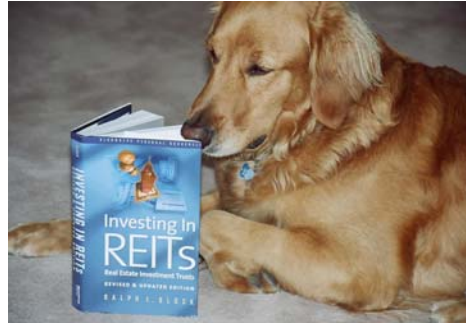


“The Essential REIT”

January 12, 2007



“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. “Pssst...Wanna Buy a Forecast?”

Investment prognostications may not be “obscene,” as that term has been defined from time to time by the US Supreme Court, but we should be careful about exposing small children and other innocents to market forecasts. I suspect that more investors have blown themselves up by relying upon the bold proclamations of so-called “experts” than from any other cause. The investment world can be more dangerous than a hungry Tasmanian devil, and it’s foolish to pay heed to some bozo who claims to know what’s going to occur over the next 12 months in the economy or the financial markets.



Even the best and the brightest are foiled by too many moving parts, which interact in strange and mysterious ways. Even if we get most of the “elements” of a trend exactly right, forecasts will still go wrong. Just ask the economists, who are reasonably bright fellows and who generally work pretty hard. They get paid for making forecasts, and they still cannot get it right consistently (and maybe not even most of the time). And yet we still make and read forecasts, perhaps because they are often entertaining. A

more psychological explanation was offered by the inimitable James Grant in Thursday's WSJ. Said he, on the topic of predicting interest rates, "The ritual lives on because people crave certainty...." Perhaps the best that can be said for investment forecasts is that, if the assumptions behind them are adequately disclosed, we might learn something about the intelligence – or lack thereof – of the forecaster.

a. 2006 – With the Benefit of Hindsight. With those important caveats out of the way, let's now prognosticate. With your permission, I would like to begin with a quick rehash of what happened last year. While past is never, of course, prologue, we should try to understand what happened previously – if for no other reason than to help us guess whether prior trends will remain in place and drive similar investment results. Those who understood why REIT stocks were strong in 2004 and 2005 weren't fooled by Barron's and other Cassandra's into dumping their shares in January 2006.

To put it bluntly, REIT stocks were moving like cheetahs on steroids in 2006, blowing away everyone's forecasts. According to NAREIT data, equity REITs scored an average total return of 35.1% last year, its sixth best year ever, and only 207 bps below the second best finish (in 2003). For the five years ending December, 2006, equity REITs have delivered an average annual total return of 23.2%. **HOO-WAH!!!** We know that this rate of return cannot continue, so that's not the point. The issue is what caused the pundits to blow it so badly last year – or, to put it another way, why were the performance numbers so awesome?

There were, I think, two irresistible forces – which are interrelated. One was the acceleration of the REIT privatization mania, in which private equity funds have, like Mafiosi dons, been skulking around Reitville for the past couple of years, liking what they see, and making too-good-to-refuse offers to REIT organizations. These offers have, in most cases, been kindly received by Dudley Do-Right boards of directors and REIT executives, some of whom may be thinking that today's low cap rates are too good to be sustainable (or perhaps are just tired of being kind and courteous to outside shareholders, analysts and regulatory beasties).

So REITs have been going private with wild abandon, and the trend was capped off by Blackstone's \$36 billion offer for Equity Office last November (which, as rumors have it, may be topped by another group of voracious bidders). But it hasn't been so much the *number* of deals that's been driving REIT stock prices into the ionosphere, but rather the premiums being paid above estimated NAVs, *e.g.*, Blackstone paid an 8.5% premium over EOP's prior closing stock price, but everyone was "sure" that the stock had then been trading at well over its NAV.

So, much of the spectacular performance of REIT shares last year was due simply to investors' realization that the NAV assumptions that investors and most analysts had been using were atrociously low. As REIT stocks tend to trade within a band – albeit sometimes wide – surrounding NAV (and as most REIT boards of directors are now willing to entertain buyout offers), significant upward revisions to NAV estimates have, quite logically, pushed REIT prices relentlessly higher and caused the shorts unbearable pain.

All of which gets us to the second, but quite related, point. Why were estimated NAVs "too low?" Answer: Because REIT investors underestimated the voracious hunger for commercial real estate assets by major pension plans and other institutions in 2006. As the laws of supply and demand have not yet been repealed, this desire to add to real estate allocations has driven down cap rates and pushed up valuations much more than expected. We can, perhaps, see this phenomenon at work most clearly in midtown Manhattan, where nominal cap rates for reasonably good quality office buildings are south of the mid-4s, and the "price per pound" (sq.ft.) has levitated into the quadruple digits.¹

There are two possibilities here. Buyers are either: (a) willing to accept lower internal rates of return (IRRs) than in years past, *i.e.*, something like 7.5%, unleveraged, for quality product, or (b) are making some very aggressive and unrealistic assumptions about net operating income growth over the next several years. While we won't know except with hindsight, we can at least make the claim with a straight face that

¹ Buyers of quality midtown Manhattan office properties, we learned last year, are routinely willing to pay over \$1,000 per sq. ft., even when near-term lease rollover opportunities are limited.

the right answer is (a), not (b); indeed, several factors, as noted below, suggest that today's buyers can, indeed, obtain 7.5% IRRs despite having to swallow some pretty skinny first year yields. And those types of investment returns are not unreasonable when viewed in the context of yields available on bonds today and prospective returns from equities.

So last year's modestly upbeat forecasters, including yours truly,² won many battles, but badly lost the war. We got the space markets right (steady improvement in virtually all sectors), and made reasonably good calls on the direction of interest rates (the Fed would take a break in the second half of '06, while the long bond's yield would be relatively flat). The economy wasn't trashed by oil prices, which, by year-end, were flatter than road kill on a busy Texas highway. Also, as suspected, the end of the housing mania crimped spending and put consumers in a foul mood – but hasn't trashed GDP growth, which is still running at a respectable pace of somewhere close to 3%.³

Good space markets, flat interest rates, decelerating inflation, and a moderate-growth economy are ideal for investors in commercial real estate (and, of course, REIT stocks). So, those who guessed correctly that those conditions would prevail in 2006 would logically have assumed total returns for REIT stocks at something like 12-14%, *at best* – but 35%? No way! So we forecasters missed the most important drivers of all: Significant *undervaluation* at the end of '05 (albeit with hindsight), and the willingness of property buyers to accept cap rates and IRRs even lower than those which prevailed at the end of the prior year. Forecasting is a very humbling endeavor.

b. Moving On to 2007.... Let's begin our Sisyphean forecasting task⁴ by looking at valuation levels at the end of 2006. I don't know about you, but it's my belief that Green Street Advisors is the very best REIT research firm in existence, particularly with NAV estimates – so I will use their NAV numbers. At year-end 2006, the average equity REIT was trading at an NAV premium of about 7%, which is very much in line with the average going back to the beginning of the modern REIT era. So REIT stocks have not been trading at bizarre prices relative to commercial real estate.

But this, of course, begs the question. Perhaps commercial real estate prices were “too rich” – the term suggests some kind of gross chocolate dessert at a midtown Manhattan eatery – at the end of last year. Of course, we cannot know this except with hindsight. However, investors who buy BBB+ bonds are getting yields of just over 6%, and we can perhaps assume, with some reason, that equity investors are likely, given today's reasonable valuations and the likelihood of slowing profit growth and topping profit margins, to reap returns of something like 8-9%, including dividends. Let's also assume that buyers of quality commercial real estate can get unlevered returns of something like 7-8%. Given the relative levels of risk, it doesn't seem as though commercial real estate is being mispriced today, or that those who are buying at current prices are in need of a frontal lobotomy.

So commercial real estate and REIT stocks were fairly priced going into 2007. What else can we boldly assume? The economic data coming out of Washington puffs up the bond bulls one day, but rains on their parade the next. Employment growth is up, but the manufacturing index is down. Oil prices and other commodities are down, but wage costs are up. It appears that home price declines will bottom out this year and inventories are flattening – but homebuilders' write-offs continue, and funny money mortgages have yet to come home to roost. Stock market performance suggests strength, but we've got an inverted yield curve. Consumers haven't shut down and their net worths are increasing – but auto sales have been weak, and they are very tight-fisted. Businesses are hiring, but slowly, and are not boosting dividend payments.

If this schizophrenic behavior continues all year, space markets should remain reasonably healthy, but leasing will be a bit tougher and rental rate growth will slow a bit, particularly as new supply begins to bite in some markets and sectors later this year. Employment growth will moderate, to perhaps 1% this year.

² My forecast was a 9% total return for 2006. For shame!

³ Some believe that Americans are, on the whole, spoiled brats and ungrateful for their blessings, but that's another story entirely and well outside the purview of this humble newsletter.

⁴ Remember the Myth of Sisyphus? He was that poor guy who was condemned to forever roll a large rock up a steep hill, only to watch it roll back down again – and again, and again and again.

The prospects of slowing NOI growth will put mild upward pressure on cap rates in some sectors, but investment returns will be satisfactory. And, thanks to respectable NOI growth, REIT NAV estimates will rise 4-6% by the end of the year. Interest rates will be sticky, which will neither goose nor trash REIT stock prices.

Should the economy become weaker than anticipated, however, perhaps due to a downward spiral in home prices or some exogenous geopolitical event, the Fed has lots of room to cut interest rates; this will tend to offset any negative effects upon commercial real estate prices that might otherwise be inflicted by downward revisions in occupancy and NOI growth expectations. And, should oil prices continue to trade in the low \$50s, US consumers will enjoy a stealth tax cut in the form of lower gasoline and home heating costs, which will goose consumer spending. (A collapse in oil prices, of course, would toss all forecasts awry, but that's not likely to happen, despite the barfing of oil futures by speculators early this year).

Finally, neither equities nor bond markets are apt to provide any stiffer competition for commercial real estate than they have thus far, and so we won't have to worry about H. Ross Perot's "giant sucking sound" of money coming out of commercial real estate and going into other asset classes. Indeed, the only sucking sound we're hearing so far this year is coming from the bottom of the oil barrel.

Add it all up, and there is no reason to expect significant price appreciation or depreciation in REIT equities in '07. They began this year with an average dividend yield of a bit over 3.5%, so we can start there. Let's add something like 4-6% in average NAV growth, due to rising NOI, in most markets and sectors, being capped at slightly higher cap rates, and using REITs' normal debt leverage. As NAV premiums were reasonable at the end of last year (right in line with historical averages), we can also assume no expansion or contraction in NAV premiums or P/AFFO multiples. So it's difficult to justify an off-the-wall forecast that would make me a hero or a goat. My guess? The average annual total return for equity REITs in 2007 will be 8%. And anyone who'd be unhappy with that is either ignorant or a fool.

c. Other Guessing Games. As long as I'm taking the risk that the small limb I've crawled out onto will be chopped off, I'll hazard a few more guesses that will probably bite me in the butt (to badly mix metaphors). Let's begin with sectors.

I think the hotel REITs will have a much better year in '07. 2006 was awfully good (+28.2), but was less than scintillating when compared with the return for equity REITs of 35.1% (sometimes the relative performance game makes me want to toss my cookies). I think the hotel guys will beat the benchmarks this year; per share AFFO growth will be splendid, over 20% in many cases, and most of these stocks still trade below NAV estimates. I'd focus, however, on the likes of HST and SHO, which own upper upscale and even luxury assets, which will be more resistant to competition from increasing supply. *Caveat:* Last year I also predicted that hotels would outperform, so take my enthusiasm with more than a few grains of salt.

The mall REITs were another underperformer last year, and they should, at the least, revert to the mean in '07. This sector delivered a total return of "just" 23.8% in 2006, although this is a bit misleading as it includes one of the REIT villains of all time, Mills Corp – which fell 50.6% last year and thus dragged down mall sector performance.⁵ After several years of outperformance, investors fretted about the prospects of a major cutback in consumer spending (due to the single-family home debacle and high energy costs), and thus assumed that space leasing and rent growth would slow, occupancy would climb, and bankruptcies would proliferate.

Little of that happened. Reports of the death of the American consumer are always exaggerated, and Holiday Season spending, while muted vs. some prior years, was still respectable. There will always be winners and losers in retail, but the best mall REITs, *e.g.*, General Growth, Macerich, Simon and Taubman, will always find a way to limit exposure to the turkeys while ferreting out the best retailers and putting them into their malls.

⁵ Mills was an accident waiting to happen, and it's surprising how many investment pros were fooled by the Mills management team.

Furthermore, cap rates haven't fallen as much for malls as for many other sectors, so there is less risk of a back-up; also, institutions are perhaps underweighted in malls, given that most of them are held by REIT organizations. Meanwhile, NOI growth will remain respectable (as much as 3%), and AFFO growth, at least for the best-situated mall REITs (those focusing on the higher-end consumer), will range from the high single-digits to the low double-digits this year and next – well ahead of their strip center peers. Finally, if one believes Green Street's estimates (which are generally very accurate), most of these stocks are trading at only modest NAV premiums – at least they were when I began to write this newsletter on Monday. Those who dumped mall REITs last year will buy 'em back this year, especially if oil prices continue to look like Charles Atlas' 98-pound weaklings.

Second caveat: I am assuming, in my bullish calls on the hotel and mall sectors, that the housing market doesn't get whacked so badly that consumers decide not to travel or to shop. These REITs do benefit from rising consumer discretionary spending, and a sickening crash in the single-family housing market could create a nasty reverse wealth effect. However, the housing numbers now being reported are a type of curate's egg⁶ and, while there are still many housing bears, it doesn't appear that the home price decline will be terribly long or steep except in those markets where the crazies held sway for a time. However, this soft-landing forecast is based upon moderate GDP and job growth, and flattish mortgage interest rates.

I thought a lot about sectors that are likely to run out of gas but, like the Ohio State Buckeyes, have come up empty. Apartment NOI growth is likely to decelerate from last year, as job growth slows and new supply creeps into the markets, and apartment cap rates have been very aggressive and may levitate a bit as the year moves along. So, this is one sector that *may* underperform (although I continue to be enthused about owners with good assets in great locations and strong development pipelines, *e.g.*, AvalonBay and Archstone-Smith). Self-storage is another sector that may underperform, given its 589 bps outperformance last year and its rich prices vis-à-vis estimated NAVs.⁷

The incredible Privatization Wave will slow, and feckless forecasts for a total REIT industry market cap of below \$10 billion by 2009 will prove to be more than somewhat pessimistic. The low-hanging fruit was plucked in 2005-2006, and the stronger players with much greater value-creation strategies and skills, whose stocks trade (or at least *should* trade) at reasonable NAV premiums are less likely to receive Mafiosian offers (and are less likely to want to accept them). The Equity Office transaction, however it plays out, will prove to have been the high water mark for REIT privatizations. Of course, we'll see plenty of deals this year, assuming neither REIT prices nor interest rates spike, but the pace will be more leisurely and won't come with crazy premiums.

I've been asked to hazard a guess on which companies will disappear this year. This is even a more stupid game than forecasting REIT market performance. But talk's cheap, so I will proceed. Post Properties was once a blue-chip REIT, but that status ended a few years ago when prior management violated the Clint Eastwood Rule⁸ by engaging in a business strategy that required experienced they lacked – and the company fell on hard times. New management has made changes and improvements, but the company is saddled with some tough commodities markets. The stock trades at a whopping 16% NAV discount, and is a logical buyout candidate.

Everyone assumes that Maguire, and perhaps Highwoods and Crescent, in the office space, will be gone by year-end. Yet a dark horse candidate might be Kilroy Realty (KRC), which owns quality assets in very good Southern California locations, and has added significant value for shareholders over the years through

⁶ "Something which is part good, part bad; a mixed bag. The expression comes from a 19th-century cartoon in the British humor magazine 'Punch': A nervous young curate (in Britain, a junior-grade clergyman who is usually an assistant to a more senior member of the clergy) is served a bad egg while a guest at his bishop's breakfast table. Asked whether the egg is to his liking, he stammers: 'Parts of it are excellent!' From "Merriam-Webster's Dictionary of Allusions" by Elizabeth Webber and Mike Feinsilber (Merriam-Webster, Springfield, Mass., 1999)." See www.phrases.org.uk

⁷ In early 2007, the average NAV premium of the three self-storage REITs in Green Street's universe (EXR, PSA and YSI) was 18.4%.

⁸ "A man's gotta know his limitations," – from "Dirty Harry."

development projects. The Kilroy family (Johns senior and junior) still have a very large stake in the company,⁹ and perhaps they may be receptive to a liquifying event. Perhaps, too, they are tired of all the carping about Kilroy's nearly-obscene executive compensation programs – having mega-millions in the bank can go a long way towards eliminating life's persistent pests and potholes. The assets are highly desirable, and the stock trades at a modest NAV premium.

Perhaps a final candidate might be Sunstone Hotel Investors (SHO), which stepped into some nasty stuff last year. Management drew cynical smirks from investors by complaining about its stock price, then floated an equity forward issue that, while innocuous enough, evoked fears about another Patriot American fiasco. Finally, it closed out the year with a reverse flourish by missing its Q3 numbers. Last year's total return was a paltry 5.0%. But SHO's assets are of very good quality, and would make a welcome addition to the hotel portfolio of another REIT or institutional investor. RevPar growth has been excellent, and in line with such illustrious peers as Host Hotels; until the past few crazy trading days, the stock traded at an NAV discount of over 10%.¹⁰

AVB: Closing Note: A hearty congratulations to the directors, officers and employees at AvalonBay Communities on becoming the newest REIT member of the august and select group of companies in the Standard & Poor's 500. This outstanding company, under the original leadership of Dick Micheaux and Mike Meyer, and more recently under the direction of Bryce Blair and his crew,¹¹ have created huge amounts of value over the years for shareholders, including my friends, relatives and clients – and, of course, my own family. Thanks for the excellent and outstanding work over the years, guys...you well deserve recognition as one of America's leading companies and best-of-class REIT organizations!

Best regards,
Ralph (Block)

Disclosure: I and/or the firm(s) to which I provide services may from time to time have long or short positions in some or all of the stocks (if any) mentioned above. Further, this "newsletter" is not intended as a recommendation for the purchase or sale of any particular security and is not intended to be investment advice – or any other advice for that matter. The statements made in this newsletter are my own personal opinions, and do not represent the views of any other person, real or fictitious, or even the views of Sammy, my Golden Retriever. © 2007 Ralph L. Block

⁹ Over 2.2 million shares at the date of the last proxy statement, today valued at over \$175 million.

¹⁰ Disclosure: I presently own shares in SHO, but not in the other two possible buyout candidates mentioned.

¹¹ Avalon Properties and Bay Apartment Communities merged in 1998 to become AvalonBay Communities.