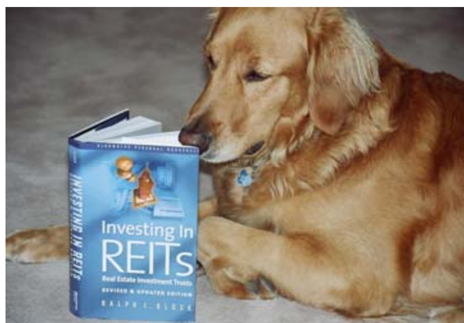
"The Essential REIT"

April 7, 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. ♫ Tiny Bubbles ♫.

One would think that the financial press is obsessed with champagne; the ongoing babble proclaiming a real estate "bubble," in Forbes and elsewhere, certainly causes us to think of that festive beverage. It also scares the bejeepers out of those of us who've suffered from the investment world's manifestations of those light and airy spherical objects. We tend to have long memories of painful events, and the brutal popping of the tech and dotcom bubbles five years ago, still fresh in our minds, causes us to look for the "newest, new bubble."

The term, of course, isn't new; indeed, many of us may recall discussions in history or economics classes of the "South Sea Bubble," describing an early 18th century version of these irrationally exuberant phenomena. Before that, there were tulip bulbs. More recent versions of bubbles include U.K. and U.S. railroads (19th century), auto and radio stocks (early 20th century), "nifty-fifty" stocks (late 1960s), Milken junk bonds and LBOs (1980s), Japanese country club memberships[1] (late 1980s) and, of course, our own tech and dotcom stocks (late 1990s).

According to Dictionary.com, a "bubble" is something "insubstantial, groundless or ephemeral" or, more applicable to the financial world, "a speculative scheme that comes to nothing." Alternatively, according to Life Style Extra's glossary of financial definitions, a "bubble" is "an explosive upward movement in financial security prices not based on fundamentally rational factors, followed by a crash." Fair enough; but should this menacing term be applied to real estate?

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[1] At the peak, the total market value of golf club memberships in Japan was about $200 billion; see http://www2.sjsu.edu/faculty/watkins/bubble.htm.

Real estate prices, particularly for homes in California and some cities on the East Coast, have been rising rapidly in the early years of the 21st century. It has been estimated by the California Association of Realtors that the median home price in California jumped 17 percent in 2003 and another 22 percent in 2004; you can buy a luxury apartment in Manhattan for a mere $1,300 per sq.ft. And prices for many high-quality commercial real estate assets have also been rising, even though 2001-2004 was a very difficult period for owners with respect to vacancies and rental rates. But rapidly rising prices, per se, do not equate to bubbles if they are "based upon fundamentally rational factors."

So, is the rise in real estate prices based on "fundamentally rational factors," or are we in "bubble" mode, making a substantial drop in prices likely? If the latter, how would this affect REIT stocks? Unfortunately, investment bubbles are labeled as such only with hindsight. However, as I seem to have this foolish penchant to rush in where angels fear to tread (and as April 1 was as recent as last Friday), I'll offer a few thoughts for your perusal.

Residential real estate, *i.e*., single-family homes and condos, does, in some locations, exhibit some aspects of our proverbial investment bubble. Prices have risen dramatically in a number of coastal markets, and this despite only modest growth in personal incomes and job growth. Growth in median family income has woefully lagged increases in home prices in California and many East Coast locations. Of course, some of those "fundamentally rational factors" have been at work, including a very modest amount of new homebuilding, as well as interest rates low enough to legitimately inflate the value of *any* investment. However, this doesn't let us off the hook, as more irrationally exuberant factors have also been at work:

A large number of impatient baby-boomers appear to have decided, again with 20-20 hindsight, that the stock market won't provide them with sufficient assets with which to retire, and have taken advantage of "hot" real estate markets and low (*e.g*., 5%) down payments to own (and sometimes to speculate in) residential real estate. Indeed, according to mortgage analyst Ralph DeFranco, of the San Francisco research firm LoanPerformance, "If you can fog a mirror, you can get a home loan," and not necessarily for personal use. Excessively easy (and cheap) capital has almost always been one of the principal bubble inflators. Item: the number of homes bought for investment jumped 50% during the 4-year period ending in 2004, according to LoanPerformance.

In many neighborhoods, a home bought at today's prices cannot be rented out for anywhere near what it would cost to service the mortgage. Affordability, particularly in California, continues to decline. Only 19% of households could afford a median-priced home in California last year, and the affordability gap between California compared to the rest of the nation reached an all-time annual high of over 36% in 2004, according to a California Association of Realtors survey.[2] The National Home Builders Association believes that 19 of the top 25 "least affordable" real estate markets throughout the US are located in California.

And risks are mounting. The percentage of homes priced above $359,650 financed with adjustable-rate mortgage loans (vs. fixed-rate loans), according to Freddie Mac, has risen to about two-thirds as of March 2005. LoanPerformance has calculated that California homes bought with interest-only loans rose from 2 percent in 2001 to 48 percent in 2004. But if you *really* want to get creeped out, hear this: LoanPerformance also estimates that the percentage of new loans that are adjustable amounted to 85% in Santa Cruz, San Diego and Oakland, and was over 70% in other major California cities. A recent article in the L.A. Times (April 3, part 1) relates the story of a developer who pre-qualified 90 potential buyers for mortgages at current variable-interest rates; however, when the developer, being conservative, asked the lender to change the loans from fully variable to fixed-rate for the first three years, only 15 of the borrowers still qualified. Conclusion: If interest rates should rise significantly, or if buyers' ardor fools (er, cools), residential real estate prices in a number of markets may soon act like a pig tossed out of an airplane.

Equity REITs, fortunately, don't own single-family residences; they own commercial real estate. And while commercial real estate prices have been strong, in response to demand for these assets from institutions and even smaller investment groups, they don't appear to be out of touch with reality. Real

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[2] See http://www.ringsurf.com/info/Real_Estate/News_/California_Real_Estate_Trends_For_2004.html.

estate cap rates hover in the 6-7% range for most quality assets; while these rates are lower than the 9-10% that was considered "normal" throughout much of the latter part of the 20th century, they are not out of line against the backdrop of 4.5% yields that have prevailed on the 10-year Treasury note (give or take 30-40 bps) during the past few years, or the 6% yield on BAA-rated long-term bonds.

Further, many seasoned investors and noted academics, *e.g.*, Messrs. Buffett, Siegel and Arnott, have been forecasting a lower rate of investment return for stocks compared with their historic averages over the past 50-75 years. Thus in a period of lower return expectations for stock and bonds, a real estate cap rate of 6 or 7% is not out of line; this is particularly so when real estate fundamentals are stable and improving modestly. Was it crazy for Regency and Macquarie to pay a 6.25% cap for the Calpers/First Washington neighborhood shopping center portfolio of 101 high-quality properties that has, for the past few years, been growing NOI at over 3% annually? Or for Macerich to pay a 6% cap for the Wilmorite portfolio, a group of shopping malls considered by many to contain some of America's most productive malls? Aggressive? Perhaps. Crazy? I think not.

So, while there may very well be some residential assets in some coastal markets that may be in danger of suffering from "bubble" pricing, it would be difficult for any informed and thoughtful observer to sustain that claim for commercial real estate generally. Is it possible that some commercial real estate buyers are overly optimistic in their IRR forecasts? Of course. Office real estate prices in the San Francisco Bay Area (almost ground-zero techville six years ago) have been rising briskly despite a lack of significant improvement in the space markets there, and Green Street Advisors, among others, has been wondering whether buyers have gotten a bit ahead of themselves. With the benefit of hindsight, perhaps the pricing on some commercial real estate assets will be adjudged a bit aggressive – particularly if interest rates move substantially higher. But, though it may sell magazines, it would be foolish to apply the "bubble" word across the board to all commercial real estate today.

But what happens to commercial real estate space and capital markets if a mini-bubble exists in some major residential real estate markets and home prices tumble by 10-15%? Can we put housing "over there," and ignore the unfortunate bloke who may have recently paid $1.2 million for a 1,200 sq.ft. home in Palo Alto? Or will his chickens come home to roost on our investments? About six years ago, I "knew" that the air would come out of the tech and dotcom balloon, but made the mistake of assuming that this wouldn't affect other sectors of the investment world or, indeed, the US economy. I won't make that same mistake again.

Of course, it's entirely possible – perhaps even probable – that there will be a "soft landing" ahead for home prices; the air may simply escape slowly and in a responsible manner, *i.e*., prices flatten or decline by 2-3% for the next 12-18 months. But if we *do* suffer a broad-based collapse in home prices, that would cause some nasty fallout for everyone. Consumers wouldn't spend as much, businesses would retract into their turtle shell, and job growth (and space absorption) could fade. A tight-fisted and job-challenged consumer, of course, will be reluctant to spend at the malls and shopping centers, and businesses won't be anxious to sign new leases. So, that modest liveliness that we've enjoyed in the space markets in recent months may just fade like Sammy after a hard day at the park.. And who knows? If the California housing bubble doesn't deflate gently, and contaminates other markets, we may be staring into the face of a national recession. That's a long-shot, of course, but it's a possibility, given the importance of consumer spending. And the odds of this happening probably increase if oil and gasoline prices continue to spike.

However, if prior relationships hold (a big "IF"), interest rates will come down to offset the drag on the economy from the "housing bust of 2005," cap rates will hold fast or even decline a bit further – and the hedgies who've been playing fast and loose with the IYR ETFs will, with substantial embarrassment, quickly cover their shorts. Is this déjà vu all over again, *i.e.*, a return to weak space markets but strong capital markets? Could the next mall portfolio trade at a 4.5% cap? We are, of course, just speculating here on how the future will unfold, and you are probably as tired of this endeavor as I am. So let's move onto another topic, shall we? But first, I cannot resist adding this bit of "poetry:"

Greetings, you boomers,
Can you remember when –
You loved those dot-coms?
Now you're at it again!

Just 5 percent down
Will make you a player;
You wanna retire?
Every day you get grayer.

Prices have doubled,
Behold riches without end;
Go for it, baby,
The trend is your friend.

But are prices too high?
Will the markets turn cool?
"Naughh – party on, dudes,
I'll find a greater old fool."

What about REITs –
A conservative niche?
"Get real, my friend,
They won't make me rich."

The boomers believe
They're in total control;
But if the bubble should pop
They'll have dug a deep hole.

Revelers become sated,
And parties do end;
During the following day,
Will consumers still spend?

Let's hope this small bubble
Will gently deflate;
Can we end the exuberance
Before it's too late?

2. The Guy Who Gets It.

I have become a big fan of SL Green Realty (SLG). I met Stephen Green at a NAREIT conference a few years ago, and was very impressed with him, his associates and the company's business strategy and capabilities as a New York City local sharpshooter. I have been an investor ever since, which has been one of my better moves in Reitdom. The stock has been an outstanding performer; its total return last year, at +53.5%, was best in the office sector; but, even more important, its average annual total return was 27% since the company's IPO in August 1997. Anyone who invested $1,000 in SLG at the offering price on August 15, 1997 would have $2,240 in value as of yesterday.

What prompted these thoughts was an article in the February 24, 2005 issue of "Real Estate Journal," a publication of WSJ.com, in which the writer, John Salustri, interviewed SL Green CEO and President, Marc Holliday. Marc, as you may know, took over the role of CEO from Stephen Green in January of last year, and has received very high marks from those investors who have followed the company. Mr. Green, of course, is to be congratulated for finding the right guy to step into his shoes. Anyway, what prompted me to mention this was several of Mr. Holliday's statements that appeared in that interview article – statements that strongly suggest to me that the man really gets it. OK, what did he say?

Holliday: "You have to assume that after it reaches dramatic highs, every sector is susceptible to some sort of pullback, and since the beginning of 2005, REITs [stock prices] generally have softened. But I don't think that correction had anything to do with operating fundamentals…2005 is going to be even more profitable [than last year]. Whether or not multiples in the sector as a whole will retract more, I don't know. I do know that if we [deliver] on what we promise, our stock price will continue to rise. End of story."

There are two important points here. First, contrary to the beliefs of those who pray daily to the market gods, not every stock market movement is predictive of future company fortunes; sometimes the market just goes its own way for a spell, based upon supply and demand. We saw this happen in 1999 – even after REIT stock prices corrected their 1997 excesses, and real estate would remain healthy for another 18 months, nobody wanted to own real estate stocks. Dotcoms were much more fun and profitable. Second,

Mr. H is focusing on his company and its fortunes, not SLG's stock price – a lesson that investors should also learn.

Holliday: "I've considered expansion into other markets…and always felt it would be a step in the wrong direction given that there is so much opportunity here [NYC] and that we have no particular expertise or competitive edge elsewhere. We could go into other markets and make money…but we would be just a market competitor as opposed to an above-average market competitor."

Marc is much too modest. SL Green is not just an above-average competitor, but a true local sharpshooter. And his comment highlights a very important issue for investors: To what extent is it wise for a REIT to expand into new markets? Of course there are some sectors of real estate, such as malls and self-storage properties, where being a local sharpshooter isn't terribly important, given the national nature of their markets and tenants. But other sectors are, indeed, more purely local businesses, and there is real value to shareholders when a management team recognizes that capital is a scarce and costly resource, and deploys such capital only in markets in which it has a competitive edge. We REIT and real estate investors can diversify on our own, thank you.

Holliday: "People say it's a great time to be a seller, but it's also a great time to be a buyer, and as long as we realize profits on dispositions and reinvest in new product, even if the market were to downshift, we'll monetize these gains and reinvest them…If you were just buying without selling, you could get trapped with a portfolio in too high a basis without having garnered the profits to pay for the new product."

Here he makes the point that the devil of value creation is in the details. Rarely do we live in times in which all property owners should be either selling or backing up the truck. Particularly today, real estate prices are in the "fair value" zone, and so a REIT that wants to create value for its shareholders must know which asset to buy, and which to sell. Capital recycling is a great strategy if executed well, particularly today.

Holliday: "We don't have acquisition goals. Certainly if we wanted to get big just for the sake of being big we could have achieved that over the years. I don't focus on how many buildings we're going to own. I'm singularly focused on driving total returns to shareholders…"

This point illustrates the vast distance that the REIT industry has come from 1996-1997; that was a time when everyone's question was, "How big is your acquisition pipeline?" (This, by the way, is not meant as a double entendre). And the Holy Grail for investors, for some strange reason, was "FFO accretion." The fact that Mr. Holliday's viewpoint, as set forth above, is widely followed in Reitville is certainly an improvement from 8-10 years ago. Unfortunately, there are still some REITs out there – whose names won't sully my lips – who still believe that bigger is necessarily better. Perhaps there are some advantages to size in the mall and storage industries, but other sectors will have difficulty sustaining that claim. Let's not forget that real estate is a commodity; giants like Procter & Gamble may be able to deter competition due to their marketing clout and ability to dominate shelf space, but real estate owners can't. And, of course, if value creation is the real name of the game, anything that makes it difficult to create value for shareholders – large size often has that inhibiting effect by making that home-run deal nearly meaningless – is something to be wary of.

Holliday: "I'm obviously a big fan of REITs…The reporting, the compliance discipline and the supplemental disclosures we put out allow investors to know almost every aspect of the portfolio and feel comfortable with what they're investing in…Plus, now the sector has a track record. I can't tell you exactly where the market is going [he didn't need to use the word "exactly"], but REIT growth will continue to be a trend in all product sectors in '05, '06 and '07."

Marc could also have mentioned much greater liquidity. The average daily trading volume for the NAREIT Composite Index stocks has risen from about $100 million in 1994 to about $1.2 billion today.

See the chart below[3]. Disclosure, transparency and better corporate governance, as well as liquidity and smarter management teams, mean that the REIT industry will continue to draw new adherents and investors despite the current weakness in REIT stock prices. Yeah, it's tough to see a stock like SL Green trade at $60 on December 31 of last year, and watch it belly-sliding this year, to the mid-$55s. Other quality names in Reitville have suffered the same embarrassing results so far this year. But the only way to make money consistently in the stock market is to own quality merchandise and to have a long-term time horizon. Personally, I am happy to have a substantial position in the company of which Marc Holliday is CEO.

Average Daily Trader Volume of the NAREIT Composite Index
March 1990–September 2004

In Millions of Dollars

Source: NAREIT

Your humble servant,
Ralph (Block)

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[3] This chart comes from "REIT Liquidity – No Longer a Problem," November-December 2004, REIT Portfolio magazine.