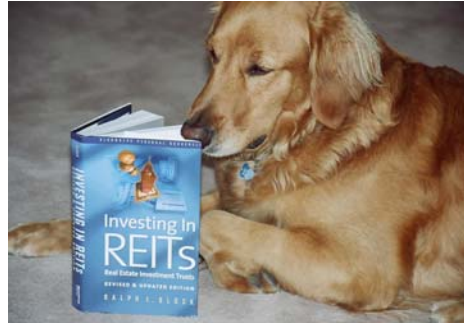


# “The Essential REIT”

June 1, 2006



*“The best way to become acquainted with a subject is to write a book about it.” – Benjamin Disraeli*

*“An author is a fool who, not content with boring those he lives with, insists on boring future generations.”  
– Charles de Montesquieu*

*“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. Mr. Market: Oracle or Loki?

It’s never a good idea to try to fool Mother Nature. Similarly, we battle-scarred investment veterans also know that it’s not smart to ignore Mr. Market. Markets have demonstrated an uncanny knack, over many centuries, of ascertaining and discounting future events and developments, and those who ignore the “price action” in the market often become a victim of it. I have thus learned over the years not to ignore Mr. Market when he flaps his arms wildly, and I am particularly attentive when my favorite stocks – or groups of stocks – are traveling in the wrong direction.

Of course, the wily Mr. Market doesn’t always succeed in emulating the Oracle of Delphi; sometimes he’s just a modern version of Loki, that funny-looking Norse god known for his callous and deceptive trickery. Thus quite often Mr. Market seeks to get us thinking in a certain direction, but then pulls the rug out from under us. Economist Paul Samuelson has famously noted, tongue in cheek, that “the market has successfully forecasted nine of the past four recessions.”

According to Barry Vinocur, who tracks such things in his daily REIT reports, at its May 23 close, the MSCI US REIT index (RMZ) had fallen 11% from its zenith reached on March 17; that was a pretty fair decline for a boring asset class such as REIT stocks, and almost 3x the average annual REIT dividend yield. REIT stocks bounced up, then down, after May 23, and at May 31 equity REITs’ year-to-date total return was 7.3% (per NAREIT). Still positive, of course, but the short-term trend is clearly down (May’s loss was 3.2%, on a price-only basis).

Perhaps even scarier, a very large number of REIT stocks are selling at discounts to estimated net asset value (NAV) – in some cases, these discounts are surprisingly large. On May 19, Mr. Vinocur quoted Green Street Advisors’ Mike Kirby: “There are 21 REITs in our coverage universe trading at discounts greater than 10%, and 10 REITs trading at discounts greater than 15%.” And these stocks do not

necessarily represent the REITs you wouldn't bring home to Mother; on May 23, General Growth Properties, Macerich, and Simon Properties, stalwarts all, were trading at NAV discounts of 21%, 18% and 11%, disrespectively. And this phenomenon wasn't limited just to mall REITs; Avalon Bay's NAV discount was 15%, Kilroy's was 4% and Host's was 13% (all based on April 30 Green Street NAV estimates).

The slide in REIT stock prices and gaping NAV discounts are, to say the least, disconcerting. But does this suggest that the enigmatic character we know as Mr. Market is role-playing the Oracle of Delphi, wisely suggesting bad commercial real estate news and/or declining property values in the months ahead – or is this just another of his Loki-type tricks designed to deflate expectations and create investment angst when investors become too exuberant or complacent? Unfortunately, we won't know except in hindsight. But let's take a look at what Mr. Market might be trying to tell us in its trashing of REIT stocks, and try to assess his veracity.

**a. Inflation and Higher Interest Rates.** *Mr. Market:* Inflation is raging, which will cause the Fed to bull short-term interest rates much higher. T-bills will soon be yielding 6%. Meanwhile, my pals, the bond vigilantes, will wreak havoc across America, eventually pushing the yield on the 10-year T-note to well beyond 6%. This is my message.

*Reitnut:* Mr. Market, you're as logical as a tabby cat at the Westminster Dog Show. Why, then, has the yield on the 10-year merely bounced around, between 5.05% and 5.20%, over the past two weeks?

*Mr. Market:* There's a flight to quality. Investors will accept only T-bills and T-notes. Risk premia are increasing for every asset class, so you can't draw any inferences whatever from flat price trends on 10-year T-notes. That's where money goes when it eschews risk, but tells us nothing about other asset classes. Look at the widening *spreads!*

*Reitnut:* The jury is still out on this, Mr. Market. World equity markets have been weak, particularly speculative markets, *e.g.*, Russian stocks, Iraqi bonds and many commodities – all of which needed a comeuppance anyway. But yield spreads in the CMBS and corporate bond markets have remained as firm as a frozen scone in Newcastle. The key question isn't what's been happening in May, but what happens for the rest of the year. There is just too much noise in today's markets.

We are, of course, all concerned about inflation, but let's keep some perspective here. On May 26, the US Commerce Dept's consumer price deflator registered a year over year gain, ex energy prices, of 2.1%, which is hardly cause for bond investors to jump out of windows or the Fed to spring rabidly into interest rate overdrive. Furthermore, commodity-driven inflation, engendered by rapidly rising oil, steel and copper prices, contains the seeds of its own demise by destroying demand and softening global economies. This, of course, eventually relieves the upward pressure on interest rates. The Fed is well aware of the dangers of overshooting and, despite the hand-wringing of some, isn't dumb.<sup>1</sup> So, no, Mr. Market, I don't believe that you are discounting skyrocketing interest rates six months hence.

**b. Recession.** *Mr. Market:* (Smile)...Well, perhaps I am discounting an economic recession, both in the US and globally. And, as you know, a recession would be bad news for both equity and real estate owners despite the likelihood that it will bring about lower interest rates. *That's* why markets have been so soggy.

*Reitnut:* But none of us is able to accurately predict recessions, not even you; Mr. Samuelson accused you of discounting nine of the past four of them. So, sure, a recession is a possibility. But it's unlikely. It seems that only three weeks ago everyone was noting the synchronization of global economies, all in a growth mode. Interest rates aren't abnormally high, particularly on a real (ex inflation) basis. The signs so far point to a soft landing in the housing sector, and GDP growth, while slowing, should remain positive.

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<sup>1</sup> See the minutes of the Fed's May 10 meeting, in which it concluded that there were upside risks to inflation but also downside risks to economic growth. Inflation "warrants close monitoring," but the rise in inflation expectations "was relatively small" and "could well reverse before long." See [http://online.wsj.com/article\\_print/SB114909063137367568.html](http://online.wsj.com/article_print/SB114909063137367568.html)

Sure, consumer spending will slow over the next 12 months (everyone knows this by now, and is discounted in current prices), but businesses, which have amassed tons of cash, will pick up much of the slack.

*Mr. Market.* Horse-pucky. I'm predicting a recession.

*Reitnut:* Fine. But I will file a motion to dismiss for lack of evidence. The only thing we may reasonably conclude at the present is that investors are becoming more cautious, driving up required investment returns.

**c. Rising Cap Rates.** *Mr. Market:* Cap rates will soon be rising, and that's the reason for both the sleazy action in REIT stock prices during the month of May and the large NAV discounts even in such quality names as Avalon Bay, General Growth, and Host. If I am wrong about this, then why aren't private investors swooping in to snarf up the shares of these companies at such discounted prices?

*Reitnut:* Perhaps cap rates will, indeed, firm, but it's not likely that they will rise meaningfully. Certainly we have little evidence of rising cap rates, despite a significant rise in long-term interest rates that began at the end of March – and increases in short-term interest rates have been occurring since well before then. These increases in rates have been able to move the cap rate needle only ever so slightly, in some sectors of retail dependent upon leveraged buyers and in some apartment markets where the condo converters have gone fishin' and no longer are bidding for assets. Listen to what Real Capital Analytics (RCA) says about cap rates:

“Despite increasing interest rates, cap rates continued to decline for offices and industrial properties and were up only modestly for retail properties. However, cap rates in the apartment sector appear to be more sensitive to rising rates and have risen nearly 20 bps on average. Overall, relative to increases in Treasury rates this year, cap rates have proven to be resilient.”<sup>2</sup> RCA goes on to note that interest rates are less of a factor for unlevered buyers such as pension funds, and that prospective improvements in occupancy and rental rates are largely offsetting the negative influences of rising interest rates.

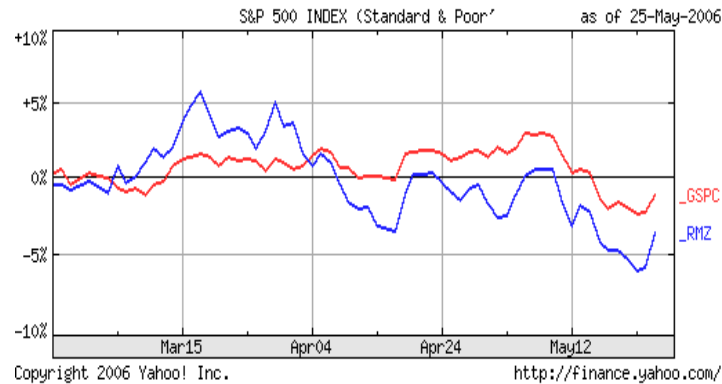
The primary driver of higher cap rates, under present economic circumstances, would be significantly higher interest rates over the next 6-12 months. But, with liquidity being slowly drained from global markets by higher interest rates, it is much more likely that interest rates will eventually top out, perhaps in the second half of this year. And, if investors are, indeed, becoming more risk-averse, why wouldn't a greater desire for stable cash flows translate into lower, not higher, cap rates?

**d. More Competition.** *Mr. Market:* Ah, but perhaps investors will no longer want to buy commercial real estate, as they will soon decide that other asset classes are relatively more desirable. This phenomenon occurred in 1998-1999, when investments other than commercial real estate offered more compelling returns. This can happen again.

*Reitnut:* There is no sign of this occurring, either in the private real estate markets or in the broader equities markets. Rather, REIT stocks have been trashed for no other reason than traders (perhaps investors also) are raising cash; this is occurring in *all* equities markets. The following chart shows an unusually high correlation over the past three months between the S&P 500 index and the MSCI US REIT index:

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<sup>2</sup> Real Capital Analytics, May 2006, p. 3.



What this tells me is that those who determine prices on the margin have no preference for large cap stocks vs. REITs; I could show you a similar chart, comparing the Russell 2000 vs. the RMZ, and it wouldn't look much different. So, Mr. Market, with all due respect, I cannot agree with you that investors are on the brink of shifting out of commercial real estate (or REIT stocks) and into other asset classes. Again, I move to dismiss for lack of evidence.<sup>3</sup>

All right, end of debate. So let's wrap things up. It's difficult to conclude that Mr. Market is acting as Oracle, providing us with some sort of warning that commercial real estate and REIT equities should be priced significantly lower. Key assumptions for this conclusion include: We are closer to the end than to the beginning of the rise in interest rates; the US economy, while about to slow, will maintain a positive trajectory; inflation is up a bit, but not running amok (core inflation is just slightly above 2%<sup>4</sup>); and other asset classes don't offer much better risk-adjusted returns. But, if that's so, why have REIT stocks performed worse than the broader equities markets when April and May are taken together?

The answer, I think, lies in excessive investor euphoria near the end of March, which had to be worked off – although the correction has lasted longer and been deeper than I had expected – along with increased shorting of REIT stocks by hedgies and other momentum “investors.” Janet Morrissey, of Dow Jones Newswires, reported on May 22 that “the number of shares of REITs being shorted by investors rose for the third consecutive month, according to a JP Morgan Report.” Morrissey said that the study concluded that short interest, as a percentage of total equity float, increased 26 bps to 3.6% during the four weeks ending May 15, or 130 bps higher than is the normal case for all NYSE stocks.

What do I conclude from all this? Mr. Market isn't discounting higher interest rates, a recession, rising cap rates or prospective relative underperformance by REIT shares. Instead, Mr. Market has been acting like the mythic Loki, playing games, scaring away the momentum boys and other short-horizoned players. He is also merely reflecting the mood of current marginal investors, *i.e.*, they are reducing their risk tolerance a bit, and demanding higher returns from every asset class. If this is so, there's not a lot any us can do about it, but our returns will be higher going forward as a result of today's lower prices. Finally, if interest rates top out this summer, as I expect, there should be some reasonable upside in REIT stocks over the balance of the year. And some REIT stocks, for the first time this year, are looking pretty darned compelling even on a short (6-12 months) time horizon

## 2. Preferreds: Even Odd Ducks Can Swim.

I've always admired ducks; whether or not one believes in God, Creation, Intelligent Design, or none of the above, the existence of ducks, like rivers, mountains and sunsets, is one of Mother Earth's proudest

<sup>3</sup>Indeed, while REITs declined 2.8% in May, the S&P 500 fell 2.9% and the Russell 2000 tumbled 5.6%.

<sup>4</sup> See, for example, [http://www.aei.org/publications/pubID.24437.filter.all/pub\\_detail.asp](http://www.aei.org/publications/pubID.24437.filter.all/pub_detail.asp)

attributes. And, based upon my observations – not as a Cheney-type duck-hunter but as a frequent visitor to our local Westlake lake and other bodies of water throughout the US, ducks are perfectly designed creatures. Their shape and feathers allow for efficient swimming in all conditions and environments, they can travel on land, water and air, and they have few natural enemies. And, for the most part, as evidenced by their contented quacks, the merganser crowd is a very happy one.

Of course, *some* ducks are perceived as “odd” – which is defined as “deviating from what is ordinary; strange or peculiar.”<sup>5</sup> And the term “odd duck” is often applied to unusual or quixotic individuals (“he’s an odd duck”), and even to puzzling or conflicting phenomena (“our U.S. tax code is an odd duck”). A related expression is “strange bird,” *e.g.*, “Howard Dean is a strange bird.”

In recent years many REIT organizations have been issuing preferred stocks. Of course, preferreds have been widely accepted, albeit not widely followed, denizens of the investment world for many years; however, they are, in many ways, odd ducks, and *REIT* preferreds, the subject of the following discussion, are perhaps odder still. Let’s look at the reasons for their peculiarity.

Except for an even odder duck, a handful of REIT *convertible* preferreds, they do not share in a REIT’s growth – in dividends, cash flow or NAV accretion, even though they are considered “equities.” And yet the owners of these securities, unlike bond holders, aren’t creditors of the company and thus have no standing in the creditor pecking order. Preferreds, like common stocks but unlike bonds, have no maturity dates, and can theoretically remain outstanding until Armageddon (or at least until Britney Spears becomes a great-grandmother). They have fixed dividend rates, yet the dividends are not treated as interest expense and thus count towards the REIT industry’s 90% payout requirement – as Public Storage and PS Business Parks have figured out. And, though treated as “equity,” holders generally cannot vote on major corporate transactions (or even for the election of directors).

So are REIT preferreds ugly ducklings? Or just loveable odd ducks? Let’s look closer at their characteristics, first focusing on the negatives, then on the positives.

Their personality disorders may be summarized as follows: (a) they have no claim on any growth or increase in value of the company they represent; (b) as virtually all of their returns come from yield, and as they do not benefit directly from strong economic growth, they tend to be more sensitive than REIT common stocks to rising interest rates; and (c) they are “heads they win, tails you lose” investments, as there is no maturity date offering protection from secular increases in interest rates, but the company can redeem the stock in five years after issuance should interest rates fall. Other negatives:

(d) Dividends are at the Board’s discretion, and thus offer less protection than bonds should a company fall on hard times; (e) the liquidity of most REIT preferreds is almost embarrassing, *e.g.*, most of them trade no more than a few hundred or thousand shares a day, making them comparable to the Roach Motel (where you can check in but will find it difficult to check out); and (f) in a buyout or going private transaction, holders can be bypassed entirely, exposed to higher debt leverage, and otherwise treated with neglect (benign or otherwise, perhaps as the annual Christian Coalition convention might treat an unannounced visit from Teddy Kennedy).

And yet, these funny feathered creatures do boast some positive attributes: (a) yield spreads over the common stock of the same company are much wider today than has been the case in prior years – the typical REIT common yields just 4.3% today,<sup>6</sup> vs. something like 7.7% for the average preferred, *i.e.*, a 340 bps advantage; (b) preferreds are not volatile – a welcome change from our REIT common stocks these days; (c) due to the stability of REITs’ cash flows, preferred dividends are, in the vast majority of cases, very safe (even Mills will probably continue to pay its preferred dividends); and

(d) Perhaps most important of all, as prospective returns on REIT common stocks have declined due to today’s low cap rates and modest external growth opportunities, the 7 ¼ - 8 ¼% returns available on REIT

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<sup>5</sup> From [www.dictionary.com](http://www.dictionary.com)

<sup>6</sup> Per NAREIT data for equity REITs as of May 26, 2006.

preferred stocks today look a lot more competitive with REIT commons than has been the case during much of the past six years. We can get 7.6% today from Kilroy's preferreds; can we get a lot better than 8-9% total returns on its common stock over the next three years? Perhaps – but more likely not.

So are REIT preferreds worthy of inclusion in diversified portfolios? Much depends upon one's investment return expectations, a.k.a. one's "greed factor," as well as a willingness to accept liquidity that, at times, is so low as to cause even press secretary Ari Fleisher to pull his hair out (at least what's left of it). Another issue for investors might be their willingness to accept the risk of unrealized losses that could stretch out for many years should interest rates rise on a secular basis – the preferreds may trade below par value (and one's cost basis) for quite some time.

But if stable income is a prime objective, then these little guys rank right up there with bonds; indeed, their yields are higher than bonds of a similar risk profile, perhaps due to their lack of creditor status and limited liquidity. For example, Vornado has a bond (5.6% due 2/2011), which recently traded at a 94 bps spread over the comparable US Treasury note (5-year duration). But VNO's preferreds, *e.g.*, the series E, F, G, H and I all yield something like 7.2%, where their spread over the 30-year US T-bond was about 200 bps (7.20% vs. 5.17%) at May 26. Those extra 100 bps are quite attractive if one isn't terribly worried about liquidity; furthermore, a failure to collect dividends or interest payments on *either* Vornado's preferred stock *or* its bonds is as likely as Sammy learning to play the saxophone.

It is also possible to find some unusual bargains in the world of REIT preferreds. Check out non-rated issues of high quality companies, whose preferreds trade as though they are almost junk. Examples include Cousins, Kilroy, LaSalle, SL Green and Sunstone. The only reason that the SLG preferreds, for example, trade at a 7.6% yield is that they are not rated – but those who know the company would rate SLG's credit as high as that of virtually any other high-quality REIT.

For individual investors, REIT preferreds are particularly attractive. Unlike bonds, almost all are listed on the NYSE (or, in some cases the ASE). And, also unlike bonds, they can be traded in small quantities and dollar amounts, often with modest bid-ask spreads.

Of course, very few (if any) REIT investors should substitute REIT preferreds for REIT common stocks. Over any reasonable time period, *e.g.*, 3-5 years, total returns will be better on REIT commons. However, REIT preferreds are excellent complements to the fixed-income portion of investment portfolios and, for those cognizant of the peculiar risks inherent in REIT preferreds, including a lack of maturity date, perhaps even a substitute for medium-grade, long-term bonds.

REIT preferreds are odd ducks, for sure. However, like most ducks, they are normally friendly little creatures, well designed for the purposes for which they were created. I own several of them myself, and can assure you that they require no feeding and very little maintenance, while rewarding me with much more income than I get with my REIT commons – albeit at the cost of upside in dividends and capital appreciation. But *do* be aware of their oddities, and be very careful when attempting to adopt these friendly little fellows or when finding them a foster home elsewhere, *e.g.*, when you want to sell. On some days there are simply no bidders for a particular quacking odd duck.

Your humble servant,  
Ralph (Block)

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