GREEN STREET
ADVISORS

Vornado Realty Trust (VNO)

How to Lose $57 Million on a $66 Million Investment

February 26, 2008 ■ Recent Price $89.33 ■ DJIA 12,685 ■ RMZ 866

I. Macklowe Mezz-Writedown Overshadows Good Operating Results

Vornado Realty Trust's (VNO) 4Q07 FFO was heavily weighed down by a nearly complete write-down of its $66 million mezzanine-debt investment in four New York office buildings acquired by Harry Macklowe from Blackstone/EOP at the height of the commercial real estate frenzy a year ago. Although the $57 million ($0.32/sh) reserve was not surprising, it overshadowed VNO's otherwise good operating results (see Section V. below). The unrealized loss also highlights the risks in mezzanine-debt investing, especially in connection with a deal that will likely live in infamy as the poster child of the excesses and hubris that characterized the transactions market in early '07. In an August '07 office-sector report, we questioned whether VNO had effectively participated in the "Pebble Beach" of the current real estate cycle by taking a very junior slice of the Macklowe-EOP deal. Today's news provides the answer.

While the final chapter of the Macklowe saga has not yet been written (i.e. VNO's loss remains unrealized, for now), the four buildings must be worth at least $960/s.f. before VNO can recoup even the first dollar of its mezzanine investment. Based on our rough math, the seven Macklowe/EOP properties together would have to command a low-4% nominal cap rate in order for the value to be in the upper $900s per s.f. (upper-$5 billion range in the aggregate, vs. a $7 billion purchase price). Although the final outcome remains uncertain – Deutsche Bank, the deal's first-mortgage lender, is likely to attempt to sell the seven assets individually or in groups over the next year – it seems unlikely that VNO can ultimately avoid losing the lion's share of its investment. Some nuisance value likely remains in VNO's holding, but a large reversal of this write-down is a long shot.

II. Collateral Damage to VNO's Reputation?

The mezzanine write-down reflects the conservative accounting typically employed by VNO given that accounting rules did not yet require any such action. However, investors are unlikely to focus on that aspect of today's news. Instead, the prospect of losing most or all of a $66 million investment will negatively influence the market's perception of VNO's well-regarded (and well-paid) team, led by CEO Steven Roth and President Mike Fascitelli. **A key question is assessing the magnitude and duration of this negative impact.** While VNO's long-term track record invokes confidence, it is highly disappointing that a team as smart and savvy as this one could lose a large chunk of a sizable investment in its own back yard – the New York office market – especially in the context of a multi-year hiatus from buying assets there between '99 and late '06.

This ill-chosen allocation of capital should be put in context: VNO's total-return performance remains near the top of the office-group on a 5-year basis and near the group-average on a 1-year basis. However, should additional bad news surface, investors may wonder if this management team is deserving of its top-notch reputation. Moving forward, VNO's performance on its investment in Toys "R" Us could be an important wildcard in the perception of management's capital allocation prowess.

III. Toys "R" Us Update

VNO's one-third investment in Toys "R" Us (TRU) was made in July '05 (the total unlevered price was roughly $7.2 billion, while VNO's share was about $2.4 billion). The investment thesis was predicated on the idea that a profitable turnaround of the domestic toy business could be engineered, while relying on the underlying real estate value as a backstop. The turnaround appears to be working following the right-sizing of the U.S. toy business (i.e. the closure of 84 stores in '06). During the most recent Holiday period – which accounts for 80% of TRU's sales – the domestic toy business recorded a 3% year-over-year gain in comparable-store sales, while Babies "R" Us and the international segment generated a 1% gain. These gains followed 4-6% growth in the prior-year Holiday period. Full financial information for TRU's Holiday period is not yet available.

Important disclosure on the last page.

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A key concern with TRU is its enormously high leverage, which ranges from 75-85% of unlevered value using an EBITDA multiple range of 7-8X (our most recent NAV value equates to an 8X multiple, while selected public retail comps appear to trade at an average of 9.5X). Roughly $1.35 billion of TRU unsecured bonds have recently traded for about $0.75 on the dollar, suggesting a scary-high cost of debt of 14% using today's capital structure. Based on equity-market valuation benchmarks (EBITDA multiples), VNO's investment in TRU appears to be holding up okay, though hardly lighting the world on fire (i.e. at a 7X multiple, it is worth roughly its $7 billion purchase price). Conversely, based on signals from the debt market, the value of the equity sitting behind the debt that is trading at such a high yield is highly suspect. The ultimate value of VNO's TRU investment hinges on how this valuation disconnect is ultimately resolved.

Thanks to extensions on maturing debt, TRU can avoid the need to refinance any large maturities until 2010, when roughly $2.5 billion of debt comes due (30% of TRU's unleveraged value). Should today's credit woes persist for another two years, there is a scenario where VNO and its private-equity partners face serious refinancing problems, perhaps necessitating a liquidity event (e.g. an IPO). Through this investment, VNO is exposed to the greater risk/reward profile of investing in a retailing entity, rather than the real estate supported by retail activity. The enhanced operating risk emanating from the TRU investment is greatly magnified by the high financial leverage.

IV. Still Hoarding Dry Powder; Busy on the Development Front

VNO continues to hoard cash and investment capacity, resulting in no new investments during 4Q07. The REIT currently has roughly $3.5 billion of dry powder in the form of cash (20%) and available capacity on its two lines of credit (80%). However, management now appears bearish on real estate values, suggesting VNO will continue sitting on its hands for awhile from an acquisitions standpoint. The company's recent lack of buying activity marks a huge departure from its bullish stance just a year ago, when management mixed it up with Blackstone, a large private-equity firm, in the epic $40 billion battle for EOP ultimately won by Blackstone. VNO's current caution also contrasts with key New York peer, SL Green (SLG), which recently allocated a significant amount of capital to the $1.6 billion Citibuilding acquisition (in Downtown New York) at the end of '07. SLG has also actively repurchased stock and invested in additional mezzanine loans.

VNO's 10-K provides the annual update on the company's active development pipeline. The schedule shows projects having expected costs of $2 billion (about 6-7% of real estate asset value, roughly on par with the office average), but high-profile "shadow" projects (e.g. Farley Post Office, Hotel Penn) are excluded. Very recent media reports regarding the sizable and complex Farley project in New York suggest it is nearing its death bed, citing increasing costs and a shrinking spirit of cooperation among the various parties, especially the Dolan family, which controls Madison Square Garden. (On a "related" note, recent Los Angeles media reports speculate that Related's project in Downtown LA is also likely to be delayed, suggesting large, multifaceted urban projects are having a tough time.)

While it is difficult to handicap the odds of the complicated Farley project stalling out, it would be a negative for VNO. However, our NAV estimate conservatively ascribes only about $2/sh of value to this long-lived project on a discounted basis. To the extent that the Farley project is shelved, the value of VNO's significant surrounding existing buildings will also be negatively impacted (via modestly lower rent-growth expectations in out-years), but it seems unlikely to be a hugely material negative.

V. Operational Review

VNO reported solid 4Q07 operating results, highlighted by a 25% year-over-year increase in the company's "comparable FFO", which removes the impact of one-time items (e.g. Macklowe writedown). A quick recap of VNO's results:

New York Office (45%) of Asset Value: This segment continues to be the star of VNO's portfolio. Occupancy remains high at nearly 98% and 4Q07 leasing activity was quite robust, as rates on renewed leases increased an eye-opening 91% on a cash basis. Same-property NOI increased 10% for the quarter and the full-year. These metrics are all superior to those posted by rival SLG.

Washington, D.C. Office (25% of Assets): Occupancy increased 50 basis points sequentially to over 93%, and 4Q07 same-property NOI increased 2%. Annual same-property NOI increased 4%. The transformation of Crystal City from a Dept.

of Defense (DOD) haven to a submarket that is attractive to private-sector tenants is ongoing, as the most recent DOD Base Realignment and Closure (BRAC) will still have a negative impact on VNO as the onset of the next decade nears.

Retail (20% of Assets): VNO's retail portfolio has been a steady, reliable performer in recent years. The REIT operates a collection of eight malls (30% of retail s.f.) and strip shopping centers (66% of retail s.f.) and valuable street retail space in Manhattan (nearly 4% of retail s.f.). The retail segment posted respectable 4Q07 results that were slightly above par among retail REITs. Occupancy climbed 40 basis points since the end of 3Q07 (to over 94%), while same-property NOI increased 5.6% for the quarter and nearly 3.5% for the year. VNO is currently in the process of redeveloping more than 1.5 million s.f. of space at its regional malls, the bulk of which is expected to be completed by 2010.

Merchandise Mart (10% of Assets): The Merchandise Mart segment continues to be the laggard of the VNO portfolio. The Mart business experiences seasonality given that results are dependent on the timing of trade shows and events. The Mart's same-property NOI declined 3.5% compared to last year, while occupancy remained flat versus 4Q06. NOI results for the year were not much better, registering a 2.5% decline.

VI. Recommendation

Our VNO NAV estimate is unchanged at $116.75/sh pending a more detailed review of the 4Q07 financial results.

Shares of VNO currently trade at a 23% discount to NAV, roughly on par with the office-group average. Our Pricing Model concludes this is appropriate, resulting in a warranted share price of roughly $90.00.

At the current price, we continue to rate the shares of VNO as a HOLD.

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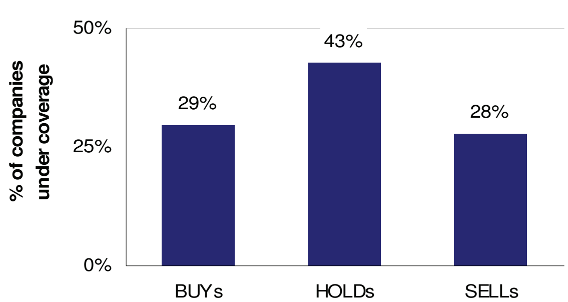
At any given time, Green Street publishes roughly the same number of "BUY" recommendations that it does "SELL" recommendations.

Green Street Recommendation Distribution (as of 2/1/08)



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

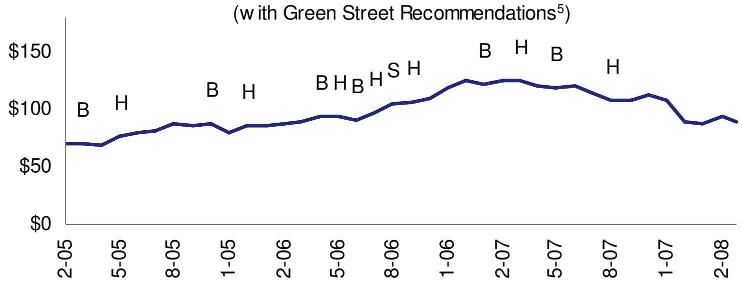
Year Ended December 31:

Year	Buy	Hold	Sell	NAREIT Eqty[4]
2008 YTD[3]	5.1%	6.6%	6.1%	-1.0%
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]	**3866.0%**	**385.2%**	**18.5%**	**483.5%**
Annualized	**27.8%**	**11.1%**	**1.1%**	**12.5%**

The chart below shows VNO's price performance over the last three years, along with Green Street's recommendations during that time.

VNO Price Performance

(with Green Street Recommendations[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 February 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.
5) Green Street has only three recommendations: BUY ("B"), HOLD ("H") and SELL ("S"). The firm does not consistently publish price targets and therefore price targets are not included in this graph.

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