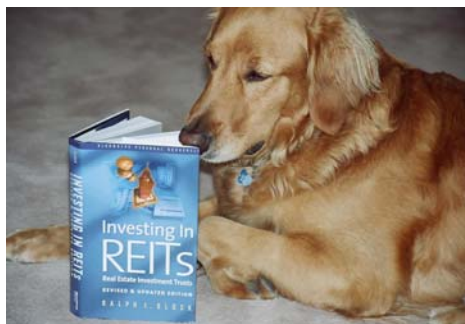


# "The Essential REIT"

March 4, 2005



*"Writing does for me what giving milk does for a cow." -- H.L. Mencken*

*"Writing is not necessarily something to be ashamed of, but do it in private and wash your hands afterwards" -- Robert Heinlein*

*"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. Never-ending Earnings Season.

When our stocks are performing poorly we investors tend to put the companies under a powerful microscope. Those of us with more than a few gray hairs have learned to respect Mr. Market; while he's certainly not always right, especially over short time frames, it usually isn't a good idea to dismiss him as a raving lunatic. REIT stocks' performance this year is certainly nothing to boast to one's brother-in-law about, and it behooves us to consider whether the market is telling us to brace for bad things relating to future REIT operating performance. February has certainly been a better month than January (up 3.0%, per the NAREIT equity REIT index), but that's like saying that Senator Dukakis performed quite well in Iowa in the 1988 Presidential elections.<sup>1</sup> Through the end of February, the NAREIT equity REIT index was down 5.7% year-to-date.

Despite the embarrassing performance, there were very few negative surprises in Reitdom coming out of the earnings season conference calls, and nothing that should set off any alarm bells for investors; indeed, real estate markets are improving, and REIT stocks' poor performance in '05 can be blamed squarely on negative fund flows resulting primarily from rebalancing activities and worries about rising interest rates. Short sellers may also have been a contributing factor.<sup>2</sup> About the worst that can be said about REITs' late earnings season is that the conference calls dragged on into March, and it seems that any day now some REIT such as BRE Properties or AMB Properties will be sending out announcements for its *next*

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<sup>1</sup> He won 55% of the vote there, but George H.W. Bush trashed the Massachusetts senator in the electoral college, 426-111. See <http://www.presidenclect.org/e1988.html>.

<sup>2</sup> Banc of America Securities' Ross Nussbaum stated, on February 28, that "The short interest in REITs at February 10, 2005, totaled 189.4MM (2.5% of the float), a 9.6% sequential increase from January and the largest increase since October 2002."

conference call.<sup>3</sup> All right, enough whining. It's time for a few impressions from the never-ending Q4 earnings season.

Let's start with apartments. Owners are slowly getting up off their butts after being decked by The Hulk on steroids, who appeared to us in the form of low interest rates – leading to a sizzling single family housing market – and sluggish job growth. And interest rates still remain low, which encourages opportunistic merchant builders to continue to develop despite lackluster tenant demand and keeps mortgage rates affordable for those who want to buy rather than rent. But job growth has improved a bit, and the gap between apartment rents and mortgage payments has widened. The economic balance is tilting slowly towards apartment owners, and this will accelerate as interest rates move up. So, the butt-kicking is over for apartment owners.

Nevertheless, while NOI growth is now positive (up about 1% in Q4 over the prior year) and concessions are abating, the bounce-back may be anemic and a disappointment to those who have bought into a big NOI splurge. Guidance has been reduced by several apartment REITs, at least with respect to NOI growth this year, partly due to stubbornly high operating expense increases; so, the stocks have been poor performers in 2005 (even worse than the REIT industry as a whole). Through February 28, the average performance has been -7.8%, compared with -5.7% for all equity REITs (per NAREIT data).<sup>4</sup> The only bright spot for the apartment owners has been the prospect of selling chunks of assets to condo converters at crazy cap rates; Archstone-Smith and Avalon Bay have been doing this, and Equity Res is self-developing condos. This trend is cyclical, but will create value for shareholders until the fat lady sings. And sing she will when the last apartment REIT announces a program to sell to condo converters.

The office markets continue to be a story of the Haves and the Have-Nots (although, unfortunately, there are more of the latter than the former). Washington DC remains very healthy, notwithstanding some new supply issues there, and Manhattan (especially Midtown) continues to tighten; large blocks of space available there are as prevalent as sunshine in Southern California in February,<sup>5</sup> and rents will most likely begin to move up towards the end of the year if the economy continues to grow at a reasonably healthy pace. Meanwhile, Southern California is looking pretty good, as Westside LA now appears to be joining San Diego and Orange County as pretty decent markets. Reckson, SL Green, Vornado and Kilroy should particularly benefit from exposure to stronger markets; Boston Properties will too, but it continues to suffer from lingering ills in Boston and SF (though there are signs that the latter is beginning to stabilize).

But most other markets aren't much to write home about. Prentiss Properties, whose Howard Cosellian executives like to "tell it like it is," stated that both coasts are doing well, and "rents have firmed" in those markets. Concessions and free rents are abating in California and the East Coast, according to management. However, "Central US is still problematic. Chicago is stable, but Dallas is the worst – high concessions, high vacancy, disappointing job growth. Suburban Maryland is also challenging." And yet, according to management, markets overall are improving, albeit slowly. "There is good, solid momentum in most of our markets, but this won't hit our bottom line for a few quarters." So, we should expect the office recovery to continue, but at a halting and uneven pace. AFFO growth will be scarce for all but the lucky (or smart) ones who have substantial assets in the strongest markets. Finally, demand for office assets among pension funds remains strong, and cap rates refuse to levitate. It makes one question the conventional wisdom that selling lots of assets at today's cap rates is a smart move. I suspect that even 5% on the 10-year (certainly no slam-dunk) won't move the cap rate needle much.

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<sup>3</sup> One day after writing this, Equity Lifestyle Properties announced the date and time for its Q1 '05 conference call. But we have yet to hear Q4 results from Home Properties or Public Storage!

<sup>4</sup> Green Street Advisors' Craig Leupold summed it up nicely in a recent report to clients. Says he, "The bond market's refusal to obey the predictions of economists probably explains why the apartment sector has been the worst performing property sector thus far in '05."

<sup>5</sup> A March 1 report from Merrill Lynch estimates that only 9 blocks of contiguous space of 200K sq.ft. or more are available in Midtown Manhattan, compared with at least 12 potential lessors for similar amounts of space. "Trophy Assets Remain in High Demand," Merrill Lynch, March 1, 2005.

In the industrial sector, market conditions appear to be recovering more quickly than in the office sector. World trade is in pretty good shape, and ISM indicators are still in positive territory. But, first, a quick detour. I continue to be a believer in the Moghadam theory of industrial real estate, *i.e.*, buildings and related distribution facilities designed for speed and that expedite the global movement of goods, particularly when located in major “hub and gateway” markets, will, over time, outperform. On-tarmac properties owned by AMB, perhaps the essence of “high-throughput” industrial properties, delivered same-store NOI growth of 5.1% for 2004 (vs -0.9% for all AMB’s properties, on a weighted average basis). So, investors need to be careful about risks of obsolescence with respect to some industrial properties used purely as warehouses.

All right, back to sector performance and prospects. Industrial property absorption was strong for the second consecutive quarter, at over 50MM sq.ft., compared with the 10-year average of 33MM sq.ft. AMB’s results for Q4 reflected this, as same-store NOI finally managed to reach positive territory in Q4 (+0.4%). This was confirmed by Pro Logis’ results, which also improved in Q4; NOI was up modestly (+0.3%) amidst sharp occupancy gains. Catellus’ same-store NOI was only slightly negative (-0.7% in Q4) when eliminating lease termination fees and such. So the industrial markets are recovering more quickly than their office cousins. But, while there appear to be few danger signals at the present time, beware of pressure from new developments in this sector – as long as interest rates remain low, the recovery continues and pension funds’ thirst for new, quality properties remains unslaked, the danger of significant new construction will remain. As we know, builders normally start these projects without pre-leasing.

If the office and industrial markets have, like Los Angeles, been suffering from perpetual rain, the retail sector has been enjoying Hawaii-like weather. Malls are performing very well, as bankruptcies are flat to down, tenants (which, by and large, remain in good shape financially) hunger for new space, and 2005 lease expirations are already pretty much addressed. In both the mall and neighborhood shopping center sectors, occupancy rates are generally firm to slightly up, rents are increasing and spreads are strong. Cap rates remain low (*e.g.*, the First Washington – Calpers portfolio traded at a “nominal” cap rate barely north of 6%), and development remains in check due to the requirement for substantial pre-leasing.

Recent trends include retailers “cross-dressing,” *i.e.*, some traditional mall tenants are experimenting with life-style centers, outlet center tenants are being lured to malls, and big-box stores seem to be looking everywhere for space.<sup>6</sup> And you’ve all read the headlines: the consolidation among retailers and retail real estate owners continues. Are there no risks in retail real estate? Ha! There are risks *everywhere*, which tend to bite us in the butt when we least expect it. While the Wal-Martian Factor still looms out there, the biggest near-term danger for retail REIT owners is rising interest rates. Such would increase carrying charges on credit cards, pinch consumers’ cash flows, make variable mortgage rates more expensive and perhaps even sour their moods by causing housing prices to dip. And the hedgies, knowing all this, will trash every retail REIT stock in the event of a spike in interest rates.<sup>7</sup> Rising gasoline and energy costs may also become a bugbear, particularly for discounter and “low-end” retailers. So, while I think retail will continue to enjoy relatively smooth sailing, sharks are always cruising just below the surface.

## **2. Portfolio Management: When to Hold ‘Em and When to Fold ‘Em.**

In the last issue I threatened you with a discussion of REIT portfolio management in the “Reitnut” style, *i.e.*, how I manage my personal REIT stocks. Why am I presumptuous enough to think that you might care? Well, I have managed REIT portfolios for over 32 years (some of it professionally), have been through numerous battles (and bear markets) and have yet to blow myself up. That must count for something, right? So, if you have no objection, let’s proceed, shall we?

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<sup>6</sup> Even Wal-Mart is looking at malls, if one can draw any conclusions from their recent opening of a multistory store in a mall owned by Westfield in El Cajon, Calif.

<sup>7</sup> On February 28, the 10-year T-note took a dump, its yield rising 9 bps, to 4.36%. On the same day, the mall REITs, on average, fell by 1.8%, according to NAREIT, vs. a drop of just 0.8% for the average equity REIT.

First, my personal REIT investment philosophy is that I want reasonably good returns with only modest risk. Show me a REIT without apparent NAV or cash flow growth prospects, and I will normally ignore it unless I really like the management and think that growth will resume in 12-18 months. Or, show me a REIT with a high risk profile, and I'll be inclined to treat it as I would a pit bull that's never been loved – I keep my distance.

I also have this quaint belief that high portfolio turnover is costly; furthermore, constant trading creates distraction from other things I like to do. Thus I will sacrifice some prospective superior short-term performance in order to keep trading at very modest levels. Yes, I do trade a bit, but only around the fringes.

Beyond those issues, I have this desire – which the pundits have proclaimed irrational – to live off of my REIT dividends. This objective, together with my belief that REITs ought to be sharing the lion's portion of their cash flows with us mere shareholders, causes me to take a peak at the dividend yield when I invest. Yield is certainly not a huge issue for me, and I always own some lower-yielding REITs, *e.g.*, Alexandria, Equity Lifestyle, Host Marriott and Public Storage; however, I must really like those companies and their stock valuations, or believe that substantial dividend increases are just around the bend.

These objectives (all right, let's be honest and call 'em prejudices) naturally cause me to keep certain specific criteria in mind when running my REIT portfolio. First and foremost, while recognizing that quite often excellence is in the eye of the beholder, I look for REITs with excellent management. This approach provides the best opportunities for above-average long-term returns with the least risk. The best REIT executives not only are able to create superior growth in cash flows, dividends and net asset values, but also have a pretty good idea when R-I-S-K, that dirty little 4-letter word, is unacceptable. In short, they really know real estate, they know markets, they know how the game is played, and they play it well. And they are very good capital allocators, often leveraging their expertise and extensive tenant contacts into lucrative JV deals. Think Kimco, Regency, General Growth, Simon, Avalon Bay, Archstone-Smith, Boston Properties, SL Green, AMB, Pro Logis, even Host Marriott. And there are, of course, a number of others of similar ilk. Because of my management bias, I will rarely own a REIT until it's developed a 2-year track record as a public company (though I will cheat a bit if a REIT has a particularly good pedigree, *e.g.*, Gramercy Capital).

Beyond excellent management, I look for good assets in excellent locations. I don't think it's ever been "proven" that high-barrier markets such as Boston, D.C., Manhattan and San Francisco will provide better long-term returns from the ownership of commercial real estate than, say, Dallas, Atlanta or Las Vegas, but I have a belief, shared by many smart real estate folks, that this will be so when measured over two or more market cycles. (Look where the smartest apartment REIT executives, *e.g.*, at Archstone-Smith, Equity Residential and United Dominion, are buying).

These types of locations, together with great in-fill properties even in sunbelt cities, will tend to be less subject to risk from new competing development, and will be less commodity-like, perhaps giving their owners somewhat more pricing power as land values and construction costs continue to rise with inflation over time (the downside to these locations, of course, is that job growth tends to be less, and living costs for employees are higher). Thus in the office sector, for example, I am long Boston, Kilroy, SL Green, and Vornado, and have no long-term interest in Highwoods, Crescent, or even Carr America (though I will look at them when they become unduly cheap). In apartments, I much prefer Archstone-Smith and Avalon Bay to Amlis and Post (though I particularly like the management teams at the first-mentioned REITs).

Next, for the reason that a major risk to real estate owners is excessive debt leverage, and because acquisition opportunities come most readily to those with lots of financial muscle and who can close on deals quickly, I look for a strong balance sheet. This is just common sense; while I won't sell a REIT that temporarily over-extends itself in order to make a large deal, I will want such a REIT to get its house in order relatively quickly. I tapered my position in GGP after the Rouse announcement, and will bring it back up when its balance sheet becomes less uncomfortable to me. And, of course, some sectors of real estate can handle higher leverage ratios than others, due to the nature of their cash flows.

I do keep an eye on valuations, and often use valuation discrepancies to tweak the portfolio. While I won't sell a core holding such as Kimco when its stock appears pricey to me, I won't hold a super-sized position under those circumstances. And wonderful Gazelle REITs such as, say, Centerpoint, won't be in the portfolio at all if they become wildly overpriced (again, in my opinion). But this isn't an immutable principal. Some of these stocks have been held in my (taxable) personal account for many years, and an overvalued stock becomes much less so when a big tax bite reduces the "net effective" (after-tax) stock price. So, bottom line, while I always keep valuations in mind, I don't always act upon them.

Next, I am a believer in Diversification, almost to the point of religion. I believe it is impossible for us mortals to consistently make accurate sector calls, and to be in apartments, say, or out of offices, at exactly the right time is like winning consistently at Santa Anita: It just doesn't happen. And remember that the timing needs to be right on both ends – both buying and selling. I also don't believe that any sector of real estate is inherently any "better" than any other. As a result, I will always have positions in each major sector, and many of the smaller ones as well. But I am not a slave to this principle, and will cheat a bit by sometimes modestly overweighting or underweighting specific sectors if I really like them or hate them for the next, say, 12 months, or if valuations are particularly enticing or scary for the stocks that inhabit them.

Given my wimpish and risk-averse posture, I will tend to be light in the riskiest and least predictable sectors of Reitdom. Thus I have owned only one mortgage REIT in the past 10 years (Gramercy), and have always kept my hotel exposure down to the sleeping level. I will also put a REIT on probation and consider its sale when it appears that its management team is over-estimating its expertise, losing control of its business or perhaps developing a bad case of hubris. Particularly in the least risky sectors of real estate, I will tend to ignore near-term market conditions and hold onto very good companies – who can often make lemonade out of others' lemons. There is often opportunity to be found in adversity, particularly the adversity of others. I suppose that sounds insensitive, but I suspect that more money has been made in real estate by buying right than allowing market forces to slowly increase the value of a piece of real estate. If you don't believe me, ask Sam Zell.

I am not afraid to own concentrated positions when, in my opinion, warranted. I have, on occasion, taken 8% positions in some REITs, and today I have several of them in excess of 7%. The size of my portfolio rarely exceeds 30-32 stocks (which is where it is today). "But isn't this inconsistent with a low-risk approach to REIT investing," you may ask. I don't believe so. I think the portfolio is sufficiently diversified with 30-32 names, even though the top 10 may, at times, represent more than 60% of the portfolio. This is not, I'll remind you, a tech portfolio, and real blow-ups are rare. A concentrated portfolio may certainly be an issue if one is concerned about excessive volatility, but I have the luxury, in my personal portfolio, of managing it for very long-term returns and stable and growing dividends; as short-term price movements and volatility are of little concern to me, I can focus on what I believe are those companies which will deliver the highest long-term total returns with the most modest risk profiles. And, if I make a mistake, it's only my personal net worth that suffers (though Sammy may get fewer biscuits for a period of time).

I own a handful of REIT preferreds, but they are a very small part of my REIT portfolio. The reason for this, to be honest, is that I am modestly greedy. A good REIT preferred will yield me 7%, but I think I can do better, over time, with REIT commons. Certainly that's been true over the past 20+ years. If we give today's more rational pricing for REIT stocks its due, I don't expect to get the 11-12% total returns, on average, that REITs have delivered in the past, but I still believe I can generate 9-10% in an average year. And, unless I failed 2<sup>nd</sup> grade math, that's better than 7%. Also, given my long-term horizon (see below), I am not terribly worried about short-term multiple or NAV compression kicking my returns temporarily below 7% for a year or two.

Finally, I have a very long-term time horizon. I expect each REIT I own to be in my portfolio on the day I croak. I therefore have the luxury of being able to ignore the pricing of REIT stocks by others with shorter-term agendas. Thus I can laugh at the jittery hedge funds, the performance-driven traders, the occasional mistakes by solid REIT management teams, even temporarily difficult real estate market conditions and the brain-dead magazine articles asking, "Is now the time to get out of REIT stocks?" Hopefully, this allows me to see the forest rather than the trees, and to ignore the irrational exuberance or depressing gloom

that can dominate equities markets at certain times. I didn't experience exhilaration during the rip-roaring bull market of 2000-2004 (though I confess to finding it rather pleasant), nor did I suffer "sickness unto death" when the bear ran amok in 1998-1999.

There is no "right" way to manage a portfolio, whether of REIT stocks, other equities, bonds or pork bellies. Even I would manage my own personal portfolio somewhat differently if my objective were to constantly beat the REIT benchmarks. In any event, the above philosophy works for me, but I don't claim it should be *your* way. Those of us who manage portfolios (instead of owning mutual funds) must each develop our own investment style that works best for us and that's consistent with our personal beliefs, prejudices and idiosyncrasies. Consistency is key; those who flip from one style to another, driven by the fickle winds of investment popularity, are doomed to shipwreck. Stay true to your principles, and avoid the shoals of chasing others' performance. Happy sailing!

Your humble servant,  
Ralph (Block)

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