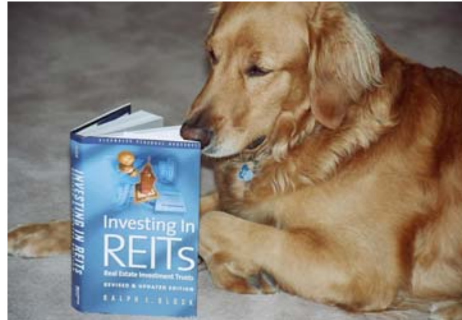
"The Essential REIT"

February 28, 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. Sammy, Speak!

My trusty friend and companion, Sammy, was born on December 20, 1999, almost on the very eve of the greatest and most unprecedented bull market the REIT world has ever known. Sammy, of course, is a Golden Retriever (as you can determine by looking at the picture above); however, unlike his humanoid brethren, he is remarkably free from the many character defects that often interfere with successful investing.

In particular, he isn't distracted by the daily drivel of investment "news," nor is he mesmerized by those who whine about a 10 basis point shortfall in expected same-store sales increases or the siren songs of self-proclaimed investment pundits. He couldn't care less about the performance numbers chalked up by his neighboring Boxer just up the hill, and he doesn't panic whenever a favorite company misses consensus earnings estimates by a few pennies or if the Dow falls by 5%. And, on the basis of his track record, he's a pretty sage investor – never having lost so much as a nickel on any trade.

Sammy, as you might guess, is particularly interested in REITs; their dividend checks have kept him amply stocked with Natural Balance kibbles and biscuits, not to mention the occasional cup of vanilla or peppermint ice cream. Accordingly, I think he's entitled – at long last – to express his opinions on subjects other than clothing for canines (*never*) and the merits of glo-balls vs. Nylabones (*depends upon one's age*). Let's tear Sammy away from his marrow-filled Petsmart bone and get his take on recent events in REIT world.

Me. Sammy, what do you find particularly amusing in Reitland these days?

Sammy. Today's REIT world sure isn't your father's REIT world. At times, such as during the past week or two, REIT stocks have been as volatile and unpredictable as that Doberman at the park. It's ironic, really. You have an asset class with very stable and predictable cash flows, providing pretty good dividend yields, but trading with more daily gyrations than many tech stocks. At one point on Tuesday, Archstone-Smith was down 5% for the day – almost twice its annual dividend yield. And, of course, the trashing wasn't due to bad news – or any news at all, for that matter.

This is what happens when hedgies and others who love to sling money around discover that their own trading strategies can influence future prices, at least over the near term. The short interest in many REIT stocks has increased substantially over the prior month, reflecting short-term bets being placed by traders; for example, the short interest in Simon Properties rose almost 15% last month, to over 10 million shares. The short interest in Kimco rose by 14.3%. The momentum boys see this, and pile on; the negative sentiment on REIT shares today is as thick as a husky's coat. Of course, volatility can also be our friend; REIT stocks have enjoyed more than a few melt-ups over the past few years.

But REITs are not alone. The entire investment world has become trader-ized in recent years; this has been masked by some unusually low volatility until very recently. In truth, there aren't too many individual investors left with a long-term time horizon, and everyone wants to play the Performance Game. Investors have been pouring capital into foreign funds and markets ever since they began to outperform US markets. It's no coincidence that REIT stocks' recent swoon (after performing so well for so long) has come at almost the very same time as Monday's 8.8% plunge in the Shanghai Composite Index following its 130% gain in 2006.

Nobody wants to own an underperforming asset class, but everyone also wants to capture that last nickel of performance. Heaven help us if our braggart stock-dabbler brother-in-law threatens to lord it over us at Thanksgiving. So when a few investors begin to head for the exits – perhaps doing nothing more than taking some winnings off the table – everyone follows (sometimes in panic). This, of course, creates some pretty crazy markets. On Tuesday, the VIX index, which measures volatility, spiked 64% to close at 18.31.

Here's another example. Early on Tuesday morning, the shares of Diana Shipping, a dry bulk carrier (DSX), were down 17.3% (and managed to close down "only" 8.1%. The bad news? There was *no news* at all! Meanwhile, the Baltic Dry Index[1] has remained strong despite the hand-wringing over China. Of course, Diana is no General Electric, but it's a solid, profitable company that owns a fleet of large dry bulk ships with a readily ascertainable market value. The craziness in Diana's – and ASN's – stock prices may be a new sign of the times, and the VIX may trade at higher levels. But perhaps this new volatility is healthy; some believe that investors have become far too complacent (more on this later).

The best thing to do in this environment is to ignore the market, find yourself a friendly Border Collie, and spend a few days at your local doggie agility course. But, meanwhile, I may go long on 20 contracts of doggie biscuits for April delivery. As we can now buy whey futures,[2] why not futures on canine treats?

Me. What else amuses you these days, Sammy?

Sammy. I am watching with interest the current battle between Ventas and Health Care Properties (HCP) over Sunrise REIT, a Canadian company. Ventas agreed to buy Sunrise for $1.8 billion in January following a round of competitive bids. Ventas claims that HCP was one of the bidders, but dropped out. Ventas stated in a press release, "[our] acquisition of Sunrise REIT [is] the result of an extensive auction process conducted by the Sunrise REIT independent trustees. HCP was a participant and a finalist in that very thorough and complete process. At the conclusion of Sunrise REIT's process, HCP withdrew from the process and declined to submit a final binding proposal."

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[1] This index is an approximate measure of the rates being paid to ship dry goods on large marine vessels. See http://www.dryships.com/index.cfm?get=report

[2] I kid you not. See http://www.topix.net/com/cme

But now HCP is b-a-a-a-c-k, with a higher offer of $2.0 billion, which equates to a cap rate of something like 5.6%. (Ventas is challenging the legality of this new offer in court). Perhaps HCP is within its rights to come back with a new and higher offer after it bowed out of the prior bidding, but some might argue that this isn't fair play (to the extent such a concept still exists in Corporate America). Anyway, both sides are throwing some sharp elbows, and perhaps NAREIT ought to be careful not to invite both Mr. Flaherty and Ms. Cafaro to the same discussion panel at the next NAREIT conference in New York City; the fur might really fly! The take-away here is that healthcare asset cap rates are, for better or worse, beginning to look like those in other real estate sectors.

There's also an interesting story unfolding at U-Store-It (YSI). The Amsdell family, who organized this REIT and took it public in October 2004, caused the company to pig out on an acquisition binge that ended poorly. They missed numbers, bought some things the cat must've dragged in, and otherwise did their level best to give the REIT industry a bad name. Finally, due to outside shareholder pressure and to preserve the value of their shares, in April 2006 the Amsdells brought in veteran storage executive Dean Jernigan as CEO (he very successfully led Storage USA to an excellent track record before it was sold to an affiliate of General Electric in 2002).

But now, it seems, the Amsdells believe that "Dr. J" isn't moving fast enough or jumping high enough (though he's been CEO for less than a year), and have been maneuvering quietly to find a buyer for YSI. Needless to say, Mr. Jernigan and the present board don't want the Amsdells anywhere near corporate headquarters, and they were persuaded to leave (perhaps hoping that they will just go off and chase their tails). But the Amsdells own about 15% of the company, and may not go gentle into that good night. (I could teach them how to bark at the moon, but for some reason I don't think that will appeal to them).

Anyway, YSI is no dog; it's an improving company, and I like it – especially at the current price. Shareholders would seem to be in a favorable position: Either CEO Jernigan and his crew turn this puppy around, and the stock rises to reflect the improvement, or the company gets sold at a higher price. Meanwhile, we get a dividend yield of 5.4% while we wait. I can live quite well with that.

Me. What do you make of today's Limbo-like cap rates, Sammy? How low can they go?

Sammy. You continue to bore us by repeating, in almost every issue of The Essential REIT, that the wind is at our backs; but you do have a good point, Reitnut. In their efforts to beef up allocations to commercial real estate, institutional investors are finding that they have to pay to play, and are willing to accept initial yields on new investments that are low by historical standards. Of course, expected internal rates of return (IRRs) and other metrics such as risk and replacement cost are at least as important as initial cap rates in determining pricing, so we can't just look at reported cap rates and chortle. And yet, investors seem to be underwriting some pretty strong NOI growth, especially in the office and apartment sectors, as well as low cap rate residuals, in order to justify current pricing. It's called Spreadsheet Magic, and we've been there before.

Nevertheless, expected IRRs (if achievable), while well below historical ranges, are still reasonable in a low return world. My poodle friends who hang around consultants' offices tell me that today's institutional investors are willing to accept unlevered IRRs on core, high quality commercial real estate in the range of 6-7%, which doesn't seem crazy, on a risk-adjusted basis, when compared with the expected returns on bonds and other equities. And they accept sub-5% initial cap rates (and even, in some cases, below 4%) on the road to getting there. Of course, neither commercial real estate nor REIT stocks are cheap at these cap rates and prices, but what asset class is cheap these days? (Maybe that's what Tuesday's carnage in the stock market was trying to tell us).

But some of the brightest guys in the world of commercial real estate have no trouble with today's prices, and are willing to back their views with their own company's money. Steve Roth was a whisker away from accepting a cap rate of below 5% for Equity Office's assets; Blackstone was able to win the battle on the basis its ability to tear once-proud EOP into strips of quality rawhide and sell them off to others willing to pay even fancier prices. And just who are these "muddle-headed" buyers?

Well, the Shorenstein people out of San Francisco haven't gotten where they are by buying dumb, and they agreed to buy 17 EOP-owned Portland office buildings from Blackstone at a cap rate reported to be in the 4.6% range. Portland! And we also have learned that Macklowe Properties, players in Manhattan for many years, has agreed to buy most of EOP's Manhattan office buildings at a price that equates to $1,100/ft, or a cap rate that UBS Investment Research has pegged at 3.6%.[3] And then, a few days later, Rob Maguire, who's never been anyone's fool. agreed to have his REIT buy a few choice office buildings in Southern California from Blackstone for almost $3 billion, or a cap rate, according to Merrill Lynch, of 4.1%.

Are Messrs. Roth and Maguire, along with the Shorenstein and Macklowe folks, nuts? If you don't think so, it's hard to argue that today's low cap rates are "too low." Of course, all these pricing patterns can change quickly, due to changes in world capital flows or, perhaps, because (as one sage Reitster recently suggested to me) there is an element of "follow the leader" among pension funds and other institutional investors, *i.e.*, "don't be the last pension fund on your block to own Manhattan real estate!" In any event, the stock market action this week notwithstanding, it's hard to argue that the REIT market, which trades at an NAV premium that's just slightly above historical levels, is a bubble primed to pop.

Me. So, Sammy, do you view the recent and unsettling market break this week as simply sound and fury, signifying nothing? Perhaps yet another buying opportunity? Are you a "What, me worry?" kind of dog? (You don't worry about much anyway – hell, you don't even have to prepare a tax return, wash your clothes or even get dressed in the morning).

Sammy. Jealously doesn't become you, Reitnut. Investors who want to feel good about their present investment goals and strategies need to make a basic decision about world economies. Admittedly, if China's economy falls apart, the aftershocks will reverberate around the world, and even a steel-and-cement doghouse won't be safe. Similarly, if the U.S. sinks into a recession, perhaps due to an implosion in the housing market sparked by a sub-prime lending train wreck, today's stock prices will be wistfully admired six months hence. So, if that's what you believe will happen, you better lighten up, my friend, and pretty darned quickly.

But, the brooding of our former Fed head notwithstanding, I think the odds of a collapse of any important world economy are slim. Interest rates are up, but aren't high enough to strangle anyone. Sub-prime borrower defaults will cause local pain, but not enough to destroy consumer and business confidence. World trade continues to grow (despite the carping of some nitwits in Congress), and the Chinese Communist Party leaders are the *last* ones to want to slam hard on the brakes – their economy requires continual and substantial growth in order to avoid serious social unrest. Businesses are in very good financial condition, and their balance sheets are laden with cash (some of which ought to be used to boost cash dividends substantially – but that's another story[4]). The private equity business is perhaps a bit frothy, but there is no catalyst for its immediate collapse.

You and I are having this conversation in the late afternoon on Tuesday, and so if I told you what will happen to the markets on Wednesday and Thursday, you'd rightfully tell me that I am baying at the moon. However – and regardless of what the markets do over the next several trading days – if you believe that there is no snarling pit pull (er, recession) right around the corner, you ought to be taking advantage of the bargains presented to us. There are lots of REIT stocks now trading below their estimated NAVs and, for the reasons I suggested earlier, I think these NAVs will hold up. Centro Properties Group, an $8 billion Aussie-based real estate firm, apparently agrees with me, as they announced late Tuesday that they agreed to acquire New Plan Excel (NXL), a strip center REIT, for $33.15 per share, in cash – a 12.3% premium to NXL's average stock price over the past 30 days. Green Street's estimated NAV for NXL? $25.50, based upon an average nominal cap rate of 7.1%. So the backlog of capital waiting to buy U.S. real estate remains alive and well.

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[3] See Wall Street Journal, "Blackstone Makes Quick Cash," p. B-9, February 21, 2007.
[4] According to a story in the February 28, 2007 Wall Street Journal (p. D1), the number of S&P 500 companies boosting their dividends this year is down 11% from the comparable period last year.

Me. A final point, Sammy…Didn't Mr. Greenspan just suggest a recession, beginning as soon as later this year?

Sammy. Glad you asked. But before we get to the hallowed words of our former Chairman, I want to quote Ed Yardini, one of the most widely-respected economists plying the trade these days. He noted on Tuesday that, "My view is, so far the economy continues to demonstrate that it's remarkably resilient." He believes that GDP growth, while a bit slow now, will accelerate to 3% by the end of the year, thanks to continued consumer spending. Unafraid to disagree with the redoubtable Mr. Greenspan, he says a recession this year is "not possible."[5]

The "Greenspan – Recession" thing is another sign of our bizarro short-term focused investment world. Investors – and I use that word loosely – heard the "R" word in connection with Mr. G's speech, and inquired no further. They remind me of a black Labrador friend of mine who, when he hears the word, "water," will immediately jump in, without even checking the water temperature or to see if a hungry alligator lurks just below the surface.

Greg Ip is a veteran Wall Street Journal columnist and has a well-deserved reputation for telling it like it is. He said, in a Wednesday WSJ article about the Greenspan story: "Mr. Greenspan didn't say a recession was likely. Indeed, he said most forecasters don't see one, the global environment is "benign" and there has been no "significant spillover" from the contraction in housing activity. His comments appeared more aimed at questioning the conviction of many investors that because each of the last two expansions lasted a decade, this one, now five years old, will, too." Mr. Ip then noted wryly, "In a widely distributed email yesterday, Stan Jonas of hedge fund Dutch Book Partners LLC wrote, 'MR. GSPAN SAYS A RECESSION IS LIKELY.'"[6]

All of that said, nobody should be complacent. Investors should, like us canines, sleep with eyes and ears partly open. The fireworks of this week should remind us of just how inter-related the global economy is these days; a hiccup in Singapore (not to mention China) can cause massive indigestion in New York and Sydney. And, as our illustrious ex-Fed chief noted in his recent speech, "We do not and cannot look into history without being very concerned when you see the absence of awareness and concern about risk that we see today." At some point, the global economic scenario won't be as solid as it is today, and our water bowls won't perpetually be full. As always, it's a good idea to keep some extra biscuits in the closet.

Best regards,
Ralph (Block)

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[5] Los Angeles Times, February 28, 2007, p. C1.
[6] See Wall Street Journal, "Markets Find It Hard to Break the Greenspan Habit," p. C-1, February 18, 2007.