, that 11.8% NAV premium would vanish quicker than Sammy at pill-taking time.

Or, to put it another way, should investors stammer, apologize and tug at their forelock if they decide to buy MAC shares at their current price of $95 – or an implied property economic cap rate of 5.0%? I don't think so. Indeed, I would be happy to own MAC's assets at that kind of cap rate (and I do). Of course, the stock wouldn't be a steal, but nobody contends that REIT stocks are cheap today. The bottom line is that, if the Macerich exercise tells us anything, those who claim that REIT stocks are in "bubble mode" are a few coyotes short of a pack.

Of course, one could argue that *all* real estate cap rates are too low today. However, today's buyers are underwriting unlevered IRRs on core commercial real estate assets at a bit north of 7%, which doesn't appear unreasonable when compared with prospective returns on bonds (6%) or non-REIT equities (8%). As always, much depends upon one's preferences and perspectives.

3. Stock Splits: An Endangered Species in Reitland?

REIT executives must be a superstitious lot. Today we witness a number of REITs with triple-digit stock prices, including Alexandria, Avalon Bay, Boston, Essex, Public Storage, Simon and Vornado. Do the boards of directors of these fine companies have a haunting fear that declaring a 2-for-1 or 3-for-1 stock split would signify a REIT market top? A good friend of mine, who's been investing in REIT stocks almost as long as I have, is puzzled by this reticence, and suspects that Joel Marcus, et al are W.E.B. wannabees (Mr. Buffett, as you know, refuses to split the stock of Berkshire Hathaway, which now trades hands (when it trades) at $110,000 per share. At their present rate of ascent, the stocks of the aforementioned REITs will reach that level in just short of two years).

Stock splits, of course, mean nothing in terms of value creation. The same pie is just divided into more slices. But stock splits have always been popular with individual investors, and many of them like to buy in round lots – it makes looking at brokerage statements easier on the eyes, if nothing else. So why not indulge them? After all, the "small investor" – perhaps anyone weighing less than 160 pounds – has always been an important asset for public companies, particularly as he (or she) tends to have a longer-term time horizon, less apt to barf his holdings on a 2 cent earnings miss.[5]

So what's the harm in splitting the stock? Oh, perhaps there's an extra bit of administrative cost, but today's REITs are large enough to easily absorb that expense. And it would send a message of confidence that today's triple-digit stock prices are not some fleeting phenomenon reflecting investor irrational exuberance. After all, Milton Cooper hasn't been afraid to split Kimco's stock, and successful companies could do a lot worse than to emulate that wonderful and wise CEO.

Best regards,
Ralph (Block)

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[5] I rest my case by pointing to the irrational behavior of institutional investors following their reading of Archstone-Smith's Q4 press release. Behave yourselves, children.