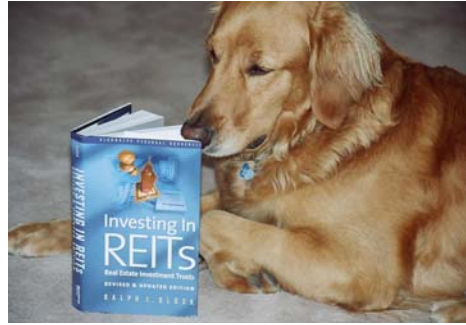


"The Essential REIT"

June 3, 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. Of Bubbles and Bubbleheads.

It seems that any "pundit" who screams something loud enough and often enough, no matter how absurd, will ultimately win converts. If I could get ample air time on CNBC and CNN, like the other talking heads, and continually proclaim that every investor should put 80% of his or her assets into Saskatchewan flaxseed or Yoda mugs, a fair number of poor souls would probably believe me. What got me off on this tangent was yet another proclamation that "real estate" is trading in "bubble" territory, this time by folks who ought to know better – "investment strategists" at Bear Stearns. Barry Vinocur, in his "REIT Flash" service to subscribers, refers us to a Bear Stearns 11-page missive entitled, "'REIT all About It: A Bubble Looming In Real Estate?'"

Let me first acknowledge that, not being a client of Bear Stearns, nor doing any business with it, nor being able to find the article at the Bear Stearns website, I haven't been able to read said report. However, based upon its salient features, as contained in Barry's summary, it would appear that the authors are claiming that: (a) REIT stocks are expensive (as evidenced by their statement, "most would agree that REIT valuations are somewhat rich"); and (b) REIT stocks are primed for a major price decline ("in our opinion, these statements [earnings will grow into their valuations] are similar to the ones used to explain the sky-high valuations of many stocks during the tech bubble of the late 1990s"). Ooh...clever ploy! By associating statements concerning REIT stock prices today with past history concerning techs and dotcoms in the late 1990s, the authors can suggest "REIT bubble" but without saying so directly.

Barry suggests that the Bear Stearns write-up might be "one possible explanation for the recent REIT slide," i.e., REIT shares were trashed badly for much of last week (this week has been a different story altogether). Another obvious catalyst was a Merrill Lynch report ("Risk-Reward Less Compelling"), which suggested that REIT equities have gotten ahead of themselves; Merrill also downgraded six REIT stocks from "Buy" to "Neutral." I love it when that happens. But I am less interested in REIT stocks' day to day

squiggles than in the amount of misinformation that's being spewed forth by persons and firms who ought to know better.

Let me draft a simple letter to Mr. Bear and Mr. Stearns. The letter will, as is true for most letters, lack documentation, but perhaps it will serve to goad investors to question what is rapidly becoming the conventional wisdom about "real estate," *i.e.*, that its pricing is being driven by mindless euphoria.

Dear Messrs. Bear and Stearns:

I read with a great deal of interest your recent report, entitled "REIT All About It: A Bubble Looming in Real Estate." [Well, in all honesty, I didn't read it, not having access to it, but I read a summary in Mr. Vinocur's "REIT Flash." No matter; I am not going to chide you for lousy reasoning but, rather, am using your article to try to clarify a few things for REIT investors].

First of all, did you make a distinction between commercial real estate and residential real estate? While both are, certainly, "real estate" – bricks and mortar, used to provide space for individuals and businesses – their similarities are limited and their differences are vast. The differences extend to ownership motivation (primarily psychic enjoyment and shelter vs. a pure investment), risk factors (the differences are too numerous to describe), financing (nearly 100% on homes), cash flows (puny current yields from home rentals, with most of the investment return coming from appreciation) and investment return variables, among other factors. Indeed, although there are times when investors have thrown money at both residential and commercial real estate assets indiscriminately, and although both types of real estate can, at times, play host to irrationally exuberant investors and consumers, their investment returns are dependent upon very different dynamics and frequently diverse widely.¹

Residential real estate is normally bought as a lifestyle choice, not to make money. While it *can* be bought for investment, most consumers of homes – at least those that I know – do not buy them primarily to make money or think of them as an investment alternative to the stock market. Most homeowners don't move their families from Santa Monica or San Jose to Phoenix or Atlanta for a year or two when housing values surface from time to time. "Net operating income" from residential real estate bought for investment at today's prices, especially in California, Florida and other "hot" markets, is often nil and, at the least, is well below that which is obtainable on most commercial real estate. And residential real estate can be financed with much more leverage than is usually the case for commercial properties; indeed, some benighted home buyers, thanks to Aunt Fannie and Uncle Freddie, have been able to finance home purchases merely by punching a time clock each morning. Heck, I'll bet Sammy himself would qualify for an interest-only, variable rate mortgage on a spiffy new doghouse (not that he would want one – his preferences run in the direction of indoor master bedrooms).

So when we compare the determinants of prices and pricing trends for single-family residences and for commercial real estate, we find they are as different as sorbet and sirloin – both are foods, but... . Of course, it all comes down to supply and demand, but there are vast differences in supply and demand dynamics between residential real estate, on the one hand, and commercial real estate, on the other. Furthermore, prices of residential real estate are much more subject to emotional and psychological forces than is the case with commercial real estate. Indeed, the extent to which home buyers are able to delude themselves about what's a "fair price" can, at times, remind us of some fairly frothy periods in US investment history. Home buyers couldn't care less about cap rates or replacement costs. The bottom line here, guys, is that one should be very careful not to confuse residential real estate with its commercial cousin; frothy market conditions in one type may *or may not* be present in the other.

¹ I wrote that sentence on June 2 on the basis of my memory and belief, and thus was happy to see the assertion vindicated by Fidelity's Steve Buller in an article appearing in today's WSJ, beginning at page C-1. Steve was quoted as follows: Prices for commercial real estate and single-family housing "have acted quite differently at different times." I have a great deal of respect for Steve; he's one of the many Good Guys in our industry.

Now let's look at your other assumptions and conclusions, which seem to be that (a) most observers believe that REIT stocks are expensive, and (b) arguments for retaining them in an investment portfolio can be compared to owning tech and dotcom stocks in the late 1990s. I don't know whether "most" intelligent REIT investors out there consider REIT stocks "expensive," and I don't much care. What I want to determine, from time to time, is whether they truly *are* pricey (or cheap, or about right). Those who've been investing in REITs for some time know that one of the most reliable indicators of over- or undervaluation is the stocks' relationship to their estimated NAVs – perhaps as estimated by Green Street Advisors. NAV premiums of over 20% have generally indicated REIT market tops, while discounts of 10-15% or more have signaled bear market bottoms.²

Today the average REIT stock trades at an NAV premium of less than 4%; this compares with a Green Street average, going back to 1993 (the true dawn of the Modern REIT Era) of 7.1%. So are REIT stocks expensive vs. commercial real estate? Only if you believe that REIT stocks today deserve to trade at much lower average NAV premiums than has been the case over the past 12+ years (a very dubious argument). But wait! Suppose that commercial real estate itself is significantly overpriced. Doesn't *that* make REITs expensive?

Let's consider that last point. Certainly even a 4% REIT NAV premium may be "expensive" if NAVs are "too high" and unsustainable, based as they are on the prices at which commercial real estate assets trade in the vast private markets. So, is commercial real estate outrageously expensive today? Not only isn't it in bubble territory, but it is not even unduly expensive in light of prevailing interest rates and bond yields. Real estate market cap rates are, of course, in the eye of the beholder (and the numerous real estate brokerage firms and service providers out there), and every such firm has its own cap rate estimates. Furthermore, averages tend to mask wide differences among property types, locations, physical quality and structure, age, occupancy, tenant quality, yada yada.

However, most observers would concede that quoted cap rates, averaged across all property sectors, are somewhere in the 7% range today. For example, on May 1, Nicholas Buss, SVP for PNC Real Estate Finance, stated that the average cap rate now stands at about 7.5%. This is very similar to a recent assessment by Real Capital Analytics. Green Street, which studies market statistics as closely as anyone, recently pegged the average nominal cap rate for the assets held by the office REITs it follows at 7.5% (and 6.3% "economic," after all recurring tenant improvements, leasing commissions, etc). Their figures for industrial property REITs were very similar, at 7.2% and 6.3%, respectively. Green Street's mall cap rates (nominal and economic) are modestly lower, at 6.7% and 5.9%, as are their apartment cap rates, at 6.3% and 5.6%.

So let's assume an average economic cap rate of around 6% for good quality real estate in most markets, providing sustainable cash distributions equal to 6% on invested capital (unlevered). In addition, it's not unreasonable for such a buyer to expect average improvements in asset value and net operating income of something like 2% annually, close to the rate of inflation. Let's conclude that the buyer's IRR (unleveraged) will be about 7%, after management fees, other leakage and perhaps a modest upward adjustment in cap rates by the end of the holding period.

I don't know what home buyers expect with respect to their "investment" returns, but does a prospective commercial real estate investment return of 7% sound obsessively optimistic, greedy or unrealistic to you? It doesn't to me, not when long-term intermediate grade corporate bond yields are struggling to stay above 6% -- and they provide no inflation protection whatever (though, arguably, come with slightly lower risk). And not when the brightest guys in the equities business, such as Warren Buffet, Jeremy Siegel and Rob Arnott, are forecasting nominal returns from equities over the next few years of just 6-8%. And not when other very bright guys like Pimco's Bill Gross are forecasting average yields on 10-year T-notes over the next several years of somewhere between 3% and 4.5%.

² If you can get a hold of a Green Street Advisors report showing NAV premiums and discounts over time, overlay that with a chart of REIT prices covering the same periods. You'll see what I mean. Or, better yet, get a copy of my book and look at Chapter 9.

It is certainly true that today's cap rates are lower than they have been historically. While much – perhaps most – of this is due to today's low interest rates, other drivers of lower cap rates can easily be explained without resort to claims of “irrational exuberance.” These include the institutionalization of real estate, its greater transparency, better market research, incipient recovery of our nation's space markets, a lessening of risk premiums, and a steady and ongoing reversal of a perverse historic underweighting of a very solid asset class able to provide competitive returns with low correlations. No, it's never “different this time,” but woe to those who insist on driving forward by looking exclusively at the rear-view mirror.

Thus I will fall on my sword if real estate cap rates spike by more than 50-75 basis points, perhaps due to a monster rise in interest rates, which would trim the prices of REIT stocks substantially. But, in the absence of such a dire event, arguments that REIT stocks – or commercial real estate – are being priced in bubble territory are just so much hot air. Residential real estate, especially in my home state of California, is certainly another story and, as I have written recently, may indeed be floating irrationally higher on puffs of warm air. But nobody who is relatively sober and who has thought about the subject in any depth would make that claim for commercial real estate.

A final note: Today the 10-year T-note yields 3.9%, and not even the Oracle at Delphi can tell us whether it goes higher or lower; the faces of all the economists are redder than the uniforms of the North Carolina



State Wolfpack cheerleaders.

I learned in the second grade how to subtract 4 from 6, and can thus conclude that the yield on the 10-year was 200 basis points higher when such investments yielded 5.9% less than five ago, in the fall of 2000.³ Now add 200 bps to your 7% cap rate and – voila! – you have your 9% cap rate that was so prevalent back then. So, please tell your “investment strategists” to go back and realign their strategy with realities as they exist in June, 2005. Repeat after me: “4% on the 10-Year, 4% on the 10-Year, 4% on the 10-Year...”

Yours truly,

2. Chasing the Grail.

I often have been accused of favoring lost causes (*e.g.*, respectful discourse and reflective moderation in politics). Thus you shouldn't be surprised if I unsheathe my sword, don my suit of armor and search once again for the Holy Grail. That Grail, of course, is the answer to the decades-old question, “How much of my assets should I invest in REITs.” All right, all right...it's not as important as World Peace, Personal Happiness or Michael Jackson's Trial, but it truly is important to us investment nerds – and perhaps it's important to you, also, my dear reader.

Now, this topic may be as stale as a Henry Blodgett research report on Amazon.com. However, on the chance that you are cursed by constantly waking up in the middle of the night wondering whether you (or the client you advise) should invest 5% or 25% of your (or their) assets in REIT equities or commercial real estate, the following portion of The Essential REIT may be a palliative. Let's cast this as a discussion between Joe Buttpaine, who's long been a royal annoyance to his financial planner, Donald Diehard, and Mr. Diehard himself – a recent but reluctant believer in the virtues of including REITs within a diversified investment portfolio.

³ Interest rate nerds may find the following website helpful:
<http://www.federalreserve.gov/releases/h15/data.htm>

[Warning: As there is no Holy Grail – at least I haven’t been able to find it – the following dialogue is designed only to help you enjoy the Quest. My personal view is that almost everyone ought to have 20% or more of his/her/its assets invested in REITs or commercial real estate (have I covered the waterfront?), but I recognize that it will take quite some time before this radical view becomes widely accepted].

Joe: Mr. Diehard, I just noticed that you added a 5% REIT allocation to my investment account. Why?

Donald: REITs are a very good alternative asset class and, according to the recent study by Mr. Pagliari and friends, a good proxy for commercial real estate. They have performed quite well over long time periods, e.g., equity REITs have provided total returns of 12.0%, 13.5% and 14.6% for the past 20, 15 and 10-year periods, respectively, have low correlations with other asset classes, provide stable and predictable cash flows, deliver much higher dividend yields than other common stocks, and are less subject to global economic upheavals or “diworsifications” by management teams. The well-known Professor of Finance, Jeremy J. Siegel, recently stated in his new book,⁴ “I believe that REITs should be a part of a well-balanced equity portfolio, especially one with a bias towards high-dividend stocks.”

Joe: But then why only 5%? Why not 50%? I will be retiring next year, and will need a stable source of cash flows for traveling, golfing and sky-diving. Us baby-boomers aren’t yet ready to go gently into that good night. I need income, my friend; let my kids worry about capital appreciation. Besides, in the past five years, equity REITs have cranked out average annual total returns of 19.3%, kicking sand in the faces of the Equity and Bond Bullies.

Donald: Ah, but REIT performance will revert to the mean. Their returns won’t be so spectacular over the next five years. Furthermore, ...wait a minute...let’s continue this discussion in a another week or two, Joe. Reitnut has already rambled on for four and a half pages, and this discussion will take at least another four. That’s beyond my threshold of pain, and quite likely that of everyone else.

[To be continued next time...]

Your humble servant,
Ralph (Block)

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⁴ “The Future for Investors, Crown Business (2005).