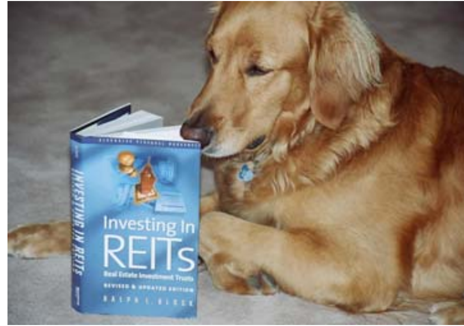
"The Essential REIT"

May 13, 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. Steve Roth and His Band of Secularists.

Vornado CEO Steve Roth sometimes reminds me of a professor, known endearingly as Harold "Mean Man" Marsh, who taught us corporate law at UCLA Law School many years ago. He was always brilliant but sometimes in-your-face abrasive. We can find among the gems in Mr. Roth's letter to shareholders this year a friendly and humorous barb tossed at the well-known former chief REIT analyst for Lehman Brothers, David Shulman (well, perhaps humorous to everyone *other than* Mr. Shulman).

Says Roth, "I salute David Shulman on the occasion of his retirement. What can I say to my dear friend David, who has an IQ of 250 and had a three-year sell on Vornado with a $43 average target [Ed. Note: VNO closed at $78 on Thursday]? I'm sorry, David, I just couldn't resist." For those who don't follow the REIT industry closely, Mr. Shulman, despite his intellectual brilliance, has been wrong on the REIT industry for the past three years, during which time REIT stocks have performed like gazelles on steroids.

How did a very bright guy like David so badly miss the Big Picture? Before trying to answer that question, let me kindly acknowledge that he certainly wasn't the only guy to have missed it. Furthermore, even those of us who have been bullish on REIT stocks over the past three years certainly never thought that they would turn in total returns of 3.8%, 37.1% and 31.6% in 2002, 2003 and 2004, respectively (per the NAREIT Equity REIT index). All of which, of course, simply reminds us of the difficulty of making macro calls on the future performance of asset classes. "Tactical Asset Allocation" is an emperor who's been disrobed years ago, though some investors – and too many newspaper and magazine article writers – still don't know it.

So what did David (and so many others) miss?

- They believed that real estate cap rates would quickly spring back to historical levels of 9-10%, and thus refused to accept the secular shift in the pricing of real estate. Or, as the inimitable Mr. Roth has stated in Vornado's 2004 Annual Report, "Over the last several years, real estate has repriced. I believe this is a long cycle move. Get used to it; give or take 10%, these prices are here to stay, for some time."

- The combination of the Internet and the information revolution, the coming-of-age of the REIT industry, the expansion and deepening of the CMBS markets and the inter-dependence and accessibility of markets across the globe has meant that Real Estate, as an asset class, has recently been able to compete for investors' capital like never before, and real estate will be priced on the basis of its risk-adjusted prospective returns vis-à-vis other asset classes.

- A corollary to the forgoing is that relatively low bond yields (particularly when adjusted for inflation), combined with high equity prices (which translate into expected nominal returns of just 6-8%), have enabled Real Estate (and its close cousins, REIT stocks) to compete effectively for that global capital.

- Enron, WorldCom, the Tech Wreck, Nine-Eleven and related events have changed investors' psyches in ways that most observers still do not fully acknowledge; investors have simply become more risk-averse and yield-conscious. And, more of them now believe in investment diversification. They have thus been playing right into our hands – real estate satisfies these new preferences.

- Space markets and capital markets are not joined at the hip – if, indeed, they ever were. This phenomenon, long accepted as a "given" by equity investors, profoundly surprised those REIT investors who have approached REIT stocks as if they were simply liquid real estate. The real estate bears did not consider that REIT – and, indeed, real estate – investors might be basing their decisions not on near-term space market facts but, rather, on longer-term capital allocation issues.

- And, last but certainly not least, the bears did not consider the hypothesis that real estate, either direct or securitized in the form of REIT stocks, has been under-owned for many years, by both institutions and individuals, for reasons explained in many Essential REITs past (for example, REITs have, until recently, been virtually unknown to 401K plans). The REIT industry, despite its awesome growth, is still not huge, and goosing one's "real estate" allocation by only 5% can do wonders for real estate pricing and REIT stocks when multiplied by hundreds of institutional investors and millions of individual investors.

So, the cyclicalists have lost and, to misquote Richard Nixon, "today we are all secularists" (well, at least most of us are). Of course, that's not to say that cap rates won't rise in response to a significant rise in interest rates. They will indeed, and REIT stocks will fade faster than Sammy after a long afternoon of tennis ball chasing at the park if the 10-year leaps towards 5% (this was the risk I noted in my REIT forecast "poem" at the end of last year).[1] And this is what Steve Roth means by "give or take 10%."

Thus it's most important to think of cap rates as trading within bands. Caps will fluctuate between the top and bottom ends of these bands, depending upon interest rates, prospective RE cash flow growth rates, the attractiveness of other asset classes, yada, yada, but the bands will not be where they were as recently as five years ago. Those looking for 9-10% cap rates on good quality assets would have better luck finding a unicorn.

And, at the risk of sounding like Sherlock Holmes, there is yet another phenomenon afoot that makes me even more confident that real estate and REIT investors will have the wind at our backs for quite some time. This is what I refer to, for want of a more clever label, as the Pension Fund Conundrum:

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[1] See also the recent Green Street Advisors "Real Estate Securities Monthly – Heard on the Beach," dated May 2, 2005, in which Mike Kirby examines the recent high correlation between REIT stocks and interest rates. Says he, "REITs have underperformed the S&P every time interest rates have moved up more than 40 basis points in the last 16 months, and they've outperformed when interest rates have dropped."

US Labor Secretary Elaine Chao, referring to a corporate defined benefit pension plan funding deficit estimated at $450 billion, says that current pension rules "allow employers and unions to underestimate future pension liabilities and make promises they cannot keep." The Labor Department wants this fixed – a recent reform proposal changing how companies would have to value their plan liabilities would, according to Barron's "Current Yield" reporter Jennifer Ablan, "force pension plans to buy long-dated assets to match the lengthening of their liabilities resulting from the aging demographic (both increasingly older workers and retirees)."

The problem, however, is that there isn't enough long-term debt available in which pension funds can invest. Bill Gross, the well-known and widely-respected bond guru at Pimco, notes that the size of the bond market is $30 trillion, but, he says, has an average maturity of just six years. These short duration bonds must be used to match liabilities that extend from 15 to 40 years. Says Gross, "There has been this terrible mismatch between assets and liabilities, and the Treasury is part of the problem…it is necessary to begin issuing longer-term bonds."[2]

Thus it's not surprising that the US Treasury is now considering bringing back the "long bond" with a duration (non-callable) of 30 years – which hasn't been available as a new issuance since October 2001. That would provide bonds of 30 years' duration to hungry pension funds looking to match their liabilities against similar-term assets. But doesn't it make just as much sense to use commercial real estate as a key part of a long-term matching strategy? After all, real estate ***is*** a bond – indeed, it's better than a bond, as it promises (via in-place leases) to pay regular distributions to its owners, yet also provides upside in the form of increasing values and cash flows over time which may help to fund pension obligations indexed to CPI adjustments.

Ah, but what if the tenants can't pay? Yes, this does happen. But, outside of US government obligations, this also happens in the corporate world. Obligors sometimes cannot pay their bonds when due or make their lease payments. But unlike bond owners, who are stuck with their credits in the event that bad stuff hits the fan, real estate owners can find new tenants, often at the same or higher rental rates if the asset is properly underwritten.

So let's not underestimate the increasing importance of promised distributions to aging retirees by pension funds across America. Real estate, with stable and predictable cash flows that should continue for many years, can, like long-dated bonds, provide solutions for the needs of these pension funds. No, real estate is not technically a "bond," but, as we all know, has many bond-like features. Indeed, while risks may be higher than is the case with many bonds, it does provide both upside and a possible inflation hedge, over time. So, to the extent pension funds need to look for long-term cash flow generators, they will continue to buy real estate as long as it offers risk-adjusted returns that are attractive relative to both bonds and equities. Those REIT bears who are whining about REIT stocks trading at P/AFFO ratios of 19-20x may be whining for a long time.

2. A Quick Summary of REITs' Earnings Season.

Q4 2004 may have been the longest REIT earnings season ever, but the late Q1 season may have been the most compact. Thanks, among other things, to Sarbanes-Oxley (which has brought some benefits but, on balance, may be yet other instance of government over-reaction), nobody wants to put out any information unless and until blessed by the Popes of the accounting world, and this simply takes time. But perhaps accordioning all the calls into a period of just over two weeks doesn't matter a whole hell of a lot, as there were few surprises in our world this past quarter. Here's a brief report:

Office: Most office markets continue to improve, although some of them, *e.g*., Dallas, are still on their sick beds, and some are recovering faster than others. The most desirable space, on top floors, seems to be the biggest beneficiary of improving demand. Concessions appear to have peaked (although it still requires bucketsful of money to fit out larger blocks of space for lessees willing to commit for 7-10 years). Rents are rising in a few markets, and supply is still very much under control.

[2] Barron's, "Current Yield," p. MW6, May 9, 2005.

Industrial: Similar story…continued positive absorption, and vacancy rates are, on average, now below 10%. We are beginning to see a few increases in asking rents, but they are selective and modest. Some new supply is impeding a rapid recovery in the space markets. There is a fair amount of build to suit activity due to many lessees' desires to occupy the most modern and flexible distribution space; those owning older, less desirable properties may find that occupancy and rental rates will be slow to recover.

Apartments: Year over year revenue growth is picking up, due to easier comps, modest but steady improvement in payroll growth and lesser competition from increasingly less affordable single-family homes; however, stubbornly high expense growth (including real estate taxes) is cutting into NOI improvements. The condo conversion mania still appears to be intact, providing ample portfolio tuning opportunities for those REITs willing to scoff at FFO dilution – but, due to the weirdo prices the converters are willing to pay, along with the spike in Libor, many of these sales will even be accretive to FFO. And, despite the convictions of the pundits, cap rates aren't rising – at least not yet; the freeze-out of levered buyers is being offset by baskets of money coming from institutional buyers. Housing affordability issues will help owners, but primarily on the coasts.

Retail: Americans are saving at the rate of only 0.1% of their incomes but, like Alfred E. Newman, don't seem to be worried about it. Neither high gasoline prices, nor the anticipated abatement of home re-financings, nor the end of the Bushian tax cut refunds have stayed consumers from their self-appointed rounds – at the malls and wherever else they can buy their "necessities." For how long? Who knows? For now, they are spending, and financially healthy retailers want more retail space, in malls, lifestyle centers, strip and outlet centers, power centers, wherever; "bring it on." Owners say their problem is finding the space in which to put voracious retailers. Luxury and upscale retailers are doing best, as shoppers there couldn't care less about $3 gasoline. All this will pass one day, but, for now, "Party on, dudes."

Other Sectors: In self-storage, the recovery is real; Americans are finding jobs, they are moving around again, and they need places in which to store their "stuff" (God forbid they should toss out that rotting camping equipment). The storage guys are reporting nice gains in NOI. In healthcare, capital continues to chase a limited supply of product, driving down cap rates despite uncertainty about Medicare and Medicaid reimbursement rates; acquisition volumes are still the name of the game in this sector. We've been waiting for a long time for a recovery in the manufactured home community sector. Will Godot ever arrive? Well, maybe; there are signs of life, but we've seen this play before. I'll let you know when Lucy Brown gets tired of pulling the football away from Charlie.

As for hotels, there is no doubt whatsoever about the recovery or its early-cycle nature. The only real issue is, "How robust?" I would rather own US hotels, rather than those in Europe. The Gritti, in Venice, is offering to convert its charges in Euros to US dollars even-up, so it must be hurting due to the scarcity of reluctant US tourists who don't appreciate getting only 77 Euros for $100. Or, to put it another way, a 300 Euro room rate was equal to $285 as recently as 2 ½ years ago. Today it's equal to almost $400, an increase of almost 40%.

Which earnings reports particularly impressed this humble observer? Here's a list, with brief commentary:

Residential. Archstone-Smith (who cares about dividend coverage when you can sell assets at 3.5% cap rates?); and Avalon Bay (best apartment developer cranks up the pipeline at what will probably prove to be a very opportune time).

Office: Boston Properties (beginning to skinny down so that a brilliant development team can create some significant value for shareholders over the next few years); SL Green (local NYC sharpshooters continue to turn pigs' ears into silk purses, while taking advantage of what may be America's best office market); and Alexandria (opportunistic development positioning in Mission Bay).

Industrial: AMB Property (increasingly playing the development card, while its hub and gateway strategy is looking better and better); and Pro Logis (global development company in REIT clothing).

Retail: Simon (this gorilla isn't resting on its haunches, taking full advantage of its management depth and multiple product lines); Macerich (levered, yes, but, Mama Mia, what great redevelopment opportunities); Federal (Don Wood and his team have been dealt good cards, and are playing them very well); Kimco (Milton

Cooper and crew continue to create value in the most interesting ways, recently by building their fund business); Pan Pacific (small, when smart and disciplined, is beautiful indeed); and Regency (development juggernaut also continues to make very shrewd capital allocation decisions).

Storage: Public Storage (Ron Havener is either very lucky or very smart, but who cares? He's gotten this roadster cranking along on all eight cylinders, and the Preferred Redemption Gambit is turbocharging AFFO growth).

3. Two Academic Giants Debate Equity Returns.

I have suggested above that capital will increasingly seek the best risk-adjusted returns. If this is so, it becomes important, in estimating whether commercial real estate will continue to be in demand by investors, to understand what kinds of returns non-REIT equities are apt to deliver in the years ahead. Two well-known and widely-respected observers of the stock market scene, Rob Arnott (editor of the Financial Analysts Journal and a sub-advisor to Pimco, among other credentials) and Professor Jeremy Siegel (Professor of Finance at the Wharton School, and author of several outstanding books, including "Stocks for the Long Run" and "The Future for Investors"), were featured in a BancAmerica Securities conference call on January 18, hosted by Ross Nussbaum. I have, below, attempted to accurately transcribe their opening statements, followed by a few personal observations:

Arnott: Investing is math. Long-term returns, or IRRs, consist simply of yield plus growth, along with changes in valuation levels. It is this simple. If markets are fairly valued, returns on equities will be equal to yield plus growth in free cash flows. With a dividend yield of under 2%, we should expect investment returns about 300 bps less than those obtained historically. But what about that growth rate? The 20th century was a good growth period; technology and efficiency improvements helped to generate substantial growth. But even during this period, annual growth in earnings and dividends per share averaged only 4%, of which close to 3% was inflation. There was only 1.25% of real growth. So, we should expect, going forward, 2% yield + 1% real growth + 2-3% of inflation, or 5-6% nominal total returns on equity investments.

So why should investors expect 10% returns? The market's problem is that expectations are too high. Corporations cannot grow earnings at 8% on a long-term basis – this would be without historical precedent. We are in the early stages of a secular bear market where stock values will decline for a considerable period of time. My concerns are these:

(1) poor quality of earnings, *e.g*., companies are borrowing earnings from future periods, as their pension funds are assuming returns of 8.6%, after fees and expenses – which will not happen, as nobody will get 8.6% on a balanced portfolio;

(2) valuation levels are high by historical standards, as stocks trade at 17x consensus operating earnings (vs. 12x historically); we are in the top quartile of historical valuations; this is not appallingly expensive, but expensive nonetheless; a secular bear market can last for 15-20 years;

(3) equities are now priced to provide a real return of only 1-2%, or pretty much on a par with government bonds; but, investors expect a lot higher returns – so, as reality sets in, we could see downward pressure on equity valuations; and

(4) the demographics won't be favorable for stocks for the next 10 years, as the baby-boomers will begin retirement and look to sell financial assets so that they can buy goods and services needed in their retirement; they will have to sell equities to a smaller workforce; this is the 800-pound gorilla, and he's not far away.

Siegel: You presented a strong case, Rob, but let me try to chip away at it a little bit. First, we *both* agree that real returns for equities won't be as high as they have been historically. Equities have delivered 6-8% *real* returns since the late 19th century. You and I disagree only on how much below historical returns they will be. Your have reduced projected equity returns (vs. historical returns) by 3%, *i.e*., which would provide investors

with 3-4% real (after-inflation) returns. I, however, would reduce long-term equity returns by only 1-2%, so my view is that real equity returns will be 5-6% going forward (or about 8% nominal). Why do I believe this?

An alternate way of looking at valuations is to flip PE ratios around and look at earnings yields. Like bond yields. There are lots of ways to measure earnings. Let's assume $74 for the S&P500. If so, we have a 16.1x PE ratio, or a 6.2% earnings yield. But let's be conservative and assume that this is an inflated number, and that real and recurring earnings are $65 for the S&P, after expensing options, etc. At that level of earnings, the PE ratio is 17.5x, and the earnings yield is 5.3%. But now lets deduct pension fund underfunding; that would reduce earnings on the S&P 500 to $60.90, for a PE of 19.7x, and an earnings yield of 5.1%. And this is a real return, as earnings will grow to at least offset inflation. This 5% real return is higher than the 3% real return forecasted by Mr. Arnott, and is consistent with my expectations for investment returns.

How do he and I differ? We cannot use historical earnings per share growth and claim that's the norm for us today. The growth rate will be higher, as the dividend payout ratio has declined from 60% to 33% today. A low payout ratio means that there is more money for reinvestment without needing to float more debt or sell additional equity. So, we will have higher earnings per share growth in the future. I don't believe that Rob's [famous] study is predictive of the future, even though *some* retained earnings have indeed been wasted. Earnings growth has in fact been stronger since the advent of lower payout ratios.

Finally, yes, demographics are important. Lots of stocks will be sold. But my model shows that investors in China, India and other foreign countries will step in, as there will be lots of interest in US equities from the developing world. Globalization will be a big factor in all of this. Our markets will be supported by developing countries, which house 80% of the world's population. [End of this informal transcription.]

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Summarizing briefly, Mr. Arnott believes that stocks will deliver 3% average annual real total returns over the next 5-10 years, or 5.5% nominal returns assuming 2.5% inflation. Mr. Siegel hypothesizes a real average annual return of 5-6%, or 8% nominal returns. To be conservative, let's give Mr. Siegel a small edge, and assume a nominal return of 7% on equities. How does unleveraged real estate compare? Many wizened veteran real estate investors assume that "what you see [in nominal cap rates] is what you get," and that an asset bought at a nominal cap rate of 9% will deliver an average annual total return of 9%;[3] at today's nominal cap rates averaging, say, 7%, that would mean that real estate will, like stocks, deliver a 7% average unlevered annual total return.

Conclusion? Real estate and non-REIT equities will deliver returns that are pretty much similar, both at the 7% level. But when adjusted for risk, which delivers the best returns? It seems to this humble observer that real estate comes out on top, no matter how "risk" is defined. Personally, I would require a higher return to invest in stocks than in real estate, given the greater predictability of real estate cash flows and its lower volatility. But we don't have to reach that conclusion. All that's necessary for capital to continue to flow into real estate and REIT stocks is that investors perceive that their returns are somewhat comparable to equities, given their low historical correlations. And on that cautiously optimistic note I will leave you until next time.

Your humble servant,
Ralph (Block)

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[3] It's interesting to note that the average annual return from real estate, per NCREIF data (if my memory is somewhat accurate), has been approximately 9%, roughly equal to the prevailing level of cap rates over many years until recently.