Global Expansion of REITs:
Moving Towards Pricing Efficiencies

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History of REITs

We are now well into the second decade of modern REITs, which began with the Kimco (1991) and Taubman (1992) IPOs. It is easy to forget why modern REITs came into being. The real estate industry was largely a private industry through the early 1990s because generous debt, often in excess of 100 percent LTV, made access to large equity pools irrelevant. All one needed for capital was access to friendly lenders, rendering the public equity market unnecessary. But as regulators reacted to lenders' excessive exposure to real estate loans, many of which were originated in the no-money-down decade of the 1980s, real estate debt eventually evaporated. Overnight, borrowers were faced with maturing mortgages, with little chance of refinancing. Even for properties that had not fallen in value, owners generally lacked sufficient equity to reduce their LTVs from 90 to 110 percent to 50 to 60 percent. Plummeting real estate values and recessionary cash flows accentuated this problem.

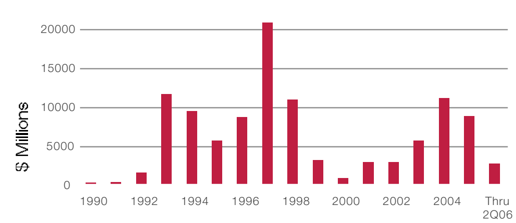
Since almost everyone was highly leveraged, the carnage was widespread. Only borrowers with loans not due for 5 to10 years were immune from refinancing pressures. In this environment, as our friend Stan Ross has noted, many major real estate operators were faced with the choice of filing either an S11 for an IPO, or a Chapter 11 bankruptcy. Both were unappetizing choices for intensely private real estate players.

As bankruptcies skyrocketed, several savvy real estate operators recognized that if their properties were de-levered, their cash streams carried a value on Wall Street. An IPO not only protected their tax positions, but also allowed owners to monetize their property management contracts by exchanging those income streams for shares in the new public company. This monetization generated value for management contracts that would have been rendered valueless if the properties were lost in bankruptcy or sale. Thus began the wave of REIT IPOs, creating a massive debt for equity swap for many major real estate players.

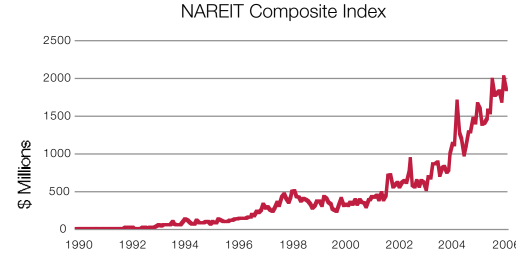
Once an IPO was completed and the balance sheet was cleaned up, these operators, freed from personal recourse, had a new lease on life. Some used this "new lease" to continue what they had been doing – developing new properties. Others realized that while the development environment was weak, acquisitions from distressed owners offered a once-in-a-lifetime investment opportunity. REITs issued stock to raise the equity required to develop and purchase additional properties, frequently exchanging their shares and operating units for properties. The most visionary companies quickly grew to sizes that justified the costs of being public, while others either overleveraged or remained too small and stagnated.

The total market capitalization of all REITs jumped from $12.9 billion in 1991 to $88.8 billion in 1996. Similarly, the market capitalization of equity REITs jumped from $8.8 billion to $78.3 billion during that time period, when the number of equity REITs grew from 86 to 166. These new REITs were fully integrated real estate operating companies, operated by some of the industry's best owners and operators. But they were far less leveraged and far more transparent real estate investment vehicles than had ever previously been the case.

U.S. Equity REIT Market Capitalization



Average Daily Dollar Trading Volume of the NAREIT Composite Index



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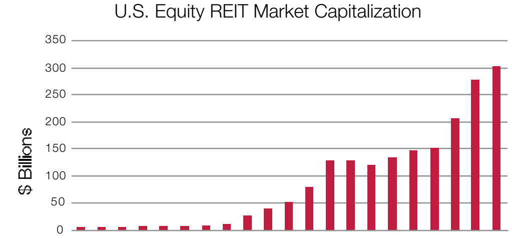


Global Expansion of REITs

Capital Market Integration and Impact

In 1997, we wrote a paper entitled "The Forces Changing Real Estate Forever." In this paper and subsequent work, we laid out why – contrary to the prevailing view of the time – REITs were not a fad. Our argument was simply that once large amounts of equity were required for the ownership of real estate, many of these assets would be publicly owned, as the public market is the primary source of large pools of equity. We also noted that modern management systems allowed a greater span of control for stabilized properties than had previously been true, providing both operating and capital scale economies. We argued that the typical REIT of that time was not large enough to be economically viable, and that much larger public companies would rapidly evolve.

These predictions were on target. The number of REITs in excess of $2 billion market cap has grown from six in 1996 to 20 in 2005, while the average equity REIT market cap grew from $472 million in 1996 to nearly $2 billion in 2005. By 2005, nine REITs were members of the S&P 500, with equity market caps ranging from $4.2 billion to $18.1 billion.

An abundance of attractively priced debt makes leveraging properties an attractive bet if one believes that cap rates remain stable while cash flows grow. These highly leveraged bets will pay off if such market conditions prevail. In this regard, they are simply LBOs, going private with higher debt levels than are "acceptable" in the public market. LBOs have existed for many years, and real estate has a long history of being comfortable with high levels of debt. Since many LBOs subsequently go public, or sell assets (often to public companies), you should expect that many of the assets which are going private today will end up in public companies within 5-7 years.

While the popular view held that REITs were a fad, and that near 100 percent LTVs would return, we believed that capital markets were becoming too interconnected for such inefficient debt underwriting to return. Over the past decade, we have repeatedly noted that no industry has ever gone private after having been public in a major way, even though individual companies frequently go private. This has turned out to be the case. An early REIT which went private was Irvine Apartments. More recently, REITs such as Gables, Arden, Amli, Town and Country, La Quinta and Centerpoint have all gone private. In fact, over the last five years, an estimated 43 companies have gone private, but 51 companies have also gone public over this period. Further, the market capitalization of those who have gone public exceeds that of those who have gone private.

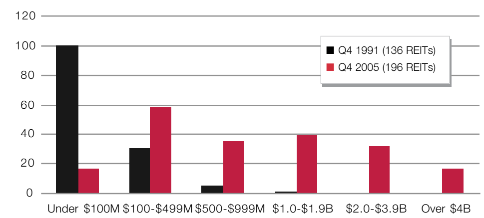
The performance of REITs has been remarkable over this new era. Importantly, there have been no major scandals, though several REITs have underperformed. FFO growth has been 3.5 percent annually over the past decade, while total REIT returns have massively outstripped other asset classes.

For each of the past five years, Wall Street analysts have forecasted that REIT pricing would burst and that REITs would underperform. And for five years running, we have dissented from this viewpoint. Fortunately for us, the analysts have been consistently wrong. Their inability to accurately predict REIT returns relative to other asset classes reflects the fact that they have generally used simple mean reversion price multiple models, where their historic mean multiple reflects a period of immense real estate underpricing. But mean reversion pricing models benchmarked against a period of abnormally poor real estate pricing cannot accurately predict returns.

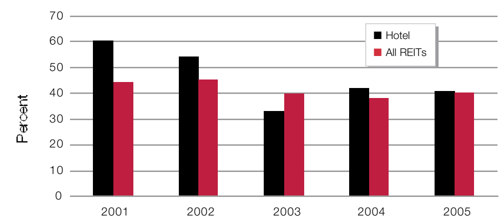
We have consistently used the Capital Asset Pricing Model (CAPM) to assess the expected returns of REITs. This model has indicated for each of the past 13 years that REITs would substantially outperform other assets. As we enter 2006, for the first time in 13 years, CAPM analysis indicates that REIT returns will be roughly in line with their risk, providing a total return of 6-8 percent. That is, REITs are finally being priced appropriately, after 13 years of underpricing, as public markets figure out how to price them.

A similar conclusion concerning real estate pricing is derived from evaluating cap rates. Using REIT implied cap rates to proxy cap rates for well leased and well located real estate reveals that the NOI cap rate is 6 percent on average. After reserves for cap ex, TIs and leasing commissions, this implies a cash flow cap rate of roughly 4.25 percent. In addition, property level cash flows should grow by approximately the rate of inflation (2.5 percent). Thus, the total expected unlevered return for real estate is roughly 6.75 percent. This 6.75 percent return on the tenant lease claim compares to 8 to 8.5 percent for the tenant equity claim

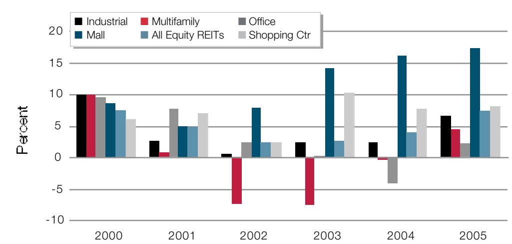
Number of Listed U.S. REITs



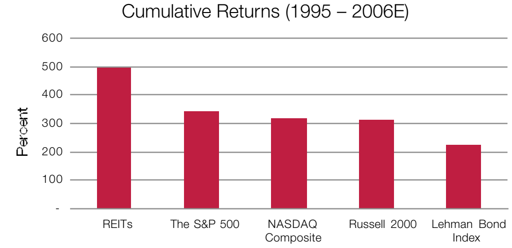
Debt/Total Capitalization



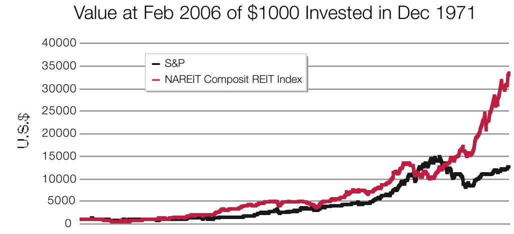
FFO Per Share Growth



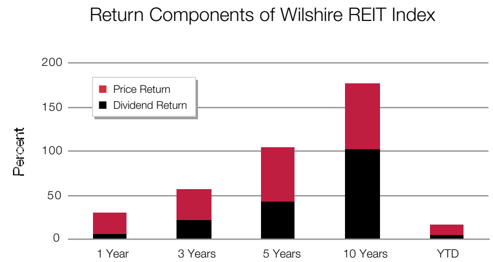
Cumulative Returns (1995 – 2006E)



Value at Feb 2006 of $1000 Invested in Dec 1971

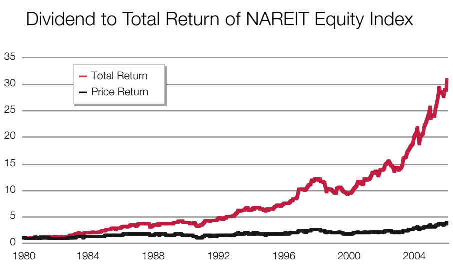


(stocks), and 6.6 percent for the tenant debt claims (corporate bonds). And since tenants will pay their lease claims before they pay their equity claims, real estate should (and does) provide a lower expected return than stocks. Since tenants will generally equally honor lease and debt claims, real estate should (and does) provide about the same expected return as corporate bonds. This balanced expected return pattern for real estate has not existed for real estate for 13 years. Welcome to the new era!



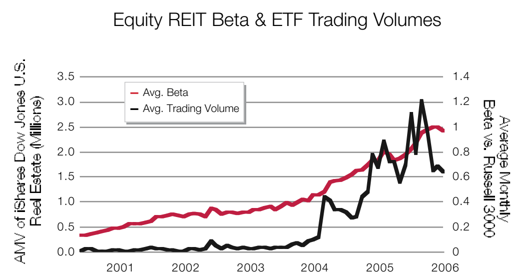
REITs Around the World

Several U.S. based REITs already have non-U.S. footprints, and even more are moving in that direction. However, there have been two factors limiting the extent to which firms (both U.S.- and non-U.S.based) have been able to penetrate non-U.S. markets. First, the enormous success of the REIT markets in the U.S. have provided plenty of opportunity for continued growth for the past 5 years. Second, foreign governments have been slow to enact comprehensive regulations enabling efficient REIT markets, only realizing upon the success of the U.S. market that that they could be losing massive capital flows to the U.S.



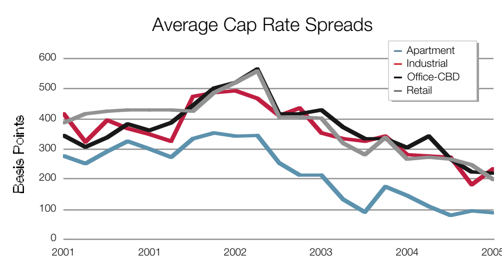
Asian countries are far ahead of Europe and South America with regard to REIT market sophistication. Australia is considered more mature than the U.S. in terms of its listed real estate industry, but is far outweighed in terms of market capitalization of listed firms (by a factor of 4). Europe lags, with France enjoying the unusual position as one of the more relaxed markets in terms of regulation. The U.K. and Germany are just now coming online with enacted or soon-to-be-enacted legislation governing REITs.

Despite the varying paces, it seems that most governments are recognizing that it is less a matter of whether regulation needs to be enacted, but rather when and in what form. This is encouraging news for investors seeking to diversify out of U.S. – centric holdings, as well as to take advantage of the upside value of non-U.S. property markets.

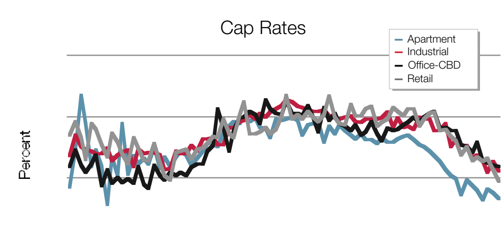


Japan. Since September 2001 – when Nippon Building Fund and Japan Real Estate Investment Corporation listed as the first two REITs on the Tokyo Stock Exchange on the heels of a revised Investment Trust Law in November 2000 – Japan's REIT market has rapidly expanded. There are currently 31 listed REITs, with a market capitalization of just under $50B. In line with other countries' restrictions on activity and distributions, Japanese REITs also are governed by strict rules. They are limited in business scope, have no employees (their management is entrusted to outside asset management companies), have set leverage ceilings, and can maintain their tax-exempt status if they pay out at least 90 percent of their dividends to investors.

Despite the traditional focus of REITs on office space – and specifically in metro Tokyo – the future for Japan's REITs should see a diversification of asset types. A shelf registration system and increasingly easier terms for loans to REITs will accelerate the growth of REITs over the coming 3-5 years in Japan.



Hong Kong. While it issued rules governing REITs in August 2003, Hong Kong's Securities and Futures Commission (SFC) has not allowed an influx of firms to operate the vehicles to date. The rules governing Hong Kong REITs are firm, and geared less towards buying and selling of properties, but more towards rental income streams. As with many other countries, the bar of 90 percent is set for distribution of after-tax income. The restriction on non-income generating properties is not absolute, but redevelopment and refurbishment projects are possible only when the aggregate contract value of such properties does not exceed 10 percent of net asset value of the REIT. The regulations are strict enough to prohibit vacant land and property development activity. Hong Kong REITs are also specifically authorized for certain purposes, and require managers who must obtain licenses to operate them.



With the absence of a mainland REIT market, Hong Kong is enjoying a flow of funds from mainland property firms that want to utilize the financing of Hong Kong's REITs, to then invest in mainland assets. The ability to invest anywhere geographically was granted to Hong Kong REITs through the SFC's June 16, 2005 amendments in a final Practice Note and revised code on REITs. Several other noteworthy amendments were included as well. For example, managing property portfolio investments was recognized as a core competency, and so likely will raise the bar for who can be entrusted to manage a REIT. In addition, the gearing ratio (a measure of financial leverage) was raised to 45 percent from 35 percent of gross asset value, and special purpose vehicles can now be considered in certain instances. And finally, proposals that required professional indemnity and title insurance were removed with the June 16 publication.

India. Although the Indian government has only recently relaxed regulation of FDI into real estate, it is doing so, and realizing the need for more liberal guidelines. In February 2005, the government announced new rules for investment into real estate; however there are still important restrictions. Only greenfield or new development is allowed, and there is no allowance for foreign firms to buy and sell unimproved land or developed buildings. There are also holding periods that are required before sale.

Interestingly – and not surprisingly given India's needs for development of quality spaces – the government has structured the rules for REITs in such a way that they force firms to add value to properties. The alternative scenario would have been one in which firms could simply ride a wave of general economic enthusiasm for India, with simple supply and demand imbalance driving up prices for any property in certain locations of the country.

In June 2006, India's regulators approved guidelines for Real Estate Mutual Funds (REMF). Initially, REMFs will be closed-end funds, with units being sold on the stock exchanges. India's REMFs can invest directly in real estate properties, mortgage backed securities, both equity and debt of listed and unlisted companies, and other securities. The relaxation of regulations and the introduction of REMFs have paved the way for REITs (with favorable tax treatment) in India, probably within the next two to three years. Some enterprising investors had been utilizing a regulatory regime intended for venture capital and private equity firms in order to receive REIT-like treatment from a tax perspective, but that approach has recently been questioned by the regulatory authorities. However, India's regulators and tax authorities are already considering significant REIT-related legislation and the tide will shift in the coming years.

Germany. Germany has lagged behind several other EU countries to enact REIT legislation, including the U.K. (the other laggard in the process) which seems to have gotten the message that it is time to make some changes. Germany is still hampered by a government that is more concerned with losing tax revenue through REITs, than with the bigger picture of welcoming investment capital that will flow into other European REIT markets. Just recently, Germany's CGI transferred three of its Paris assets into a French REIT equivalent. To France's credit (which is not often easy to give), the country has one of the more relaxed environments for REITs in Europe today, with a small handful of firms enjoying a modest market capitalization.

There is discussion in the press about how Germany's finance ministry intends to one-up the U.K. in terms of its planned relaxed regulation of REITs (in relation to the U.K.). While this is great to read, action has not been taken, and in the meantime other EU countries are setting up their own rules to attract capital.

Mexico. Mexico is still in the very early stages of development for a structured REIT market which will attract investors. In March 2006, the first request came to the Mexican Stock Exchange to list the equivalent of a REIT, the request being made by sports club Grupo Impulsa. Mexico's Fideicomisos de Infraestructura y Bienes Raíces (FIBRAs) are the country's equivalent to REITs.

The rules that do exist in Mexico are onerous at best, as noted by our friend Sam Zell in June 2005. As he noted, the advantageous nature of the U.S. REIT seems to be non-existent in the Mexican plan, with paid dividends subject to claims placed on them by state and federal governments. Although this does not even put Mexico in the starting blocks in terms of developing a mature REIT market, we have confidence that the relationship the U.S. enjoys with Mexico will help our southern neighbor take a page from the U.S. REIT market.

Likely Impact on Real Estate Markets

The most likely impact on markets is the opening of an asset class to smaller investors, as well as a rebalancing of investment opportunities geographically. Additionally, the newly developed REIT markets in many non-U.S. countries will give individual investors access to an asset class which previously was unavailable to them due to lack of liquidity, lack of diversification, and large initial buy-in requirements (for single properties). Currently listed firms will be freed from focusing on the markets to which they've been tied, and will expand the scope of their searches for participation in foreign assets.

In addition, countries introducing REIT legislation will likely see significant capital flowing to real estate markets. Over time, these countries will witness their real estate capital markets gradually conforming to the ebbs and flows of the broader markets, just as has happened within the U.S. over the past decade.

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