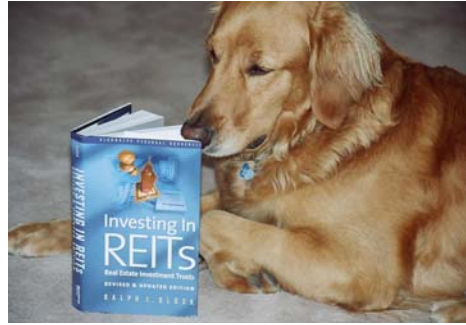


# "The Essential REIT"

November 4, 2005



*"If my doctor told me I only had six minutes to live, I wouldn't brood. I'd type a little faster." – Isaac Asimov*

*"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. Bipolar!

A "bipolar disorder," according to Dictionary.com, is "an affective disorder marked by alternating periods of euphoria and depression." Similarly, UAB Health Systems, a healthcare network, says a manic-depression "is characterized by periodic episodes of extreme elation, elevated mood, or irritability (also called mania), countered by periodic, classic depressive symptoms."

Anyone who's been watching the stock market during the month of October and into November may suspect that he's traveling in a Bipolar world without even leaving his den. One day stocks fall faster than a 30-pound crow after hitting a power line, as the depressive mood seizes investors, but then snap back violently the following day on waves of pure euphoria. Stocks have lost all correlation to earnings reports, interest rates or the price of oil, and seem to be walking randomly in response to the whims, fears and hopes of day traders.

And, as REITs are stocks as well as real estate, we REIT investors have fallen victim to this manic-depression. On Monday, October 24, the NAREIT Equity index scored a large gain of 1.91% (hey, don't laugh – that's *huge* for REIT investors). But they went into a depressive mode on Tuesday through Thursday, falling 2.5% during that time period. Then, on Friday, euphoria resurfaced, as REIT stocks streaked 2.8%; on that day, Simon Properties, helped by a strong Q3 earnings report, soared 4.6%, more than an entire year of Simon dividends.

There was modest follow-through on Monday, but on Tuesday the roof fell in, as REIT stocks were trashed 2.1%. The culprits that day were Equity Office and Parkway, whose results and forecasts were disappointing, and Mills, which couldn't issue results at all. Coincidentally – or not – Equity Lifestyles and Equity Residential were also trashed badly on the same day. ELS was particularly hard hit, dropping 5.5%.

Was it disappointment with its newly-increased dividend rate, or did “investors” just confuse their “Equities?”

We REITsters are learning to live with more volatility during the last two years – after all, REITs are finally playing in the “Bigs,” and our world has become the sandbox of all sorts of investment types who think a gross lease is an ugly dog harness. Yes, we do understand that, but it seems that the volatility in our world these days might be so high as to justify the label “bipolar.” Why is this so? Is there some logical explanation? *My guess is that this gross volatility is being driven by a huge difference of opinion on the future valuations of commercial real estate.* Perhaps we might put this into context by eavesdropping on two REIT traders who have lots of money with which to place bets on the near-term direction of the REIT market.

**Ralph:** I see over there, sharpening his claws, Danny Depressive, who, as manager of that well-known hedge fund, “Horns & Claws,” occasionally holds long positions in REIT stocks but most of the time is short (Danny, it must be disclosed, is, 4’7” and somewhat sensitive about it). Danny loves to play with IYRs<sup>1</sup>, and has a hotline on his desk to the IYR redemption center. He proudly displays the following bit of nonsense on the corkboard behind his desk:

IYRs are tools for bears,  
We love to short REIT shares;  
ETFs are really slick –  
We need no stinkin’ uptick!

And in the far corner of the room, glowering at Danny, is Mary Mania; Mary isn’t a hedgie like Danny, but is an active REIT stock trader; her average holding period is four trading days. She also publishes a newsletter called “The Industry Cheerleader.” Although Mary was a bit concerned about REIT stock valuations throughout much of last year, she has become downright giddy about the values that can now be found in Reitville – indeed, she’s often as manic as Sammy chasing a beef-flavored tennis ball.

So let the dialogue begin. Ken, er, I mean Danny...let’s start with you. Why in the hell are you so down and depressed about REIT stocks; or, to put it another way, why would you risk your clients’ assets by shorting IYRs every time REIT stocks rebound in price? Would you care to explain the Bear Case?

**Danny:** “What’s your name? Ralph? I don’t like that name; I’m gonna call you Ferd.<sup>2</sup> Listen, Ferd, real estate is so over. Most of you jerks just don’t recognize it. Housing prices are cracking, and if you think commercial real estate is insulated from that, you’re licking too many toads. Back in 1999 we knew the dot-coms were about to vaporize, but naively believed that the Ciscos and Intels would be immune to the blow-up, *i.e.*, “Oh, those are big, solid companies, with lots of earnings.” Yeah, right...when the paddy wagon comes, they take *all* the girls, innocent or not, and when house prices tank, so will the prices of commercial real estate. And it’s not just psychology, Ferd, as important as that is; the housing crash will ruin the economy and take real estate down with it.

Then there’s interest rates. In case you haven’t noticed, they’re all up, and heading higher, as are spreads over T-notes. The bully I refer to as Izzy Inflation is back, and he’s making everyone nervous as hell, including the bigwigs at the Fed. Gasoline, home heating oil and other energy prices are spiking, and ‘cane-induced shortages are driving up the cost of labor and materials everywhere. Rising interest rates have always spelled D-E-A-T-H for equities, particularly the interest-rate sensitive types like REITs.

Cap rates are at historic lows (yeah, Ferd, I know what a cap rate is), and they’ve always been very heavily influenced by interest rates. As the latter go up, so do cap rates, and real estate prices will sink into the mud. With debt leverage, the nastiness is multiplied. This has always been so, and always will be...and

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<sup>1</sup> IYR is the ticker symbol for the Dow Jones US Realty iShares, an exchange-traded fund. ETFs have apparently become the vehicle of choice for trading in REIT stocks by hedge funds.

<sup>2</sup> In a movie made 20 years ago, the title of which I cannot recall, the crusty Jack Palance called everyone he met “Ferd.”

your “this time it’s different” stuff is laughable. So, cap rates are goin’ higher; it’s not a question of if, but when – and by how much. And higher cap rates will trash REIT NAVs, and also their stock prices.

Then, of course, you’ve also got your pathetic American consumer, who’s savings rate has been negative for three months running. He (she?) will soon look like road kill from a Chevy Suburban, flattened and squashed by a quadruple whammy, including high gasoline prices (we Americans love our cars more than our children), weakening home prices (meaning no more refinancings for home remodeling or trips to the newest Travel + Leisure “hot” spot), rising interest rates on everything from credit card debt to variable-rate mortgage loans, and, very soon, home heating prices that will double from last year.

So, The Grinch will steal this Christmas. Holiday sales will be almost as weak as the 1976 Tampa Bay Buccaneers.<sup>3</sup> Consumer confidence is falling apart. Retail REIT stocks like Simon, who’ve led REIT stock performance over the past five years, will be feeling the pain as their tenant retailers get wimpy with their leasing plans, while those retailers on the bubble will close stores. Vacancies will rise, market rents will fall. And when pain is inflicted on the generals, the foot-soldiers such as the office and apartment guys won’t perform well. Indeed, the demise of the consumer will, after a few quarters lag, create a train-wreck for the US economy, and space markets will again go negative.

And valuations suck. The average REIT dividend yield is puny, at 4.8%, which is only 15 basis points higher than the 10-year T-note yield. Historically, this gap has been much wider, averaging 160 basis points. Should investors decide that the average REIT stock should yield 7%, which was normal for much of REITdom’s existence (and which is equal to the average historical spread when the 10-year yield rises to 5.4%), we’ve got a long way to fall, baby. There ain’t gonna be a lot of fun out there for REIT investors, Ferd, and that’s why I’m shorting REIT stocks every day.

**Ralph:** Thanks, Danny...but don’t call me Ferd. Before I sell all my REIT stocks, I better ask Mary how she can possibly be bullish after listening to those dire warnings from Depressive Danny. What say you, Mary? Are you worried about being out of a job next year when REIT stocks crash and burn?

**Mary.** This guy Danny is a piece of work, a perfect illustration of the crud that passes for investment analysis these days. He may know what a cap rate is, but he’s a Macro Duncie who knows nothing more than the conventional “wisdom” being spun out of the pages of newspaper financial sections every day. Has he listened to any REIT conference calls? Has he studied the current trends in tenant sales? Has he interviewed management? Danny won’t roll up his sleeves and learn what’s happening today in the real economy, and that’s just one thing that’s going to foul him up. American consumers are still employed, and they continue to shop. Despite the dire headlines, same-store tenant sales are continuing to grow at a respectable rate, as evidenced by yesterday’s retail sales report. Of course, as always, there will be retail winners and losers; American Eagle’s a winner, Gap’s a loser. Consumers may not buy that giant SUV, but they continue to spend money.

Equally as important, Danny boy just doesn’t understand the how and why of capital flows. The most important thing that all investors need to know is that Real Estate is now being assessed in a manner somewhat different from the past. Due to a number of factors, including greater liquidity, more transparency of information, a reduction in risk premiums, and the realization that commercial real estate has delivered investment returns comparable with equities over many, many years, real estate is now able to compete with all other asset classes – stocks, bonds, commodities, gold, Impressionist art, Mickey Mouse watches – for global capital. Hoary rules of thumb concerning the valuation parameters applied to commercial real estate in the past, while relevant, need to be taken with lots of grains of salt. We are no longer in Kansas.

So when perceived risk-adjusted returns on quality commercial real estate exceed the perceived risk-adjusted returns on other asset classes, capital will flow into the former –until such time as prices rise so high that required returns are unlikely to be obtained. I’d also like to point out that, while nobody can foretell the future, GDP and job growth are still running strong, which is fueling a continuing recovery in

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<sup>3</sup> [http://football.about.com/library/weekly/bl\\_worstTB.htm](http://football.about.com/library/weekly/bl_worstTB.htm)

our space markets. Some sectors, *e.g.*, offices, are recovering more slowly than others (apartments), but positive NOI growth will prop up real estate values even if cap rates do back up a bit. Furthermore, most investors are simply underweighted in commercial real estate, and are trying to increase their allocations. This is why, at least for some period of time, cap rates won't necessarily rise should interest rates continue to uptick modestly, and is why REIT stocks' dividend and AFFO yields should trade at much skinnier spreads to T-notes or investment grade bonds than has been true in the past.

Now let's talk a bit more about your "dead consumer." First off, forget consumer confidence. That's the most stupid canard in the investment world. Every intelligent investor knows that the American consumer says one thing to pollsters and does another, and that the published consumer confidence surveys aren't worth the powder to blow 'em to hell. Second, consumers are nothing if not adaptable. They will spend if they have income, and they will quickly learn to adjust their spending habits to the new reality of higher energy prices and somewhat elevated interest rates, *i.e.*, some just won't buy as many \$5 frappaccinos from Starbucks. A modest reduction in spending is hardly a disaster. Of course, lower-income consumers will be affected more, so you should map your REIT investment strategy accordingly. It may also be significant that the S&P Retail index has come back nicely over the past five days after a period of significant weakness:



We are all, of course, concerned about a housing bubble, but it's more likely to slowly deflate than explode. Certainly that's what Ben Bernanke, the soon-to-be-elected Fed Chairman, believes. Even bearish Robert Schiller expects that the housing deflation he forecasts will take many years to unfold. Yes, we could experience a sub-par Christmas holiday shopping season; however, retailers and the guys who rent space to them are in fantastic shape. Retailer balance sheets are very strong, inventory is under control, and shopping center occupancy rates are very high. There is likely to be a slowdown in demand for retail space next year, but quality space in excellent locations will barely miss a beat – although, as noted earlier, it will be increasingly important to own the right kind of retail space. Wal-Mart-bait in tertiary (and even secondary) locations won't fare very well, *i.e.*, it's best to own Simon and Federal, not Pennsylvania and Heritage.

I will acknowledge, Danny, that rising interest rates affect REIT stock valuations (just as they affect the values of equities, bonds, Bugattis and everything else). However, the pundits, including most economists and even the Fed, are overrating the threat of inflation. Indeed, the numbers that came out last Friday tossed a lot of cold water on the inflation hot-heads; employment costs for the 12-months ending September, 2005, were up 3.1%, the lowest rate since 1999, and Friday's inflation report showed core inflation in Q3 rising just 1.3% vs. 1.7% in Q2. According to the highly-respected economist, Ian Shepherdson (of High Frequency Economics), "There is nothing here [the inflation report] that looks remotely inflationary." So if inflation is truly a kitty cat wearing a lion's mask, and with the US economy likely to cool over the next few quarters, interest rates will peak by the spring of next year – if not well before that. Most importantly, the equities markets will begin to discount this six months ahead – like right now.

So from my perspective, Danny – perhaps I ought to call you Dorky – I see a few risks out there to the economy, but nothing to give it more than a mild and temporary cold. It's unlikely that interest rates will

continue to rise much higher or for much longer – assuming I’m right about inflation – and cap rates will remain stable as capital continues to flow into commercial real estate (at least until such time as investors believe that they can do a lot better with equities, when adjusted for risk). We are learning from market statistics and REIT executives alike that the space markets continue to gradually improve, driving NOIs and supporting current real estate valuations.

Meanwhile, REIT stocks are presently trading at persistent *discounts* to their NAVs – something we haven’t seen since the summer of ’02. So even a modest uptick in cap rates has already been discounted in the prices of the stocks. And when the discounts become large (and even when they don’t), REITs get acquired. You better cover your shorts, Danny, before you’re walking around naked.

**Ralph:** Mary, thanks much for your thoughts. You beat the crap out of Danny last Friday, but he kicked your butt on Tuesday. I’ve learned to take each day with many grains of salt, as my time horizon is at least 10 years. Meanwhile, someone else just drifted into the room. Who are you, fella?

**Alvin Allocator.** Alvin Allocator’s my name, and investment consulting’s my game. What do you want to talk to me about? I’ve been beefing up my clients’ commercial real estate portfolio allocations, and just missed out on the CRT Properties, Gables Residential, Capital Automotive and AmlI deals. Now I’ve got Post, Arden and a few others in my sights. So I’ll give you two minutes, that’s all.

**Ralph:** OK, Alvin, what is your angle on REITs and commercial real estate? Who’s right, Danny or Mary?

**Alvin:** Frankly, Scarlet, I don’t give a damn. I keep only one thing in mind: Pension and other institutional funds are starved for good quality commercial real estate; they are underweighted in it and want to own more. Some of these clowns have a sub-5% allocation to commercial real estate and are embarrassed by it. Sure, there are some that have been players for some time, and now seek to cut back a bit, *e.g.*, Calpers. But most of these guys are looking for steady, stable and predictable 6-7% long-term investment returns (most of it from current income), and they can get it even at today’s historically low cap rates – even after management fees and expenses. And if they can buy large property portfolios by taking over a few REITs, so much the better. Yeah, we know we must often pay a stock price premium to acquire a REIT, but if we wait ‘til they trade at big discounts, then toss a huge premium onto the table, we can still buy ‘em at NAV. AmlI was a great example of this.

Accordingly, we love it when Danny Dork over there shorts IYRs and drives down REIT stock prices. We’re waiting in the wings, and have huge buckets of capital that we’ll use to buy a large REIT portfolio for even a 5.5 – 6.0% nominal cap rate, as my buddies are doing with AmlI. Maybe we get a 5% current cash return (after cap ex outlays and corporate/Sarbanes-Oxley savings), plus another 2-3% in capital appreciation and NOI growth over time...say, an IRR of 7.5% after all fees and expenses. And we can buy properties today at, and sometimes below, replacement cost; meanwhile, land and construction costs move relentlessly higher. Those who argue “bubble pricing” in commercial real estate today are airheads. And consider this: You think you can do better than 7.5% in the stock market, when risk is factored into the mix? Equities ain’t cheap, and not a day goes by when some stock isn’t blown up by Danny and his hedgeie friends for “missing their numbers” by a penny or two. The stock market has not been a hospitable place for some time, and commercial real estate is a great place to put long-term investment dollars to work.<sup>4</sup>

Look, fella, you’ve heard, over the past two weeks, from some of the brightest minds in the REIT industry, including Milton Cooper, Ed Linde and Hamid Moghadam, not to mention the smart and experienced CEOs from Archstone, Avalon Bay and Kilroy, that the flow of capital into higher-quality commercial real estate is unabated, despite clear rises in interest rates. And yet you let guys like Danny push you around, make you afraid of holding your REIT stocks. Go ahead, sell ‘em. That just creates more opportunity for guys like me and my clients.

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<sup>4</sup> Today’s WSJ contains an interesting article on investors’ interest in timberland, for reasons similar to their interest in commercial real estate. I think this trend will continue, although slowing down at times when interest rates spike up.

I won't argue, friend, that the current environment will last forever. However, as long as investment grade long-bonds provide yields beginning with a 6, as long as equities continue to struggle to provide investors with returns of greater than 7%, as long as my clients are substantially underweighted in commercial real estate (direct or securitized), as long as the space markets in the US continue to improve, thus reducing the risk premia attached to the ownership of commercial real estate, and as long as I can get prospective unlevered IRRs from quality real estate in the neighborhood of 7%, I'm gonna continue to buy it. And if I can buy it cheap from you dumb, impatient REIT investors, so much the better.

**Ralph:** Thanks, guys...Well, I'm not sure what, if anything, we've learned, other than the fact that opinions today differ so widely that we ought to expect monster volatility over the next few months, at least. I wasn't able to get to the NAREIT convention this week, but reports indicate that a very wide variety of opinion was expressed there (although bulls seem to be somewhat scarce and apologetic – obviously a good contrarian indicator).

My own opinion? I thought you'd never ask. I tend to side with Mary. I believe that the U.S. economy will slow significantly over the next couple of quarters in response to rapidly rising interest rates (there is always a lag effect). By next spring, those same interest rates will be heading back down as the Fed backs off and investors again worry about recession and deflation. The space markets will be sluggish next year, but the falling interest rate environment will do wonders for REIT stock prices. They thrive in a low-inflation, low-interest rate, low-growth environment. Meanwhile, however, today's panic du jour – inflation and high interest rates – will continue to put pressure on REIT shares over the short term, so 2005 is apt to be a very mediocre year for REIT investors.

In any event, with so much disagreement out there, we must learn to live in a Bipolar world, at least for some period of time. Only active traders and long-term investors need apply. Those who don't know which they are – or cannot decide – will be skinned and dressed for Turkey Dinner.

Your humble servant,  
Ralph (Block)

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