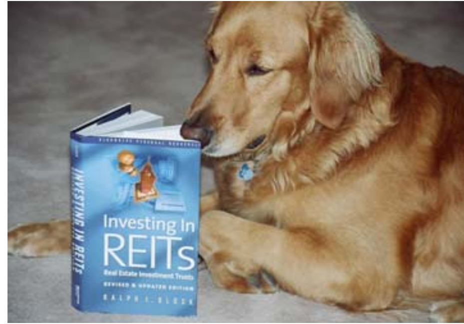
"The Essential REIT"

January 20, 2006



"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. A Dialogue With Sammy: Living in a 4% World.

On a lazy Saturday morning about two weeks ago, I was drinking my Tanzanian Teaberry coffee and reviewing the prior day's closing stock prices. I happened, for whatever reason, to focus closely on the dividend yields of some of my favorite REIT stocks. What I saw made me a bit uneasy; it was like waking up to find the coffee pot dancing with the toaster on the kitchen table. What jarred me out of my Saturday morning lethargy was the number of REIT stocks trading with dividend yields hovering around 3%; these included Avalon Bay (3.0%), Corporate Office Properties (3.0%), Equity Lifestyle (0.9%), Host Marriott (2.5%), Kilroy Realty (3.1%), LaSalle Hotels (3.1%), Pro Logis (3.0%), Public Storage (2.8%), and SL Green (3.0%).

Well, Sammy saw the puzzled look on my face, and proceeded to initiate a discussion with me. (You might think that this would startle me more than 3% REIT dividend yields, but I have been communicating with my good fuzzy friend for quite some time; Goldens are remarkable creatures).

Sammy: What's happening to our REIT yields, dude? You have taught me well, and I know that it's as normal for a REIT to yield 3% as for a Black Lab to snarl. REITs are supposed to be high-yielding investments; this has been so for the past 40 years. As they must dividend out at least 90% of their pre-tax net income, they don't have the ability to grow cash flow as rapidly as non-REIT companies. Furthermore, they are capital intensive, which also limits growth rates. Commercial real estate is commodity-like, so using brand names or technology breakthroughs to generate double-digit returns on invested capital is problematical. And commercial real estate today is as picked over as my chew-rope; REITs are finding it tough to goose FFO increases or NAV accretion with vanilla-variety acquisition pipelines. Giving a REIT investor a 3% yield is like giving me a Nylabone that's been pre-owned by a pit bull. Not very appetizing.

Reitnut: Sammy, I hear your whelps. However, before you go out and dig a few holes in the garden out of frustration, let's try to understand why today's REIT stock yields are as low as they are. First, keep in mind that the 3% club is a very elite organization, and even such quality stalwarts as AMB Properties, Archstone-Smith, Boston Properties, Simon Properties and Vornado don't have membership cards; their yields are closer to 4% than to 3%. Furthermore, the average yield for equity REITs is 4.4%, per NAREIT data. You say you don't like blue-chip companies in the industrial space such as AMB or Pro Logis because of their sub-4% yields? Then consider promising newcomer First Potomac, or under-followed Eastgroup, which has actually outperformed Pro Logis going back 1994; both stocks yield 4.3%.

But I do agree with you that today's REIT dividend yields – as well as their AFFO yields – are very low compared with historical data. On January 3, 2000, when everyone had "figured out" that Internet e-tailing would close down all the malls, Simon stock yielded 8.9% - and that's a dividend yield; its AFFO yield was 11.4%. In other words, Simon was trading at a P/AFFO ratio of just 8.8x. Of course, at that time REIT stocks had been banished to investors' dog-houses, so it's unfair to use valuations at that point in time. However, no matter how we slice and dice the numbers, today's yields are low. At the prior REIT market top in the fall of 1997, the average dividend yield never dropped below 5.4%. Today we are 100 basis points below that.

Sammy: So, perhaps its time to lighten up. I bet we can buy 200 boxes of Mother Hubbard's carob biscuits with your profits from just a single REIT stock.

Reitnut: Before we fret about valuations, Sam, let's explore the reasons for today's low yields. It is really a combination of at least three factors, all working together. First, today's real estate cap rates are historically very low. We can, of course, debate the "propriety" of these low cap rates but, as REIT stocks are, by and large, priced off of estimated Net Asset Values, low private market cap rates will translate into low AFFO and dividend yields for REIT stocks. If the average economic cap rate for Avalon Bay's properties is 5%, can we realistically expect to buy the stock at a 7% AFFO yield or 6% dividend yield? Second, yields on bonds of 10-30 years maturity remain relatively low; this supports low cap rates and modest REIT AFFO yields. And, third, let's not forget that most sectors of commercial real estate are just coming off of cyclical lows, and investors have always paid higher multiples for trough earnings than peak (or even normalized) earnings.[1]

Look, Sammy, it's pure logic. Investors demand high current returns when perceived growth is modest, or the risks are high (and vice-versa). This is also the case when competing asset classes offer high prospective returns (we learned this lesson in '98 and '99). If we could get 7% yields on 10-year T-notes, or could buy stocks at 12x earnings, you might be able to buy a good quality office building in San Francisco at an 8% cap rate or Boston Properties stock at a 6% dividend yield. But that's NOT today's reality, so investors need to accept lower returns in a low-return world. Today's lower-risk investments with decent upside potential don't come cheap; everyone playing in the stock and bond markets knows that.

Sammy: Well, OK, so perhaps these scrawny yields are explainable. I want to get to some valuation issues, but let's paws for a moment. Can you assure me that today's low yields on REIT stocks aren't going to drive away investors? After all, you and your associates in REIT world have been advocating the virtues of REIT investing in large part on the basis of those high yields. Now, Reitnut, they're almost skimpy – especially in taxable accounts where the average equity REIT's after-tax yield, assuming a 35% federal tax bracket and no state income tax, is 2.9%. That's only 140 bps higher than the after-tax yield of 1.5% on the average S&P 500 stock. Pfizer and Bank of America yield more than a number of REITs.

Reitnut: Certainly, Sammy, the yield-hogs are looking elsewhere. There are plenty of investors who want current yields of 7% or more, and will go anywhere to get them – including REIT preferreds, leveraged closed-end funds, Canadian O&G royalty trusts, MLPs, perhaps even Venezuelan or Syrian bonds. But REITs haven't had those folks as clientele for at least the past year, and the stocks have continued to perform

[1] Here's a quiz: What was the cap rate for San Francisco Bay Area office buildings in 2000? 7%? 9%? Wrong! Buyers were demanding 11% cap rates for pretty good office properties back then, illustrating that investors insisted on paying very low multiples of peak earnings for these assets.

pretty well. Avalon Bay, for example, was a low-yielder at the beginning of 2005 but still managed to beat most of its peers in a strong apartment sector with a 22.8% total return. Equity Lifestyle is even a better example, providing a total return last year of 24.8% despite a dividend yield low enough to make even a tech investor blush.[2] So, there is still enough interest in commercial real estate and REIT stocks to propel pretty good returns despite today's historically low dividend (and AFFO) yields.

Sammy: Perhaps not for much longer, Reitnut. Today's' equity REIT dividend yields are well below the yields that can be obtained on good-quality commercial real estate. If individual investors lose interest (as evidenced by negative mutual fund flows during the latter part of 2005) at 4.4% yields (or perhaps 3.4% after management fees if they buy via actively-managed mutual funds), perhaps institutional investors will lose interest also. After all, they can buy commercial real estate at 6-7% cap rates; I'm not much of a math student, but I do know that 6.5% is a lot better than 4.5%.

Reitnut: Keep in mind, Sammy, that those cap rates you quote are *nominal* cap rates, and don't take into account all the capital expenditures necessary to keep the properties competitive, nor do they normally include tenant improvement allowances or leasing commissions. Today's *economic* cap rates, while of course varying widely by sector, location, quality, and all sorts of other variables, are probably below 5.5%. So that narrows the gap a lot. Also, REITs are business organizations, and seek to retain some of their cash flow to goose external growth; you shouldn't expect them to dividend out 100% of their free cash flows. They also, as businesses, retain some non-income producing assets on their balance sheets from time to time, such as land for future development.

But the proof of the pudding (or, for you, the quality of the biscuit) can be seen in the very modest 7% premium over estimated NAV at which the typical REIT stock now trades. You could almost justify that premium on liquidity alone, not to mention the other attributes that usually justify a modest NAV premium such as management expertise, geographical diversification, financing flexibility and value-creating capabilities. Another such proof can be seen in the 6%-ish nominal cap rate that GE Capital – certainly no dummies – was willing to pay for Arden Realty. If REIT stocks were overpriced relative to commercial real estate, that deal would never have been done at such a large premium to Arden's pre-rumor stock price. So, Sammy, you can question whether commercial real estate itself is overpriced, but REITs sure aren't overpriced relative to commercial real estate.

Sammy: All right, let's cut to the bone. I'll concede that REITs – despite their puny dividend and AFFO yields – aren't expensive when compared with commercial real estate. But isn't the latter as expensive relative to bonds or equities as that Louis Vuitton monogrammed dog collar Miss Poodle was wearing at the park yesterday is to a collar from the bargain bin at Petco?

Reitnut: Green Street Advisors maintains a monthly "thermometer" that shows REIT stocks' valuations relative to other asset classes. In the most recent issue of their Real Estate Securities Monthly,[3] the thermometer reading of REITs vs. stocks is a sizzling 100, suggesting that REIT stocks have never, ever been as expensive *relative to equities* as they are now. This is based upon relative 52-week forward PE ratios between stocks and REITs (although they use AFFO ratios for REITs, not PE ratios).[4] The picture relative to bonds is almost as ugly; Green Street compares the average REIT AFFO yield (4.7% at January 3, 2006) with the yield on the Baa-rated long bond (6.2%), and assigns a thermometer reading to REITs of 96, due to the negative 147 bps spread between the REITs' AFFO yield and the Baa bond's yield, compared with an average *positive* spread of 41 bps going back to 1993.

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[2] ELS' dividend yield is lower than that of Intel or Microsoft
[3] Issue of January 3, 2006.
[4] The forward PE multiple (per the Green Street analysis) for REITs is 21.1x and for equities is just 14.9x. Of course, this information is only as good as the accuracy of the forecasted earnings; also, some pundits would argue that the real forward PE ratio for the S&P is somewhat higher after options are expensed and other adjustments are made. For example, the forward PE ratio for the S&P 500, according to Birinyi Associates, is 17x.

Relative to real estate, however, the temperature is much cooler. Based upon prevailing NAV premiums at January 3, the thermometer reading vs. commercial real estate is a relatively cool 34. So the crucial question for asset allocators is simply this: Can we rely upon historical pricing relationships between REIT stocks, other equities and bonds to determine what pricing relationships are "appropriate" today? We have all learned that, although we shouldn't ignore historical value relationships, relying upon them exclusively is perilous. Change is constant, and nothing is forever – at least in the investment world.

Sammy: In other words, boss, we should ask whether Risk and Reward, as well as Investor Preferences, in the vast and ever-changing investment world have changed sufficiently over the past few years to justify a paradigm shift of "appropriate" pricing relationships between REITs (and, presumably, commercial real estate), on the one hand, and equities and bonds, on the other?

Reitnut: Give that dog a bone! – your wisdom must derive from those smart Border Collies you've been cavorting with at Russell Park. But "paradigm shift?" Gimme a break, Sam; you are not *that* erudite. Truth to tell, I'm not smart enough to answer that all-important question. But don't be disappointed in me, as nobody else can answer it either. But, rushing in where angels fear to tread, I'll take a quick shot at it. There are perhaps five reasons why REIT stocks *ought* to trade at yield spreads vs. bonds, and PE multiples relative to non-REIT equities, that are much different from where they've been in the past.

These include: (a) there is much more liquidity today in REIT shares (and commercial real estate), thus eliminating the need for a significant "liquidity discount;" (b) there is much greater transparency in REIT reporting today, as well as smarter and wiser management teams – and market information is much better in the world of private commercial real estate; (c) we are early in the up-cycle for most commercial real estate sectors, which suggests both faster-than-normal growth in cash flows *and* lower risk, each of which will affect valuations; (d) there is more appreciation today by both institutional and individual investors alike for portfolio diversification and current income – and so investors are willing to pay relatively more today for current and anticipated real estate cash flow streams; and (e) REIT stocks have been orphan investments throughout most of their history, appreciated by neither equity nor real estate investors – and thus, as orphan stocks, have been priced much too cheaply relative to their investment merit.[5]

We can debate this point until you run out of kibbles, Sammy, and nobody really knows how to quantify these issues. However, one would think that markets are relatively efficient, and Green Street's REIT temperature has been "hot" for quite some time – but without being the precursor of a severe decline in REIT shares. Of course it is certainly possible that REIT stocks are overvalued, to some extent, relative to bonds and non-REIT equities. If so, then they will underperform vs. those other asset classes for a period of time. However, it's also quite possible – perhaps likely – that Mr. Market has it just about right, and that neither REITs nor commercial real estate are overvalued relative to the broad stock market or to long-term bonds.

Sammy: All right, enough of this relative valuation stuff; I'm in need of a brisk walk. All I know for sure is that about one-half to as much as two-thirds of REITs' historical total returns have come from the dividend. And so, if today's dividend yield is 4.4%, then we should expect a total return of no more than, say, 6.6% annually from our REITs, going forward. I may not be a rocket scientist, but even a furry canine like me can spot prospective investment returns that are uglier than the county dog-catcher.

Reitnut: With all due respect to Your Fuzziness, I am not sure I agree with your figures. Certainly REIT returns, going forward, won't be anything like those 12% returns we've guzzled greedily in the past. I'll grant you that. However, even with 4.5% dividend yields we can still get to 9% total returns. First, that 50% figure is based upon statistics derived from older periods in REIT history when payout ratios were much higher than they are today (or will be tomorrow); REITs will be able to generate better growth out of higher retained earnings, which will provide some help on the capital appreciation front. But, perhaps more important, I can envision the average REIT growing its same-store NOI by 2.5% annually, partially offset by recurring capital expenditures; assuming stable cap rates and interest rates, and with 50% debt leverage, this can generate a 4% growth rate in a REIT's NAV, which is a principal driver of REITs' valuations over time.

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[5] If this hadn't been so, how could REIT stocks have generated average annual total returns of 12.4% over the past 20 years?

Add another ½% from external growth, and your typical equity REIT can appreciate in price by 4.5% annually, on average. Add the dividend of 4.5% and you're at 9%, a figure that virtually all of us should be exceedingly pleased with. Those who want more should invest in Iraqi Internet companies or Alpo futures.

Sammy: Alpo futures? Yuck! I'd rather own PetSmart stock. But, Reitnut, but there's a tick in the hedge! Who says that interest rates (and, perhaps, in turn, cap rates) won't move up and trash all your assumptions of stability? In case you haven't forgotten (to badly mangle Santayana), those who don't anticipate change are condemned to learn from its consequences.

Reitnut: Of course, Samuel, you are right. But we are defenseless against unforeseeable macro changes such as spikes in interest rates. If rates rise significantly, particularly if not accompanied with an offsetting increase in economic and profit growth, *all* investments will decline in value, not just REIT shares. But we have to value our investments on the basis of known facts today, not what they may be. Sure, we must allow for the possibility that conditions will deteriorate. However, unless one is sure that long-term rates will spike, that a recession is on the horizon, or that capital flows into commercial real estate will suddenly reverse, we need to fit our investment expectations – and price our investments – on what we know today, subject to appropriate adjustment for perceived risks.

Today we know that the 10-year T-note yields 4.35%, and that the Baa-rated long bond yields something like just over 6%. Depending upon who you listen to, the trailing PE on the S&P 500 is 19x and the forward-looking PE is something like 17x. Core inflation is still not rising at much more than 2.5%, the US economy is probably going to slow down a bit this year, and employment growth will be positive but perhaps less than last year. There are a number of geopolitical risks out there in the world; higher oil prices will eventually lead to lower demand for the gooey stuff; the housing market is peaking; consumers are going to spend less and businesses will spend a bit more. In that type of environment, it's hard to see a large boost in interest rates, or any other event that will destroy REIT or commercial real estate valuations – but it could happen, of course.

There are no certainties in the investment world, Sammy. You know you'll get your kibbles and slice of ham tonight, but we investors have no idea what kinds of returns we'll generate this year or next. All investing is truly a "leap of faith." But, speaking for myself, I am quite happy with my 4.4% current yield and the prospect of another 4% of stock price appreciation, particularly given the limited risks that I see in commercial real estate today. Heck, I'm even happy with 3% yields on AVB, HMT, PSA and SLG, given the nature of such beasts.

Sammy: Arf, arf. Let's go to the park!

***End-notes*:** Quote of the Week – "I can no longer take Mills at their word. If you can't trust them, I don't see how you can buy them." – Keybanc's Rich Moore, on the wisdom of investing in Mills (as quoted in the Wall St, Journal).

From the L.A. Times, January 18: According to a recent National Association of Realtors survey, fully 43% of first-time home buyers financed 100% of their home purchase price last year. But, says Tom Stevens, the Association's President, "I am not concerned." (I asked Alfred E. Newman what he thought about this. His response: "What, me worry?")

Your humble servant,
Ralph (Block)

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