Heard on the Beach
January 2, 2008

Good riddance to 2007! In addition to the fact that REITs turned in a woeful performance on the total return front in the year that just ended (-17% vs. +5% for the S&P 500), the attractiveness of their story as an investment vehicle was dimmed by extraordinary volatility, a "Beta" well above one, and the departure of a world-class real estate company (Archstone) that had grown weary of the public market's long-time reluctance to pay up for quality.

Of course, a tough year shouldn't come as a huge surprise on the heels of a seven-year run when REITs could seemingly do no wrong. In fact, the pain that REIT investors endured this last year merely forebodes a 2008 that could be even tougher for many **private-market** real estate players who thus far haven't had to acknowledge the price declines that have already occurred in the public market. Indeed, with REITs having taken the smart side of the biggest real estate deals in '07 by being sellers (via privatizations of the likes of EOP, New Plan, Archstone, etc.) at what we now know to have been peak prices, it is obvious that most REITs spent a lot less time at the punch bowl than many private-market buyers. Confirmation of this has recently come in the form of one serial buyer of REITs – Centro – that is now on life support as a result of overindulging, while other buyers of REIT-owned property, such as Harry Macklowe, are staggering. If even the relatively sober public-market players had to endure a nasty hangover in '07, the fact that the guys who closed the bar are still sleeping it off doesn't mean they're not in for a doozy of a morning after.

To gauge the severity of the pending hangover, it is insightful to turn to a helpful guidepost on real estate valuations: the spread between expected unleveraged returns (i.e. IRRs) that properties can be reasonably expected to deliver over a long holding period vs. the cost of long-term property-level debt. As is shown in the chart on the next page, this spread has shrunk to a startlingly low level. Owners of property can currently expect to receive returns that exceed mortgage rates by only 80 basis points, a spread that is only a little more than one-third what it has typically been (average = 227 bps) during the last fourteen years.

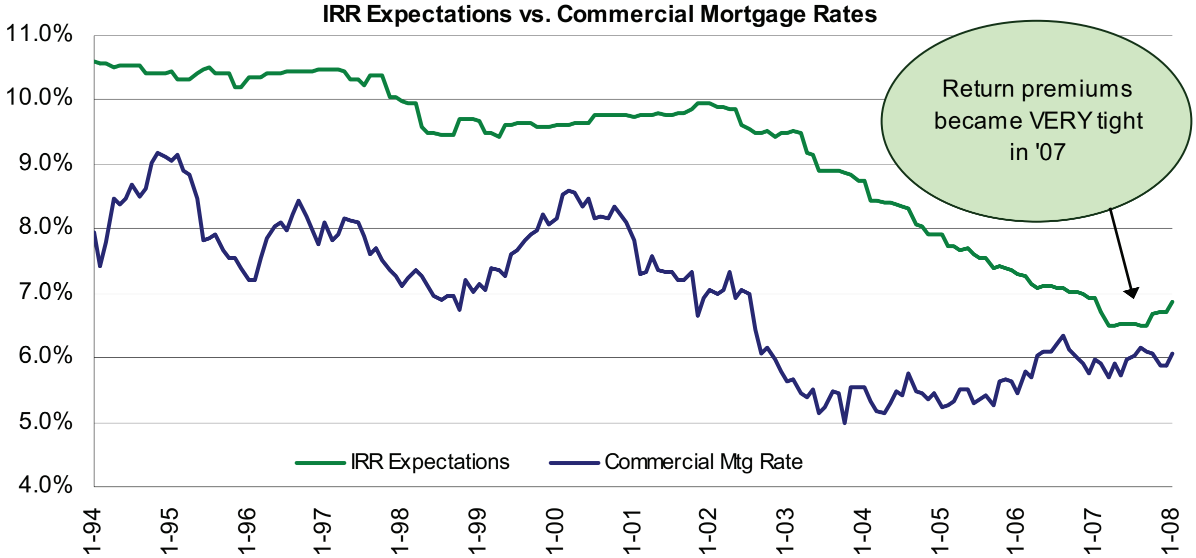
As shown on page 23, the prospective rewards to owners are particularly paltry in certain sectors, the most notable of which is office. Even assuming the economy stays healthy enough to allow office landlords to continue to rollover leases at higher rental rates and to achieve the much better-than-normal NOI growth that we are forecasting (roughly 6%/yr through 2011), office landlords can currently expect to achieve long-term returns in the "mid-6's", barely better than the return a lender can achieve by writing a well-secured loan on an office property. That gap seems way too tight[1], and it suggests that office properties are substantially over-priced relative to bonds.

How over-priced? The analysis on page 24 measures the severity of the price decline that would be necessary to bring today's tight spreads back in line with their long-term norms and, in the office sector, the answer is that values would need to drop by 24%. Property values in

[1] While initial cash yield spreads can sometimes be negative, this spread should **always** be positive, as the return to property lenders is far more secure than the projected returns for owners.

other sectors are not quite as inflated, but if spreads are to revert to historic norms, value declines through the entire commercial real estate world averaging about 20% from current levels are in order[2]. **Because we've already incorporated a modest reduction in values into our NAV estimates, this implies a peak-to-trough reduction in values of nearly 25%!**

By combining historic cap rate, intermediate growth, and inflation expectations, it is possible to approximate historic return (IRR) expectations. Normally, they substantially exceed borrowing rates, but they are now unusually tight.



Proxy for IRR expectations = economic cap rates + unusual intermediate-term growth + long-term growth (expected inflation less 110 basis points). Inflation: Philadelphia Federal Reserve survey for next ten years.

An across-the-board value reduction of this magnitude will likely strike most real estate market participants as a surprisingly nasty outcome, as conventional wisdom seems to be that the ultimate correction will be in the 5-15% ballpark once the transactions market perks back up. There are, of course, legitimate reasons why the drop need not be as severe as shown in this analysis, the biggest of which are that increased acceptance of real estate as an asset class should have caused return premiums to narrow over the last fourteen years and the queue of institutional money searching for a home in real estate is apparently still lengthy. Gauging the extent to which these issues should impact pricing is a guessing game, but they could be at least partially offset by two very real downside risks that are not factored into the analysis: 1) a potential recession leaves more downside risk than upside potential for current projections of intermediate-term NOI growth; and 2) neither corrections nor booms ever seem to stop at fair value. It is probably the case that the conclusion of the analysis is too harsh, but **a decline in private-market values of 15% or more may well be in the cards for '08 and beyond.**

(text continued on page 24)

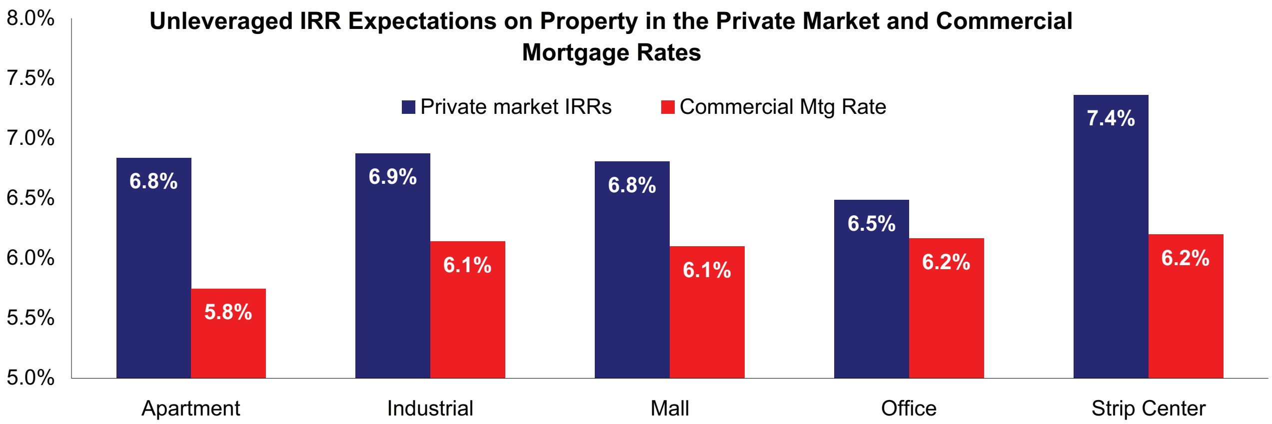
---

[2] The methodology employed to reach the conclusion that all property sectors are over-priced to roughly the same degree could be debated. By way of example, the long-term premium that has been accorded by office is smaller than what has been accorded elsewhere, so, despite the fact that premiums in office are smaller than anywhere else, the requisite price correction is roughly the same magnitude. If, by contrast, each of the property sectors should offer comparable returns, office values have much further to fall, while apartments and strip retail would fare better than shown.

The total returns that real estate investors are likely to achieve can be assessed by combining the initial yield and growth forecasts shown below.

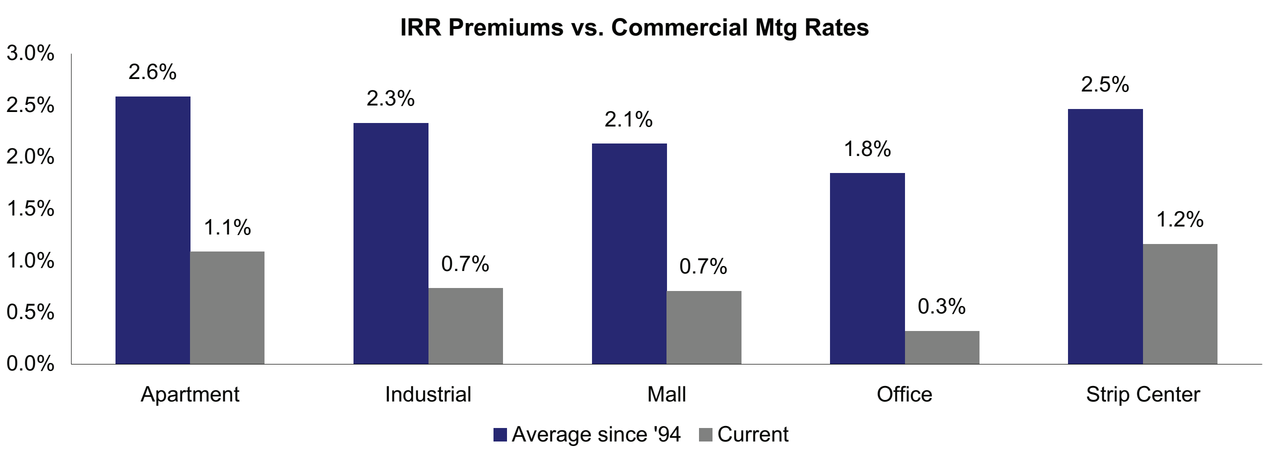
	Nominal	Economic	Projected NOI Growth					
Sector	Cap Rate	Cap Rate	'09	'10	'11	'12	'13	Long Term
Apartment	5.7%	5.0%	3.7%	3.1%	3.0%	3.0%	3.0%	1.4%
Industrial	5.9%	5.3%	3.4%	3.1%	2.8%	2.5%	2.5%	1.2%
Mall	5.8%	5.1%	3.2%	2.5%	2.5%	2.5%	2.5%	1.4%
Office	5.1%	4.3%	5.8%	6.3%	5.3%	4.5%	4.5%	1.4%
Strip	6.4%	5.8%	2.9%	2.8%	2.8%	2.8%	2.8%	1.2%

Based on these inputs, the respective property sectors are priced to deliver the unleveraged long-term total returns shown by the blue bars below. Expected unlevered returns should always materially exceed the cost of debt (red bars).



Sources: Green Street and American Council of Life Insurers.

By comparing the historic return premium (i.e. IRR minus real estate borrowing rate) for each property sector with the current return premium, prevailing valuation levels can be put into historical perspective. Just as important, because the benchmark interest rate utilized here is the commercial mortgage rate, prevailing return premia can be assessed on an absolute basis. Because mortgage investors own a much safer asset than real estate owners, this premium should never be negative, and the historically high spreads seemingly make more sense than today's tight spreads.

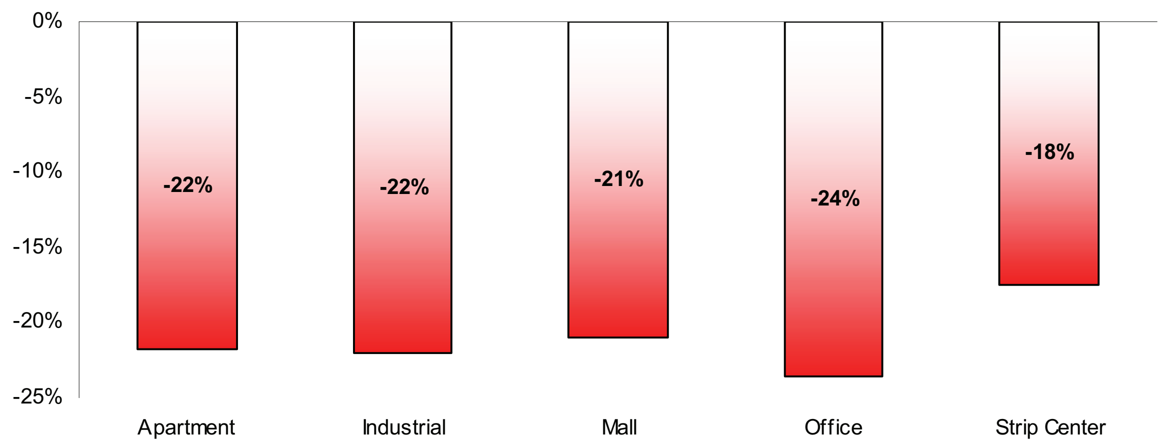


Historic IRR estimates are a function of prevailing cap rates, forward-looking inflation expectations, and intermediate-term growth expectations. Commercial Mortgage rates are from American Council of Life Insurers.

(Heard on the Beach – continued from page 4)

The extent to which the current sector-specific IRR premium (vs. mortgage rates) varies from the historic average may be evidence of mispricing. The price declines shown below are warranted if IRR premiums are slated to revert to their long-term norms. Of course, there may be legitimate secular reasons (e.g. acceptance of real estate as an asset class) why IRR premiums should now be lower than has historically been the case.

Amount Real Estate Values Should Rise (Fall) in the Private Market
Assuming IRR Premiums Revert to Long-Term Average



With public investors now willing to pay only $0.87 on the dollar for the assets owned by REITs (i.e. the observed discount to NAV is 24% and the observed discount to asset value is 13%), most of the potential bad news that is in store for property owners is baked into the REIT pricing cake. After all, holding all else equal, if property values uniformly decline by 15%, REITs will be trading at a 5% **premium** to NAV, very consistent with their long-term average. **However, while the worst is probably over for REITs, it is not yet time to back up the bus, as headline risk remains high with declining property values on the horizon.**

****

REIT Preferreds – The best investment for '08. The key takeaway from the discussion above is that real estate equity is woefully over-priced relative to fixed-income alternatives. Against that backdrop, it is probably not surprising that **the investment option that presents the best combination of low risk and respectable return is a close cousin of the fixed-income family: REIT preferred stock.** In an environment where preferreds from industry blue chips, such as Vornado and Public Storage, are priced to deliver returns north of 8%, the idea of buying private-market real estate that delivers 6.5-7.0% returns makes no sense. Even REIT common equities, which our DCF model currently indicates are priced to deliver long-term returns in the "high 8's", stack up as inferior, as the preferreds represent a much safer investment option.

Mike Kirby