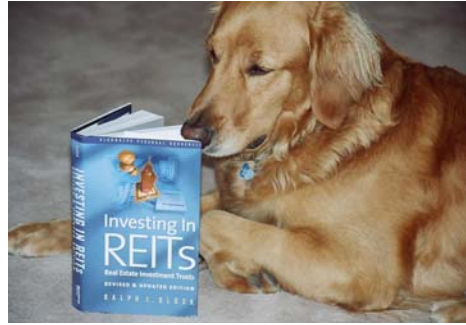


"The Essential REIT"

December 5, 2006



"Be who you are and say what you feel, because those who mind don't matter and those who matter don't mind." – Dr. Seuss

"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. Tough Questions, Few Answers.

It's been quite some time since we dropped in on that curmudgeonly creature who calls himself Reitnut. For those of you who are new to The Essential REIT, we sometimes visit with this crusty old man who's been investing in REITs since the early '70s (1970s, not 1870s). He tells us lies and whines a lot, but is sometimes entertaining. He hangs around with a fuzzy Golden Retriever named Sammy – who, frankly, knows more about REITs than Reitnut does (and is a lot nicer to be with). Wait a minute – I see them now! Sammy is trying, without success, to teach Reitnut to balance a tennis ball on his nose.

Q. Hiya, Reitnut, good morning, Sammy! I'd prefer to ask Sammy these questions, but I suspect he'll be leaving soon to rework his SL Green – Reckson spreadsheets. So you, Reitnut, will have to do.

A. Go chase your bird, Ferd. I guess it wouldn't do me any good to tell you to just go away, would it?

Q. Nope. I have to get a newsletter out, and I have some REIT questions. First of all, why haven't we seen an Essential REIT for over a month? You getting soft and lazy in your old age?

A. Don't harass me, fella. I had REITs' earnings season to contend with, followed quickly by the REIT convention in San Francisco, then Blackstone offered to buy Equity Office, after which the grand-kids were down for Thanksgiving holiday. Besides, nobody pays for this bizarre newsletter anyway, so who says I need to stick to a 3-week schedule? If you don't like it, cancel your subscription.

Q. All right, let's move on to some issues that have nothing to do with your laziness. The Blackstone buyout offer for Equity Office has, perhaps, been one of the biggest events in Reitdom this year, and

surprised most of us – not only by the size of the deal but also the price offered – an 8.5% premium in excess of where the stock closed the prior trading day. And the offer price blew away everyone's NAV estimates. On the Monday after the announcement, REIT stocks stampeded, and nobody could catch 'em. Furthermore, except for November 28, when a few strays were herded back to the barn, they've never looked back. Is the EOP deal a clear sign of irrational exuberance in REIT world?

A. That lovely term “irrational exuberance” is tough to get our arms around; both words are rather squishy, with emotional overtones. With apologies to Mr. Greenspan, I suggest that we can experience either rational *or* irrational exuberance; the latter type, of course, can give investors much worse than a bad-hair day. Its aftermath is capable of decimating an entire investment portfolio (as we saw in 2000). On the other hand, *rational* exuberance is often the precursor of less than spectacular investment returns – and that's what we're witnessing today.

And why *shouldn't* we Reitsters be exuberant? Through last Friday, December 1, equity REIT stocks have scored total returns averaging 36.9% (per NAREIT data). Every REIT pundit who dared to make a forecast for 2006 is looking for a bag to put over his (or her) head in shame. Thus it's natural for REIT investors to be a bit giddy. And, as we know from our experiences in the investment world, nothing succeeds like excess – it's so easy to put new money into investments that “are workin'.” But, of course, as Richard Russell used to say, you get your best investment returns when you buy when your palms are sweaty and your stomach churns.

But none of this means that the exuberance with which investors are buying REIT stocks today is irrational; indeed, there are some *rational* (as well as quasi-rational) reasons for these stocks to be cavorting like Norwegians at the first sign of summer. These include:

a. Greater Capital Flows and Higher NAV Assumptions. As evidenced by Blackstone's bid for Equity Office Properties, there is a growing recognition by REIT investors that the pools of private equity capital interested in commercial real estate are much larger and deeper than we had previously thought – and, equally as important, these new investors are willing to underwrite more significant NOI growth than we've been willing to do. Whether the Blackstones, *et al* can generate the kinds of returns they are promising their investors won't, of course, be known except with hindsight; however, today's reality is that Blackstone, which is certainly no country bumpkin, is willing to accept an economic cap rate of about 4.5% for EOP's mixed bag of assets.

Moreover, the Icahn over-call for Reckson (regardless of its rejection), the sale by Boston Properties of 5 Times Square for close to \$1,200/ft and “Vino's” acquisition of a Midtown Manhattan office property for \$1,000/ft are additional new data points that REIT investors are factoring into their REIT stock valuation spreadsheets, and are pushing up estimated NAVs. The bottom line is that REIT investors are now working off of greater capital inflow assumptions, slightly lower cap rates (at least for some properties and locations) and higher NAV estimates.

b. Takeover Premiums. Aside from the valuation issue, Reitsters are now realizing that, as long as the flow of capital into private equity funds continues at present levels, there is no REIT that's immune from a takeover offer. After all, using the Willie Sutton Theory (he robbed banks because “that's where the money is”), private equity that wants to own more commercial real estate is haunting the streets of Reitville because that's where the property is. And, due to private equity's ability to use much more leverage than public REITs can, bullish private investors can justify paying some very fancy prices for securitized real estate. And so, as all REITs are now, theoretically, in play, some opportunistic investors are willing to pay modest takeover premiums – at least for now. This is an unquantifiable but real factor in today's REIT stock prices, and who's to say that yet another deal won't be served up by year-end bonus time?

c. “Cover Your Shorts.” A technical, rather than rational or irrational, reason for REIT stocks' performance relates to what I refer to as the “Brilliant Man Syndrome.” Students of investment history know that (i) very bright people are often attracted to the investment world, (ii) these bright people often make lots of money in one particular corner within such world, (iii) they are then showered with affection, attention and capital, causing many of them to believe they are geniuses, which in turn causes them to

move with boldness into places well outside of their familiar domain, whereupon (iv) they get their butts kicked in. The Brilliant Man Syndrome has spawned hundreds of hedge funds, many of whose operators believe themselves to be demi-gods.

Accordingly, smart fellows such as Doug Kass and other “Masters of Macro” have been vocal short-sellers of REIT stocks pretty much all year. Perhaps their basic error has been to ignore the fundamental changes driving the pricing of commercial real estate today. Whether or not they *now* realize the error of their ways, they are experiencing great pain; perhaps many of them are now attempting, like the guy caught in the wrong woman’s apartment, to cover their shorts. Thus short covering by hedgies may be a reason (perhaps rational) for REIT stocks’ strong performance this year.

d. *The Money’s Gotta Go Somewhere.* A purely technical, albeit important, reason for the run has been the simple fact that there are many REIT-dedicated investors who need to keep up with (and hope to surpass) their benchmarks; failure to do so may result in horrendous consequences, *i.e.*, a year-end bonus of as little as a half a million bucks. So when a huge REIT like EOP gets a buyout offer, these guys don’t take the money and put it in Google or even in money market funds; they buy other REIT stocks, pushing prices higher.

So, my friend, the bottom line is that the current exuberance of REIT investors can be explained by reasons that don’t require a conclusion of irrationality. Of course, that’s not to deny that REIT shares are pricey in relationship to past standards (they certainly are), nor to claim that the assumptions that are inherent in today’s prices are not aggressive (they are). But irrational? No – at least not quite yet.

Q. OK, Reitnut, you told me more than I ever wanted to know about the reasons for the current REIT euphoria (such as it is). But let’s now move on to another important – and very related – issue. Is commercial real estate, to which REIT stocks are tied today like SL Green is to Manhattan, excessively valued?

A. Ha, ha! Surely you jest! Neither I nor anyone else can answer your question. It’s like asking, “Where will Carl Ichan’s next foray take him?” Or, “How long is a string?” Nevertheless, I have attempted an answer, of sorts, in an article I wrote for an upcoming issue (February 2007) of ULI’s Urban Land Magazine, so I suggest you take a look at that when you have nothing better to do.

Q. Well, since nobody knows the answer anyway, why don’t you give me a short response, in 250 words or less, which I promise to ignore? I’ll give you a nickel for your assessment..

A. Well, you get what you pay for. I believe that, on the basis of prices that prevail today for commercial real estate (and I admit to gross generalization), investors in this asset class are expecting an average annual unlevered investment return over the next five years of about 7.5%. This is based upon an average initial cap rate of about 6%, net operating income growth somewhat above historic norms, *e.g.*, above 3%, and only a modest increase in terminal cap rates. While these assumptions for NOI growth and terminal caps are perhaps aggressive, they are not outrageously so.

If unlevered real estate buyers can truly obtain IRRs of 7.5%, is that sufficiently “reasonable” to allow us to conclude that real estate is fairly priced today? Since I am limited in my word count, let me say only this: The answer to this question depends upon two key issues: (a) whether 7.5% is acceptable, *i.e.*, should the typical buyer be content with it, and (b) what kinds of investment returns are available elsewhere, and what kinds of risks must be taken to get them.

Forecasting returns on equities over the next five years is as difficult as predicting Sammy’s next bark, and the exercise is as futile as trying to understand the intricacies of string theory.¹ However, my personal view, for reasons expressed in the ULI article, is that returns on equities will amount to about 8 - 9% annually over the next five years. And bonds (intermediate-term, investment-grade corporates) yield 6%.

¹ For those who enjoy hurting their brains, see <http://superstringtheory.com/>

Commercial real estate is less risky than equities, but more risky than bonds. So, if we can get 8.5% on equities and 6% on bonds, would we take 7.5% on commercial real estate? Seems about right to me.

Q. Now that we're nearing year-end, I get a lot of questions about rebalancing of portfolios. What, in your view, is the "right" allocation to commercial real estate or REIT stocks?

A. Oh, no, not *that* issue again! What, you want me to write another book? Perhaps we can entitle it, "Search for the Holy Grail – Part II." Let me just make a couple of points. First, giving some credence to historical statistics, we may conclude that REIT stocks will enjoy low correlations with other asset classes. Their cash flows and income streams are, in large part, derived from long-term leases which are contractual commitments; accordingly, their cash flows are more stable and predictable than those of non-REIT companies.

They dividend out more of their cash flows than non-REITs, which reduces the risk of bad capital allocation decisions. Furthermore, Ibbotson Associates has noted, in a famous study several years ago, that adding a 20% REIT component to a diversified investment portfolio has goosed investment yields by up to 1.2%, while also reducing volatility.² David Swensen, who has guided Yale University's investment fund to a 16% average annual return over the past 21 years, has recently recommended a 20% allocation to REIT stocks.³

Bernard Winograd, CEO of Prudential Investment Management, recently stated, in "Real Estate Portfolio – REITs and Retirement," pp. 22-23, "...the standard asset allocation modeling techniques historically have recommended very large allocations that nobody ever approached. Asset modeling might tell you that, 20 percent, 30 percent or even more might be wisely invested in real estate. However, the problem is that it's impractical, especially for the larger funds." But it's not impractical for most REIT investors.

With those diversification benefits and other advantages, backed up by the Ibbotson study and Mr. Swensen's recommendation, it would seem that the burden of proof would weigh heavily upon anyone advocating a REIT/commercial real estate allocation of less than 20%. And most investors, unfortunately for them, are well below that level. So, when your clients rebalance next month, perhaps they ought to increase their REIT allocations and buy more REIT stocks, not liquidate them.

Q. But isn't this a bad time to own REIT stocks, due to their huge run and general priciness?

A. Ha! We all fall into the market-timing trap; it seems so easy, and little work is required. Just add water. Or, we can simply consult historical relationships – which will continue to apply in the future, right? Wrong. There are no wealthy market-timers, but there are many who are humble. Besides, didn't we already conclude that commercial real estate, at worst, is only slightly expensive today? And what, pray tell, is cheap? Oil? Gold? Equities? Tech stocks? T-notes? Old Nehru jackets?

Q. Let's change the subject, Reitnut. There has been a fair amount of buzz in Reitville recently about the wisdom of REITs providing guidance to their investors. Specifically, some REIT executives have noted, privately, that providing guidance is disruptive to their business, and provides no useful information to analysts or investors. What do *you* think?

A. Guidance does, indeed, present problems for REIT executives. But the problems relate to forecasting "funds from operations" (FFO), and are not inherent in the concept of guidance itself. FFO doesn't tell us very much about how a REIT's properties have performed or how the REIT has created value – or not. FFO, as the concept has evolved, is dependent upon too many moving parts, many of which are not terribly relevant for those investors with time horizons beyond 60 days.

² See, for example, http://www.rebuz.com/research02/0502/ibbotson_finds_reits_improve.htm See also the interview with Mr. Ibbotson, in NAREIT's "Real Estate Portfolio – REITs and Retirement," p. 14.

³ See the interview of Mr. Swensen by National Public Radio, at <http://www.npr.org/templates/story/story.php?storyId=6203264>

FFO numbers are just too noisy. They are often dependent upon interest rate changes (which are inherently unpredictable), lease termination fees and other non-rental income (which is as bumpy as a toad's back), asset sales (which often causes FFO dilution but may significantly increase shareholder value), property acquisitions (which may goose FFO but destroy shareholder value if bought at too rich a price or is otherwise a bad investment), preferred stock redemptions and refinancings (which create FFO charges that are relevant to nobody), and accounting pronouncements such as SFAS #141 and its ilk (which not even the accountants understand).

So how can a REIT management team possibly issue accurate and meaningful guidance when having to take all of these unpredictable irrelevancies into account? Simply put, it cannot. If it tries to do so, it may place undue importance upon FFO, an inherently flawed concept (as Mike Kirby likes to say), while perhaps also placing too much importance on "FFO dilution" and not enough on long-term value creation. Indeed, NAV and dividend growth, over time, should be more important to REIT management teams than FFO growth; providing FFO guidance only goads investors to place too much importance upon the wrong set of numbers.

But almost all REITs issue FFO guidance (two refuseniks are Public Storage and Vornado), and ending it will make some investors and analysts angrier than a pack of Wolverine football fans. But end it they should. That's not to say, however, that a REIT's management team must refuse to issue any guidance at all. Indeed, providing zero guidance could increase, rather than decrease, undue pressure on management – analysts and investors would continually badger the REIT executives, attempting to lure them with a carrot or brow-beat them with a stick into selectively disclosing some material information concerning the direction of their business.

Here's a modest proposal. Why shouldn't REIT management teams continue to provide guidance – but only on the topic of property operations and little else? Executives could express their views on property markets, including expected rates of job growth, vacancy levels, supply and other exogenous factors, and then make some general assumptions about the REIT's own properties and their performance over the balance of the year, *e.g.*, occupancy levels, same-store rental growth, property expenses, development stabilizations, etc. Investors could then get a handle on the REIT's prospective internal NOI growth, based upon the assumptions of those best qualified to forecast this – the REIT's management team – and can then make their own estimates of *external* cash flow growth from acquisitions and new developments, levels of asset management fees, NAV accretion, and such.

Q. But will anyone listen to your proposal, Reitnut?

A. Not a chance. But let's not worry about it. Sammy's got a date at the park, and he still hasn't passed his California driving test. So, I need to get him over there.

I wish each of you an excellent Holiday Season – and, if I don't get another issue out by late December, a splendid and healthy New Year!

Best regards,
Ralph (Block)

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