GREEN STREET ADVISORS

Residential REITs

Examining Financing and Development Risk

April 10, 2008 ■ DJIA 12,527 ■ RMZ 896

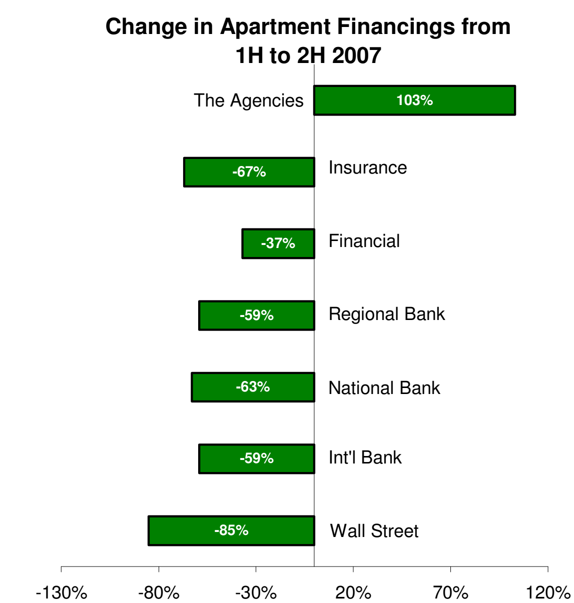
I. Overview

What began as a housing-led slowdown has morphed into a broader credit crisis and could lead to a deep and prolonged economic recession. The Fed is pulling out all the stops in its attempts to thwart a deeper downturn - cutting the fed funds rate 300 basis points since last summer and even opening up the discount window to non-reserve banks – but the economy and the debt markets remain on very shaky ground. Commercial real estate fundamentals are relatively healthy, especially for residential REITs, but this new economic environment carries an elevated level of risk. Should the economy, and as importantly, the debt markets, not right themselves by the end of next year, we could see more blood in the water, as some REITs may find themselves without access to necessary levels of capital.

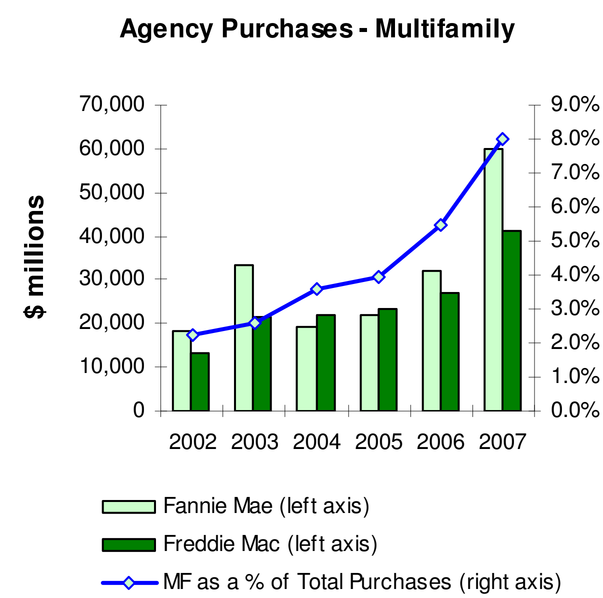
In that vein, we take a detailed look at the capital structures and funding requirements of the residential REITs in our coverage universe. **Our findings indicate that the residential REITs, even the large developers, should face little difficulty in meeting funding requirements and debt maturities in ’08. This risk becomes elevated in ’09 for certain REITs, but the continued presence of Fannie Mae and Freddie Mac (the Agencies) mitigate some of that risk.** The risk of severe fallout (e.g. bankruptcy) from the credit crunch to the residential REITs appears nil, and the crunch would have to be both deep and persistent before any of the companies in our coverage universe would be is a position where they need to raise capital in a hostile environment. Should the crunch persist, some companies such as Education Realty (EDR), American Campus (ACC), and Colonial Properties (CLP) may be in a precarious position by late ’09, but should be fine if conditions stabilize before then.

Exhibit 1 - Debt Capital Sources

Fannie Mae and Freddie Mac remain the primary source of debt capital for apartment owners, more than doubling their financing of apartment acquisitions in the second half of 2007.



Source: Real Capital Analytics.



Source: HUD, Green Street Advisors.

II. Conservative Balance Sheets Provide Some Cover

On average, the residential REITs are operating at debt to total asset ratios of about 46%, roughly inline with the other major property sectors. Because Residential REITs have relatively conservative capi-

Important disclosure on the last page.

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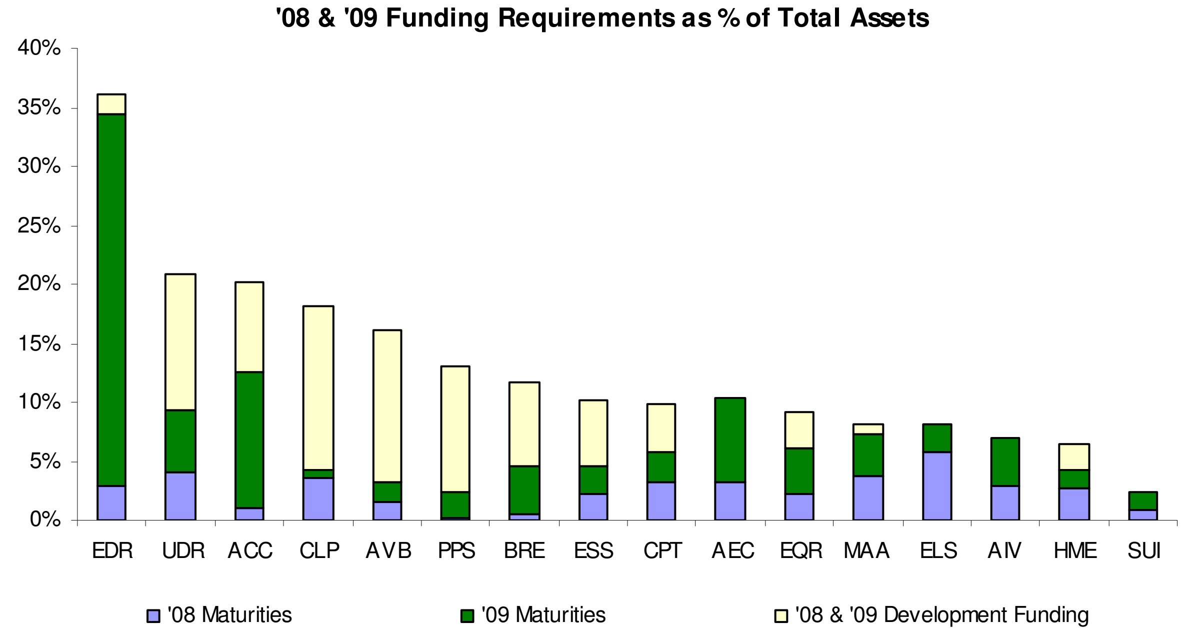
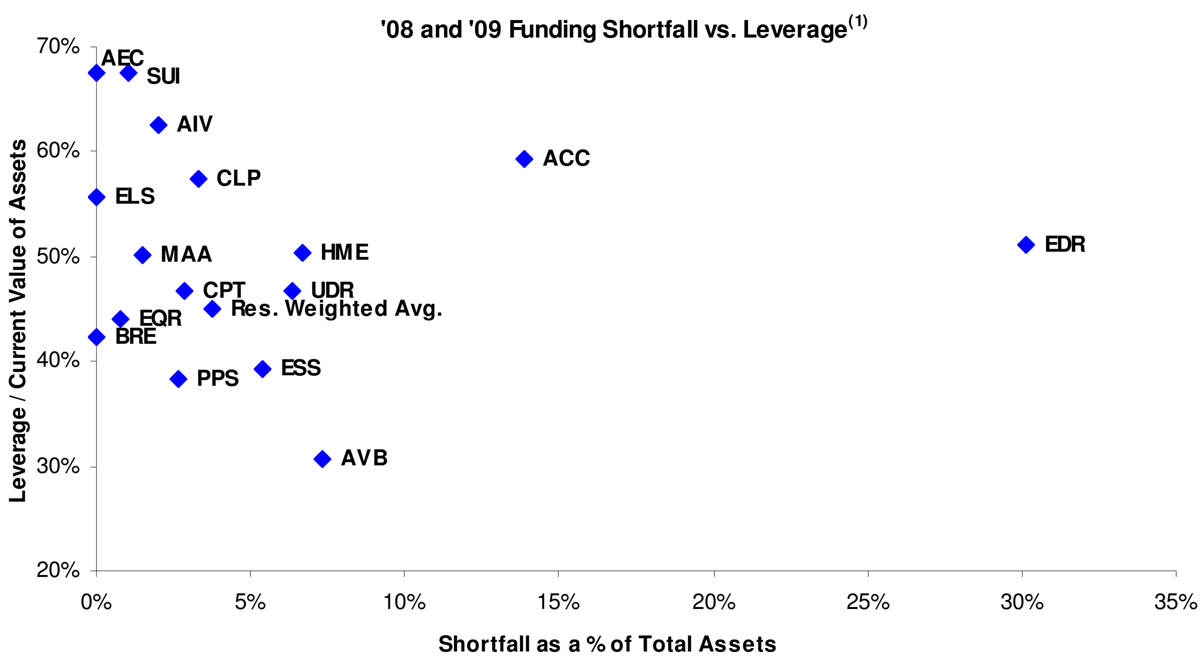
Exhibit 2 - Funding Requirements

Residential REIT funding requirements to cover debt maturities and development spending over the next two years range from 5% to 35% of assets.



To the extent a REIT has lower leverage, it may be able to cover any funding shortfall through incremental debt financing if it remains available. Otherwise, those companies experiencing shortfalls would be forced to sell assets, issue equity, or cut their dividend to fund their capital needs, with the more severe shortfalls likely to be the most costly. More details of this analysis can be found in Appendix A.



(1) Shortfall includes debt maturities, development spending, and AFFO shortfall/surplus less existing cash and line availability.

Source: Company documents, Green Street Advisors.

tal structures, tend to be sophisticated operators, have lower-risk profiles than most non-REIT borrowers, and typically have close relationships with balance sheet lenders; it is reasonable to assume that they could source additional financing in the face of tight capital markets. Residential REITs also have Fannie Mae and Freddie Mac providing liquidity (who have become the dominant source for financing – see Exhibit 1), placing them in a much better position than companies operating in other property sectors.

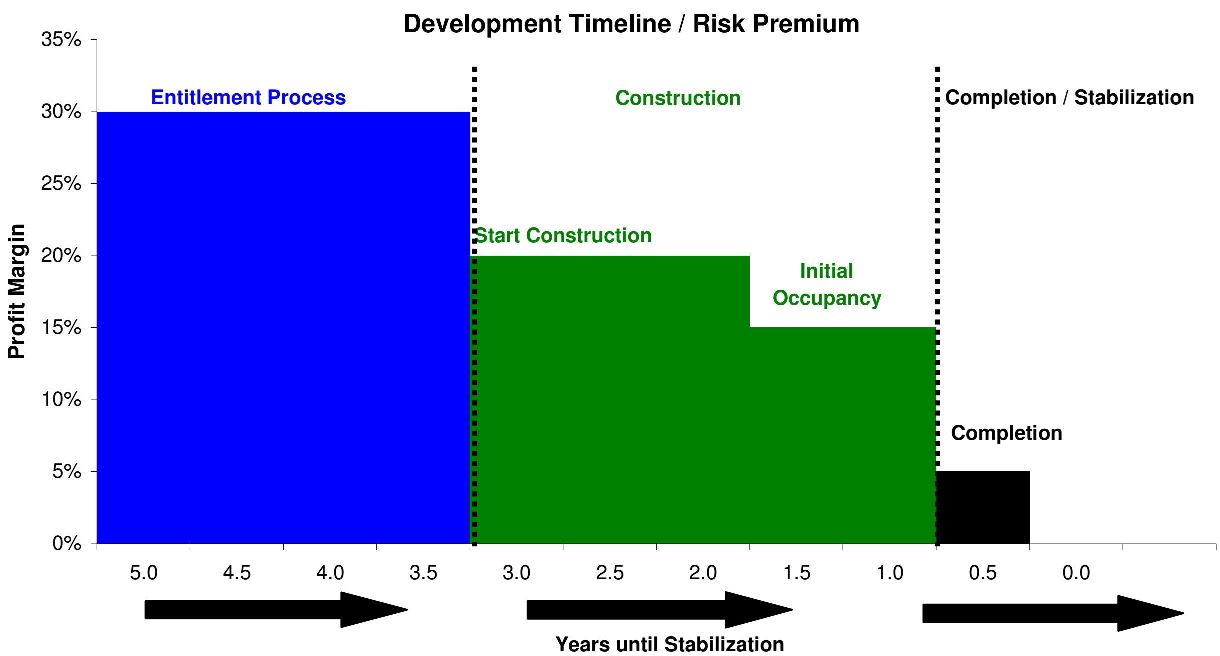
While residential REITs appear to be on fairly solid financial footing and able to access additional debt capital, the current environment still begs the question of what would happen if the credit crunch is more severe and continues longer than most observers now expect. Under this extreme scenario, most residential REITs would likely be out of harms way in '08 and throughout much of '09, as funding requirements roughly match current capacity over the next 12-15 months (see Appendix A). If financing seizes into '09, things could get dicey for several companies, and they could be forced to sell assets, issue equity, or cut their dividend to make up for the shortfall. Of all the companies in our residential coverage universe, Education Realty Trust (EDR) appears the most vulnerable to a prolonged seize-up in the debt markets, as nearly 66% of its outstanding debt comes due in 2009. The larger developers such as AvalonBay (AVB), American Campus Communities (ACC), Colonial Properties (CLP), Essex (ESS), and UDR, Inc. (UDR) also have above average exposure, but the risks appear manageable as their development funding requirements represent a much smaller percentage of total assets.

III. Development is a Riskier Business Today

Valuation Methodology Primer: Because developing properties is riskier than acquiring operating properties with proven performance, real estate market participants demand higher returns when underwriting development projects. Said differently, an investor in a development project should require a minimum development profit margin to account for the added risk of development. Therefore, an assessment of value creation from an existing development pipeline should not compare the pro forma yield on development to the yield on an acquisition, but rather the pro forma development yield to the yield on an acquisition plus an incremental spread.

Exhibit 3 - Development Risk

Below is a rough timeline for a typical "garden" apartment development and the associated risk premium above the cap rate on a comparable acquisition that should be required at each time interval. Due to the difficulties in obtaining construction financing in the current environment, developments stay riskier longer, as they need to be essentially complete and substantially leased before long-term debt can be placed.



Development – Do the numbers work when share prices are weak?

In order for a capital investment to add to firm value, its return must exceed the cost of capital commensurate with the risk of the project. For higher risk investments, such as development, the appropriate hurdle rate is materially higher than the weighted average cost of capital (WACC) for the firm. Unfortunately, the WACC for virtually every REIT has increased greatly over the last year as a result of a sizable increase in the cost of debt and equity. Against that backdrop, it is appropriate to question whether the development pipeline for any given REIT offers prospective returns that are high enough to exceed the now-elevated firm-level WACC, much less the higher hurdle rate appropriate for development. With the WACC for the average apartment REIT at about 7.5%, and return hurdles on development even higher given that company-level WACC is a weighted average combination of lower-WACC stabilized properties and higher-WACC development, there are numerous examples of REITs that are plowing money into development projects that offer a negative net present value.

Indeed, it may well be the case that the majority of REIT development projects currently stack up as value-destructive capital investments when measured by this standard. This does not mean that development is inherently a bad business, nor does it mean that REITs with large development infrastructures and projects underway should pull the plug. It does mean that development should be closely monitored and scrutinized as the next couple of years are likely to be a time when development is more likely to be a sub-optimal allocation of capital.

It wasn't too long ago when development economics looked great; how did things change so fast? The primary culprit is the bear market in REITs, but it is the more subtle message embedded in today's stock prices – cap rates are headed higher and real estate values are headed lower - that causes development to look like a money losing venture. A typical developer might contend that it is developing to a 6.5% yield at a time when cap rates are 5.5%, but REIT investors are implicitly assuming that cap rates will be closer to 6% when the development is delivered.

Most real estate executives do not think of the world this way, and they tend to dismiss this type of discussion as an academic exercise that is not particularly relevant to how a developer needs to run its business. Their argument is somewhat valid to the extent that development pipelines can't be opened and closed at a moment's notice, but the bigger point is that there are times when other capital allocations become more compelling, and the economics of share buybacks are currently far more attractive (you can buy real estate at tomorrow's discounted prices!) than the economics of development (or acquisitions for that matter). ***While a healthy debate could be had with regard to whether a given REIT should be allocating capital to any investment, what is indisputable is that if capital is to be deployed, share buybacks currently trump any other alternative.***

For valuation purposes we determine the appropriate incremental spread based on how much time remains until stabilization of the project – the longer the time to stabilization the higher the spread (as there is exposure to greater risk). The "economic" value creation of development is then discounted back using a relatively low discount rate (since development risk was already accounted for in the higher required yield).

Higher Risk Demands a Higher Spread: While we have not changed the methodology for valuing apartment REIT development pipelines, the required spreads at each time interval from completion have increased. Because financing was readily available for construction projects before the credit crunch, the main risks to development were tied to construction, lease-up, and market rent/demand. As such, once a project began leasing, its risk profile was materially reduced. In today's environment, both construction financing and permanent financing are much harder to come by and more expensive when it can be attained. As such, the risk profile of development is higher today and remains so for a longer period of time (See Exhibit 3). **This change results in an average 9% reduction to the value we assign to apartment REIT development pipelines.**

Land Values Coming Down: The availability and cost of land is another area that merits attention, particularly given the exodus of condo and single-family home developers that had routinely bid up the value of land for development. In addition, the increased difficulty in obtaining construction financing has reduced the amount of active development. While some apartment REIT management teams recently noted that prices had not yet declined, our own field work suggests they are off anywhere from 10-50% (See Appendix B). This obviously has negative ramifications for the value of land acquired over the past few years. **In mid-February, we reduced the value of land for the apartment REITs by approximately 10%, and are herein reducing values by an additional 15%.** If there is a silver lining to these reductions, it is that the difficulty in obtaining construction financing should limit the amount of new supply coming into the markets over the next couple of years – a positive for apartment fundamentals.

NAV Changes: Residential REIT NAVs, on average, **are herein reduced by just over 1% to reflect development's increased risk profile as well as the decrease to the value of land holdings discussed above.** See Exhibit 4 for NAV changes by company.

Exhibit 4 - NAV Changes

Residential REIT NAVs, on average, decline by just over 1% as a result of an increase in the risk profile of development and a decrease in the value of land holdings.

Company	Last Published	∆ in NAV - Development Risk	∆ in NAV - Reduction Land Values	Revised	∆ (%)
CLP	$34.50	$0.50	$0.75	$33.25	-3.6%
CPT	$67.25	$0.75	$0.50	$66.00	-1.9%
ACC	$28.50	$0.50	$0.00	$28.00	-1.8%
BRE	$57.25	$0.50	$0.50	$56.25	-1.7%
AVB	$121.25	$1.50	$0.50	$119.25	-1.6%
EQR	$46.50	$0.25	$0.25	$46.00	-1.1%
HME	$48.50	$0.25	$0.25	$48.00	-1.0%
UDR	$28.25	$0.25	$0.00	$28.00	-0.9%
ESS	$117.75	$0.50	$0.50	$116.75	-0.8%
AIV	$48.50	$0.00	$0.25	$48.25	-0.5%
PPS*	$48.50	$0.00	$0.00	$48.50	0.0%
ELS*	$53.00	$0.00	$0.00	$53.00	0.0%
MAA	$52.75	$0.00	$0.00	$52.75	0.0%
SUI*	$28.00	$0.00	$0.00	$28.00	0.0%
EDR	$14.75	$0.00	$0.00	$14.75	0.0%
AEC	$20.00	$0.00	$0.00	$20.00	0.0%
Weighted avg.					**-1.1%**

**Reductions to land values and/or development pipelines previously reduced per company specific research.*

IV. Creating NAV and Creating Value Are Two Different Things

It is very important to distinguish between creating NAV and creating value, the latter of which takes into account the opportunity cost of capital. For example, a development project that is targeted to deliver a 10% profit margin in an environment where a 15% margin is necessary to offset the risk would create NAV but destroy value. Said differently, development in many cases, may not cover its cost of capital even if development yields exceed cap rates. In the current apartment landscape, where NOI growth is decelerating and cap rates are rising, profit margins for development are undoubtedly coming down. As such, some developments will be value destructive capital allocation decisions, especially for projects where the underlying land was sourced in the last few years. Any analysis of development pipelines must be done on a project-by-project basis, but it is safe to say that development pipelines are worth less today than they were before the onset of the credit crunch. *A more detailed discussion of this topic is included in the green dialogue box on the adjacent page.*

V. Conclusion

The U.S. economy and the commercial real estate markets have entered into a new paradigm characterized by a higher level of uncertainty and risk. With financing much harder to come by and generally much more expensive, those companies with the most pristine balance sheets are much better positioned to weather the storm. Luckily for REIT investors, most REITs have kept fairly sound capital structures. This is especially true for the residential REITs, whose fundamentals remain relatively healthy and for whom financing is still available at a relatively attractive cost.

Despite the more favorable environment, a lack of recent transaction activity and apparently lukewarm responses from bidders on Post Properties (PPS) and a large Aimco (AIV) portfolio may forebode a further increase in apartment cap rates. Should these portfolios transact at prices below expectations, or not transact at all, this could suggest that private-market apartment values have ticked down again. Considering the stark contrast of debt availability for apartments versus the other major property sectors, investors should be wary of what this potential move implies elsewhere in REITland, where the volume of transaction data is not sufficient enough to reveal market-clearing price levels.

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Craig Leupold
Taylor Schimkat
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Appendix A ($ millions)

	Leverage					'08 Funding Requirements			'08 Funding Capacity				'08 Shortfall	
		Composition of Liabilities												
	Leverage	Secured	Un- secured	Pre- ferreds	Other	Maturities	Dev. Spending	Funding Require- ments	Remaining Line Capacity	Cash on Hand	'08 AFFO minus Dividend	'08 Total Capacity	$ Amount	% Asset Base
ACC	59%	92%	1%	0%	7%	$26	$127	$153	$193	$12	$2	$208	$0	0%
AEC	68%	75%	7%	8%	10%	$32	$0	$32	$130	$2	$0	$132	$0	0%
AIV	63%	77%	6%	10%	7%	$383	$0	$383	$606	$168	($78)	$695	$0	0%
AVB	31%	27%	60%	2%	11%	$209	$1,000	$1,209	$751	$210	$106	$1,067	($142)	1%
BRE	42%	8%	80%	8%	4%	$23	$200	$223	$620	$7	$8	$635	$0	0%
CLP	58%	24%	61%	9%	6%	$162	$375	$537	$663	$93	($37)	$719	$0	0%
CPT	47%	23%	66%	3%	8%	$238	$175	$413	$470	$1	$17	$488	$0	0%
EDR	51%	93%	0%	0%	7%	$26	$16	$42	$56	$4	($4)	$56	$0	0%
ELS	56%	77%	5%	10%	8%	$212	$0	$212	$267	$6	$66	$338	$0	0%
EQR	44%	35%	56%	2%	7%	$541	$500	$1,041	$1,400	$500	$46	$1,946	$0	0%
ESS	39%	58%	18%	14%	9%	$125	$165	$290	$151	$22	$35	$209	($81)	1%
HME	50%	88%	9%	0%	3%	$124	$50	$174	$0	$6	($16)	($10)	($184)	4%
MAA	50%	84%	0%	10%	5%	$113	$26	$139	$162	$17	$7	$187	$0	0%
PPS	38%	24%	58%	7%	10%	$5	$210	$215	$383	$12	($17)	$378	$0	0%
UDR	47%	37%	55%	4%	3%	$288	$450	$738	$600	$644	($202)	$1,042	$0	0%
SUI	68%	87%	7%	4%	2%	$16	$0	$16	$26	$5	($5)	$27	$0	0%
totals/avgs:	51%	57%	31%	6%	7%	$2,523	$3,294	$5,817	$6,479	$1,710	($70)	$8,118	($407)	0.4%

2009 (Cumulative)

		'09 Funding Requirements			'09 Funding Capacity (residual)				'09 Shortfall	
	'08 Shortfall	Maturities	Dev. Spending	Funding Require- ments	Remaining Line Capacity	Cash on Hand	'09 AFFO minus Dividend	'09 Total Capacity	$ Amount	% of Asset Base
ACC	$0	$276	$61	$337	$0	$0	$2	$2	($335)	14%
AEC	$0	$73	$0	$73	$100	$0	$2	$101	$0	0%
AIV	$0	$516	$0	$516	$313	$0	($61)	$252	($264)	2%
AVB	($142)	$232	$750	$982	$0	$0	$128	$128	($996)	7%
BRE	$0	$219	$175	$394	$413	$0	$17	$430	$0	0%
CLP	$0	$32	$275	$307	$182	$0	($30)	$152	($155)	3%
CPT	$0	$198	$125	$323	$75	$0	$33	$109	($214)	3%
EDR	$0	$285	$0	$285	$13	$0	($1)	$12	($273)	30%
ELS	$0	$86	$0	$86	$126	$0	$74	$200	$0	0%
EQR	$0	$916	$250	$1,166	$905	$0	$70	$975	($191)	1%
ESS	($81)	$130	$150	$280	$0	$0	$61	$61	($300)	5%
HME	($184)	$69	$50	$119	$0	$0	($1)	($1)	($303)	7%
MAA	$0	$106	$0	$106	$48	$0	$14	$62	($45)	1%
PPS	$0	$77	$170	$247	$162	$0	($9)	$154	($93)	3%
UDR	$0	$373	$375	$748	$305	$0	($9)	$296	($452)	6%
SUI	$0	$29	$0	$29	$11	$0	($2)	$9	($20)	1%
totals/avgs:	($407)	$3,618	$2,381	$5,998	$2,653	$0	$288	$2,941	($3,642)	5.2%

As of 12/31/07, adjusted for subsequent events that were publicly disclosed. Debt maturities and development are funded first through cash and then by the credit facility(s). Data contains company specific adjustments for construction loans, special dividends, cash in escrow, acquisitions under contract, recent financings, and proportional JV debt.

Source: Company documents, Green Street Advisors.

Appendix B - Recent Land Sales

While the apartment REITs tend to own land in more in-fill locations, and pricing has most likely not seen declines to the magnitude illustrated below, values have definitely declined as evidenced by recent home lot sales.

Date	Homebuilder	Acquirer	Lots Sold	Sales Price as a % of Pre-Sale, Impaired BV	Sales Price as a % of Estimated Original BV (a)	Deal Summary
Mar-08	CTX	JV with financial partners. CTX retains 5% ownership.	8,500	30%	21%	Combination of finished and under-development lots. Lots are located in 11 States - 50-55% are in CA and NV.
Feb-08	CTX/PHM	Private Developers	879	16%	8%-10%	JV land deal in Sacramento.
Dec-07	William Lyon Homes	Resmark Equity Partners	609	43%	30%	Lots spread throughout OC, San Diego and Ventura.
Dec-07	MHO	Metro Development and Other Partners	3,700	51%	36%	Majority of lots in FL, specifically West Palm Beach.
Nov-07	LEN	Metro Development	8,300	55%	35%	Lots spread throughout FL.
Nov-07	LEN (1)	JV with Morgan Stanley Real Estate. LEN retains 20% ownership.	11,000	40%	28%	Combination of lots and under-construction inventory. Lots are located in 8 states including CA, FL and NV.
C4Q 2007	SPF	N/A	5,900	44%	31%	Lots sale were centered in CA, AZ, NV, FL and TX.
C4Q 2007	OHB	N/A	1,400	100%	36%	Combination of lots and under-construction inventory. Lots are located in 5 states - 94% in AZ, IL and FL.
Jun-07	TOA	Wall Homes	1,200	83%	58%	Sale of Dallas operation.

(1) Due to LEN's retention of 50% voting rights in its JV with MSR, the transaction was not officially classified as a sale.

(a) Pre-sale, impaired BV is estimated at a 30% discount to original BV unless pre-impairment BV is known.

Source: Company Documents and Green Street Advisors.

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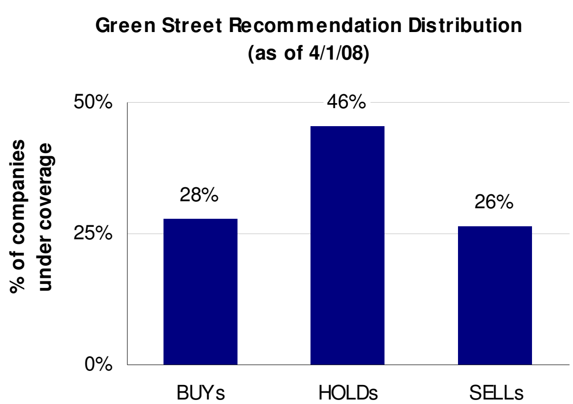

Green Street's "BUYs" have historically achieved far higher total returns than its "HOLDs", which, in turn, have outperformed its "SELLs".[1, 2]

Total Return of Green Street's Recommendations

Year (Year Ended December 31:)	Buy	Hold	Sell	NAREIT Eqty[4]
2008 YTD[3]	12.3%	11.3%	6.1%	1.4%
2007	-6.5%	-22.3%	-27.6%	-15.7%
2006	45.4%	29.9%	18.4%	35.1%
2005	26.3%	18.3%	-1.9%	12.2%
2004	42.3%	28.4%	15.6%	31.6%
2003	42.7%	37.2%	20.9%	37.1%
2002	17.7%	2.6%	1.9%	3.8%
2001	35.7%	19.1%	11.9%	13.9%
2000	53.6%	29.3%	4.4%	26.4%
1999	14.2%	-9.2%	-20.2%	-4.6%
1998	-0.6%	-15.1%	-16.4%	-17.5%
1997	37.1%	14.2%	5.8%	20.3%
1996	47.3%	30.2%	17.5%	35.3%
1995	23.6%	14.3%	-0.4%	15.3%
1994	20.5%	-0.7%	-9.3%	3.2%
1993[3]	29.4%	5.4%	6.7%	12.4%
Total Return[3]	**4137.8%**	**406.6%**	**18.4%**	**497.8%**
Annualized	**28.0%**	**11.3%**	**1.1%**	**12.5%**

1) Historical results through January 3, 2005 were independently verified by Ernst & Young, LLP. E&Y did not verify stated results subsequent to January 3, 2005. Past performance results cannot be used to predict future performance. For a complete explanation of study, see 5/9/03 report "How are We Doing?".
2) Company inclusion in the calculation of total return has been based on whether the companies were listed in the primary exhibit of Green Street's "Real Estate Securities Monthly", pg. 13-16. Beginning with May 2000, Gaming C-Corps and Hotel C-Corps, with the exception of Starwood Hotels and Homestead Village, are not included in the primary exhibit and therefore not included in the calculation of total return. Beginning with March 2003, all Hotel companies are excluded.
3) Study uses recommendations given in Green Street's "Real Estate Securities Monthly" from January 29, 1993 through April 1, 2008.
4) Not directly comparable to Green Street's performance indices because NAREIT includes more companies and uses market-cap weightings. Green Street's returns are equally-weighted averages.

Green Street will furnish upon request available investment information regarding the recommendation