July 17, 2006

Mr. Lawrence W. Smith
Director—Technical Application and Implementation Activities and EITF Chair
Financial Accounting Standards Board
401 Merritt 7
Norwalk, Connecticut 06856-5116

Re: SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets (SFAS 144 or the Standard)

Dear Larry:

The National Association of Real Estate Investment Trusts® ("NAREIT®") provided its views to the Financial Accounting Standards Board (FASB or Board) as the Board developed SFAS 144. Further, in a follow-up letter dated December 27, 2001 (the Letter), NAREIT raised concerns regarding the standard and guidance as it was thought to apply to Real Estate Investment Trusts (REITs) and other entities that manage portfolios of investment property. A copy of the Letter is attached as Exhibit A.

NAREIT is the representative voice for U.S. REITs and publicly traded real estate companies worldwide. Members are REITs and other businesses that develop, own, operate and finance income-producing real estate, as well as those firms and individuals who advise study and service those businesses.

More specifically, the Letter discussed the industry’s concern over many accountants suggesting that, since the final standard did not explicitly provide for a notion of significance, most dispositions of investment property (even individual properties) would be required to be reported as discontinued operations. The Letter further indicated that this application of the standard would create considerable confusion among financial statement users. NAREIT requested that the Board clarify, in the Standard, its intention “to allow for judgment in determining whether, based on facts and circumstances unique to a particular entity, a disposal transaction should be reported in discontinued operations.” At that time, the Board concluded that no further guidance was necessary.

National Association of Real Estate Investment Trusts®
1875 I Street, NW, Suite 600, Washington, DC 20006-5413
Phone 202-739-9400 Fax 202-739-9401 www.nareit.com
causes in their ability to forecast future profitability. Exhibits B and C are letters from two prominent industry analysts discussing their views of this problem.

Further, the analytical methodology used by at least one major credit rating agency eliminates the "discontinued operations distinction" between properties sold and properties owned. Following is an excerpt from page 18 of Moody’s Rating Methodology for REITs and Other Property Firms:

SFAS No. 144 requires that the historical and current revenues and expenses, including gains or losses on sale, of a “component” of an entity (a component is considered to comprise operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the larger entity) held for sale or that has been disposed of, be classified as discontinued operations. For REITs, this requirement normally results in properties held for sale or sold being classified as discontinued operations. As selling properties is a regular part of many REITs’ normal business operations, this results in a significant amount of each period’s earnings being classified as discontinued operations, with annual restatements to prior years for comparability. Moody’s believes the "discontinued" classification of these activities makes it difficult to determine a REIT’s real estate property business performance and therefore we combine discontinued operations related to these core activities with the operating income from real estate properties that continue to be owned but are not classified as held for sale.

A copy of the complete Moody’s document is attached as Exhibit D.

The Moody’s methodology is particularly important for REITs that have implemented “capital recycling programs.” Current reporting obscures the economics of these programs under which mature properties are sold and the proceeds are used to acquire properties with greater potential for earnings growth. Most industry participants believe that earnings from properties sold and earnings from acquired properties should be reported as results from continuing operations so as to not overstate growth in earnings from continuing operations — the result of excluding earnings generated by properties sold.

Similar to Moody’s methodology, in order to communicate appropriate trends in operating results, both in aggregate and in terms of financial statement elements, many companies are forced to provide supplemental reports to management, Boards of Directors and financial analysts that do not segregate operating results of properties that are sold.

* * *

THE NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®
The frequency of reporting discontinued operations is enormous

In order to provide an understanding of the magnitude of restatements, NAREIT surveyed fifty significant REITs as to their reporting discontinued operations. Twenty-three companies (12% of publicly traded REITs) responded to the survey and provided information with respect to their disposition of properties and discontinued operations reporting over ten quarters — 1Q03 through 2Q05. Property dispositions were reported as discontinued operations and previously reported net income or income from continuing operations was restated in 177 or 77% of these 230 accounting quarters. Management of these companies considered the great majority of these dispositions to be insignificant to the core operations and consolidated financial results of the company.

Inconsistency with Application to Other Industries

To understand whether other industries face issues of reporting discontinued operations similar to those faced by our industry, we looked at earnings reports of the 25 largest Fortune 500 companies for the same ten quarters — 1Q03 through 2Q05. Discontinued operations were reported in 25 or 10% of a possible 250 quarters for these companies. More importantly, the reasons for this discontinued operations reporting indicate that the companies disposed of lines of business, brands or major interests in affiliated businesses. Exhibit E summarizes the results of our study.

Inconsistency with IFRS 5

In addition to eliminating the complexity discussed above, we believe that an FASB interpretation that would clarify that the judgment discussed in paragraph B103 of the Basis for Conclusions of the Standard should be applied in determining whether the disposition of an asset should be reported as discontinued operations as prescribed in paragraph 42 of the Standard would significantly reduce or eliminate the wide inconsistency between U.S. GAAP and International Financial Reporting Standard (IFRS) No. 5, Non-Current Assets Held for Sale and Discontinued Operations. The International Accounting Standards Board (IASB) focused squarely on the issue of “significance” in its exposure draft and concluded that a discontinued operation is generally a component of an entity that represents “a separate major line of business or geographical area of operations” or “is part of a co-coordinated plan to dispose of a separate major line of business or geographical area of operations.” NAREIT member companies are rapidly expanding outside of the United States. Requiring very different reporting of property dispositions as compared to real estate companies outside the U.S. results in financial performance reporting that is not comparable among real estate companies around the world. In addition, forcing U.S. companies to deal with the financial communications complexities caused by the prevailing interpretation of SFAS 144 when international competitors are not saddled with this issue puts U.S. companies at a bit of a disadvantage in the international capital markets.

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THE NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®
Increased Administrative Burden and Cost

In our survey of NAREIT member companies discussed above, we asked for information regarding other specific issues that result from having to report virtually every property sale in discontinued operations. The response was loud and clear. The constant restatement and re-audit of previously filed financial statements creates additional administrative burden and cost. A specific example of this burden was identified by a number of companies— that companies are forced to restate previously filed Form 10-Ks and Form 10-Qs in order to incorporate them into filing requirements in connection with selling securities or issuing debt under shelf registrations. REITs that operate as an UP-REIT must also amend previously filed periodic reports of the UP-REIT Operating Partnership. All of these restatements and amendments must, of course, be audited.

Our Request

Based on the industry’s experience in applying SFAS 144 over the ten fiscal quarters surveyed, including the negative impacts of this reporting on the ability of investors and analysts to predict future earnings and the communications complexities faced by our member companies in the international business arena, we respectfully request that the FASB consider issuing some form of guidance that would explicitly provide for the judgment discussed in paragraph B103 of the Standard in determining whether the disposition of assets should be reported in discontinued operations.

Respectfully submitted,

George L. Yungmann
Senior Vice President, Financial Standards

cc: Scott Taub, Securities and Exchange Commission
Donald Young, Financial Accounting Standards Board

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THE NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®
December 27, 2001

Mr. Timothy S. Lucas
Director of Research and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: Application of SFAS 144 to Discontinued Operations

Dear Mr. Lucas:

The National Association of Real Estate Investment Trusts (NAREIT) would like to bring to your attention its concerns regarding the changes Statement of Financial Accounting Standards No. 144 (SFAS 144), Accounting for the Impairment or Disposal of Long-Lived Assets, could require for the reporting of discontinued operations. We understand that certain parties have interpreted SFAS 144 to require the extension of discontinued operations to all “components” of an entity, rather than only to “significant components.” For real estate companies that frequently dispose of “insignificant components,” this reporting could create considerable confusion among financial statement users. NAREIT requests that the Board clarify its intent regarding the reporting for the disposal of investment property judged to be an insignificant component of an entity.

NAREIT is the national trade association for real estate investment trusts (REITs) and other publicly traded real estate companies. Members include REITs and other businesses that develop, own, operate, and finance income-producing real estate, as well as those firms and individuals who advise, study, and service these businesses. The business of developing, owning and operating income-producing property regularly involves the disposition of individual or groups of properties from a company’s portfolio. In this context, the accounting standards for property dispositions are important to producing useful and relevant financial reports for publicly traded real estate companies.

When the Board issued its July 2000 Exposure Draft of the proposed standard, the reporting for discontinued operations was applicable or extended only to a “significant component of an entity.” Further, paragraph 42 of the proposal
specifically stated: "In assessing whether a component of an entity is significant, an entity shall consider all relevant facts and circumstances, quantitative and qualitative." NAREIT's comment letter submitted in response to the proposal did not address this issue because the use of "significant" with regard to components of a business would have allowed for judgment in determining whether a disposition would be significant and, therefore, be reported as a discontinued operation. Based on the foregoing, many dispositions of individual or groups of properties would not be judged to be significant.

As indicated in SFAS 144's basis for conclusions (paragraph B103), "the Board chose not to define the term significant to allow for judgment in determining whether, based on facts and circumstances unique to a particular entity, a disposal transaction should be reported in discontinued operations." However, the language in paragraph 42 of the Exposure Draft that would allow for this judgment was eliminated from the final standard. Some believe that a literal reading of SFAS 144 does not provide the latitude contemplated in paragraph B103.

Under SFAS 144 provisions for reporting discontinued operations, a component "comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity." Consistent with example 15 of Appendix A, some have interpreted this scenario to mean that if a real estate company owning and operating multiple properties within a market area disposes of one property in that market, the disposal would not have to be reported as discontinued operations because the operations have not been eliminated. In many cases, the operations of one property cannot be clearly distinguished because multiple properties located within a market area typically share corporate resources such as property management, leasing, security, and maintenance personnel.

Further, in many cases the cash flows of the disposed property are replaced through exchange, purchase, or improvement of another property within the same or different market. In any of these situations, the capital is reinvested to replicate and/or enhance the cash flows associated with the disposed property, rather than distributed to shareholders.

If the Board intended that the disposal of an individual property or an insignificant group of properties be reported as discontinued operations, we believe this would create significant confusion among financial statement users. It is not unusual for real estate companies to frequently dispose of properties. In a recently completed study, we reviewed the frequency of reported gains/losses from property dispositions by 40 large real estate companies during 1998, 1999 and 2000. Of the 120 annual periods (40 companies, 3 years) reviewed, property dispositions were reported in 103 (86%) of the annual periods. Further, 28 (70%) of the companies reported property dispositions in each of the three years reviewed. Treating all of these dispositions as discontinued operations and, therefore, constantly restating previously reported operating results, would cause a great deal of confusion.

Further, we believe that reporting discontinued operations suggests a shift in a company's business plan and, therefore, should not be used for insignificant dispositions. For example, it would be inappropriate for a real estate company that owns and operates hundreds of office
buildings to report the disposition of one building or any number of buildings having an insignificant effect on a company’s cash flows as discontinued operations.

We respectfully request that the Board clarify its intention “to allow for judgement in determining whether, based on facts and circumstances unique to a particular entity, a disposal transaction should be reported in discontinued operations.” We do not believe that the examples in SFAS 144 provide adequate clarifying guidance.

NAREIT appreciates the opportunity to continue to participate in Board’s standard setting process. This comment letter has been reviewed and approved by NAREIT’s Best Financial Practices Council. If you have any questions regarding this response, please contact George Yungmann at (202) 739-9432 or David Taube at (202) 739-9442.

Respectfully Submitted,

George L. Yungmann
Vice President, Financial Standards
July 6, 2006

Mr. Lawrence W. Smith
Director-Technical Application and Implementation Activities and EITF Chair
Financial Accounting Standards Board
401 Merritt 7
Norwalk, Connecticut 06856-5116

Re: SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets
(SFAS 144 or the Standard)

From: Louis W. Taylor, Managing Director, Senior Real Estate Analyst, Deutsche Bank Securities

I am a Managing Director and Senior Real Estate Analyst in the Equity Research Department at Deutsche Bank Securities. As a senior equity analyst, I have covered Real Estate Investment Trusts (REITs) for 13 years. I have an undergraduate degree in Accounting and worked at Touche Ross in Boston from 1980 to 1983. I am a CPA but allowed my license to practice to lapse in 1989.

I am writing to support NAREIT's request that the FASB consider issuing guidance for applying SFAS 144. Such guidance should clarify that the Standard is not intended to force dispositions of components to be reported as discontinued operations when, in the judgment of management and based on facts and circumstances unique to a particular entity, the disposition should not be reported as discontinued operations.

In analyzing REITs, our primary financial statement objective is to forecast "funds from operations" or "FFO", the industry's supplemental performance metric, as well as net income. FFO has been used since 1989. In its simplest form, it takes GAAP net income and adds back depreciation on investment property and any gains on sales. We then make subsequent adjustments for capital expenditures, but these adjustments start with the NAREIT definition of FFO, the industry standard. We believe the net result is a reasonable reflection of a real estate company's likely earnings trajectory. It is not a perfect definition, but it has proven to be a useful industry standard the past 16 years.

Under SFAS 144, forecasting FFO and net income is virtually impossible without extensive voluntary disclosure. The current classification of real estate dispositions as discontinued operations severely impairs our ability to come up with a reasonable forecast of future operating results. The companies have helped this process by expanding their disclosures. But that disclosure is very inconsistent and the companies are under no obligation to do so.

In preparing our forecasts, SFAS 144 creates a host of forecasting problems:
Deutsche Bank

- **It lumps everything under a single line item.** Under GAAP, results from discontinued operations lumps together, revenue, expenses, depreciation, gains and losses into a single line item. As we noted above, we need to pull out gains and depreciation to arrive at our FFO run rates. We can’t do that without the voluntary company disclosures. Dealing with this complication for significant, infrequent dispositions would be acceptable but dealing with it for virtually every property sale adds far too much complexity to our projections.

- **It treats both assets sold and assets identified for sale as discontinued operations.** Thus it is impossible to tell whether these assets contributed for an entire reporting period, or just for a portion. This is a critical data point for us. And since companies are reluctant to tell us what properties are listed for sale, it’s impossible to separate the results between those assets sold and those assets held for sale. Again, dealing with these complexities from time to time for only major dispositions would enhance our ability to assess future earnings and cash flows.

- **The line item is net of partner interests.** This is a third layer of complication. The third party interests (basically minority partners) are included as well. We’re not sure whether a partner had an interest in the assets sold, or the assets still being held, the partner’s share of depreciation, gains, etc.

**Reporting discontinued operations under U.S. GAAP should mirror the international standard.** We understand that the international standard would include only significant dispositions in discontinued operations. Many REITs are expanding outside the U.S. It seems contrary to us that U.S. GAAP stands fast when world-wide GAAP provides for more useful, less complex financial reporting.

**SFAS can easily throw off our forecasts by a wide margin.** Since real estate companies do not generate more than $0.10 to $0.25 per year of earnings growth, if our run rate is off by even a penny a quarter, it can meaningfully impact our forecasts and growth rates. With the presence of SFAS 144, our numbers can easily be off by that amount if the company’s supplemental disclosure is inadequate. In those cases, we’re really beholden to management guidance which makes us very uncomfortable.

**Forecasting prior to the issuance of SFAS 144 was reasonably straight forward.** Before the implementation of SFAS 144, forecasting was fairly straightforward and reasonably accurate. We could get very close to a company’s run rate by their disclosure of when assets were sold in a quarter. Since the company’s routinely disclosed the volume of assets sold in a period, and the average yields, if they didn’t supply the exact dates, we could still get close to the run rate by prorating the sales within a quarter. It was a very straightforward exercise that worked well for over ten years.

**SFAS is a barrier to new investors and provides no incremental investment value.** Aside from the dramatic complexities it causes for earnings forecasting, we’re seeing signs that it is discouraging interest in the real estate stocks. New buy side analysts that
are assigned the real estate sector are frequently the most inexperienced. The accounting has made their task daunting. Between SFAS 141/2, and the non-cash revenue that those pronouncements have created and SFAS 144, it is virtually impossible for a new buy-side analyst to model a real estate company without a lot of hand-holding from us. Instead of educating them on important stock price drivers, we're spending our time in the bowels of the filings explaining why some items should be in FFO and why others should not be included. Granted, we enjoy spending time with clients, but it was much easier to explain the modeling nuances before SFAS 144 went into effect. And frankly, we haven't gained any further insights into the companies from the discontinued operations treatment. It's a lot more work for zero incremental value to us as analysts and to our clients, the investing public. So after helping clients sift through all the complexities, we've seen some simply move on to other sectors.

We agree with NAREIT that the FASB should issue guidance that would:

a) eliminate insignificant dispositions from discontinued operations reporting and

b) harmonize reporting under U.S. GAAP with the international accounting rule.

I strongly urge the Board to seriously consider this matter. Dealing with the forecasting complexities discussed above is a waste of our time and adds absolutely zero value to the investing, forecasting or analytical process!

I would be happy to discuss these views with the Board.

Respectfully submitted,

Louis W. Taylor  
Managing Director  
Senior Real Estate Analyst  
Deutsche Bank Securities.

60 Wall St. New York, New York 10005
April 18, 2006

Mr. Lawrence W. Smith
Director - Technical Application and Implementation Activities and EITF Chair
Financial Accounting Standards Board
401 Merritt 7
Norwalk, Connecticut 06856-5116

Re: SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets

Dear Mr. Smith:

I am writing to support the National Association of Real Estate Investment Trusts’ request for FASB action on applying SFAS 144. I am a Senior Analyst and Managing Director at Stifel Nicolaus & Company. I was also a principal of an institutional fund manager and a REIT CFO. I prepared financial models for many REITs as an analyst for the past ten years. The Stifel team now covers about 80 public real estate companies.

We think the FASB should clarify the Board’s intention that judgment should be applied to the determination of whether a property disposition should be reported as a discontinued operation. Most REITs and accounting firms interpret SFAS 144 to require that virtually all sales of investment properties, even individual properties, be included in discontinued operations. In our industry this causes continual restatements and reclassification of previously reported income and expenses. This treatment distorts the operating picture for companies that regularly buy and sell investment properties. It creates impenetrable complexity in analyzing the financials and makes it difficult to project future earnings for companies in the investment property business.

Many REITs buy properties for repositioning purposes. Some of these assets are sold when stabilized, and the capital is recycled into properties with more upside potential. Reporting these assets as discontinued operations under SFAS 144 obscures results and discourages this type of positive economic activity. For purposes of projecting future earnings, we believe there is no difference between income and expenses for assets that were sold, and earnings from properties purchased with the proceeds. In our opinion both should be reported in continuing operations.

A key distortion cause by discontinued operations treatment is that growth in earnings from continuing operations is overstated because the earnings from sold properties are no longer presented in the on-going earnings. This is becoming increasingly apparent, and many companies and analysts are now compelled to “back out” the distortion so as to not overstate results when discussing historical and prospective growth.

We support NAREIT’s request for FASB guidance in applying SFAS 144, explicitly stating that the standard does not automatically require reporting dispositions of components as discontinued operations. We think that management judgment (as
discussed in paragraph B103 of SFAS 144) should be applied to the facts and circumstances unique to each entity, and that investment real estate not automatically be required to be reported as discontinued operations.

Sincerely,
### Top 20 Companies

Impact of Discontinued Operations on Revenue Growth

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<td>AT&amp;T Group</td>
<td>MO</td>
<td>Yes</td>
<td>89,010</td>
<td>447</td>
<td>90,057</td>
<td>61,220</td>
<td>513</td>
<td>81,332</td>
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<td>Boeing</td>
<td>BA</td>
<td>Yes</td>
<td>52,457</td>
<td>96</td>
<td>52,553</td>
<td>60,256</td>
<td>220</td>
<td>55,456</td>
<td>4%</td>
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<td>Cardinal Health</td>
<td>CAH</td>
<td>Yes</td>
<td>85,054</td>
<td>77</td>
<td>65,181</td>
<td>56,732</td>
<td>23</td>
<td>58,924</td>
<td>15%</td>
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<td>Chevron</td>
<td>CVX</td>
<td>Yes</td>
<td>135,300</td>
<td>635</td>
<td>165,935</td>
<td>121,277</td>
<td>485</td>
<td>121,762</td>
<td>28%</td>
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<td>ConocoPhillips</td>
<td>COP</td>
<td>Yes</td>
<td>135,078</td>
<td>14</td>
<td>106,040</td>
<td>104,246</td>
<td>8</td>
<td>104,254</td>
<td>90%</td>
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<td>Ford Motor Company</td>
<td>F</td>
<td>Yes</td>
<td>171,852</td>
<td>581</td>
<td>172,236</td>
<td>164,391</td>
<td>842</td>
<td>165,106</td>
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<td>General Motors</td>
<td>GM</td>
<td>Yes</td>
<td>163,517</td>
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<td>163,517</td>
<td>165,327</td>
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<td>International Business Machines</td>
<td>IBM</td>
<td>Yes</td>
<td>94,963</td>
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<td>94,963</td>
<td>94,963</td>
<td>-</td>
<td>94,963</td>
<td>8%</td>
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<td>89,906</td>
<td>-</td>
<td>69,505</td>
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<td>-</td>
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<td>408</td>
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<td>1,214</td>
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<td>246,484</td>
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<td>No</td>
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<td>Amersicaberges</td>
<td>ABC</td>
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<td>No</td>
<td>No</td>
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<td>Iowa Power</td>
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<td>No</td>
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<td>25</td>
<td>State Farm Insurance</td>
<td>SFH</td>
<td>No</td>
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### Notes

1. Sales of Kraft's sugar confectionary business.
2. Sales of Boeing's BCCs Commercial/Keyword Services business.
4. The classification of assets as "held for sale" included the sale of the Canadian natural-gas processing business and certain producing properties in the Gulf of Mexico.
5. Disposed of, or committed to a plan to dispose of, certain U.S. retail and wholesale sales marketing assets, certain U.S. refining and related assets, certain U.S., European natural gas gathering and processing assets, and exploration and production assets in the Netherlands and wholesale sales marketing assets, certain U.S. refining and related assets, certain U.S. European natural gas gathering and processing assets, and exploration and production assets in the Netherlands.
6. Sale of various non-core businesses as well as Fords' Formula One Racing operations.
7. A series of transactions that resulted in the spin-off of Hughes from GM and the simultaneous sale of GM's interest in Hughes to the News Corporation, Ltd.
10. Sale of various business segments and consumer lines.
Rating Methodology for REITs and Other Commercial Property Firms

This rating methodology focuses on real estate investment trusts (REITs), real estate operating companies (REOCs) and other commercial property firms. Moody's rates the securities of over 130 REITs and REOCs globally, which have a median rating of Baa2, at the lower end of the investment grade level. This rating methodology is part of Moody's effort to outline the systems we use for rating property firms. Our goal is to provide investors and issuers a transparent set of guidelines to allow them to better understand our rating process and how we reach our rating decisions. This rating methodology should be used in conjunction with our prior publication, Key Ratios for Rating REITs and Other Property Firms.

Moody's Rating Distribution

1. Please see Appendix 1 for more details on the types of real estate companies and regional differences. This methodology does not address commercial property firms that are principally developers.

REIT and Other Commercial Property Firms’ Ratings

Moody’s REIT and REOC rating process, like all of Moody’s ratings processes, is based on cooperative working relationships with relevant experts. In the case of REITs and REOCs, Moody’s analysts who specialize in financial institutions, structured finance and other industries (e.g., retail, non-bank finance, lodging and health care) all participate in the rating process.

REITs and REOCs issue both unsecured debt (which is the subject of this study) and mortgage debt (usually non-recourse) which subordinates the claims of the unsecured creditors. Ratings assigned to unsecured debt of a REIT or REOC tend to be lower than those assigned to mortgage-related transactions, primarily due to the absence of liens, deal structure, subordination and managements’ ability to adversely change such items as strategic models, asset composition, capital structures and leverage. The crux of Moody’s fundamental analysis is to determine the quality, diversity and sustainability of a firm’s earnings and cash flows relative to cash needs, and to translate those judgments into the likelihood of default, and recovery rates, assuming default.

Rating Models

Moody’s is often asked about our use of quantitative rating models. We use such models as part of the input into assigning ratings. Quantitative factors are not the sole determinants of ratings, however, as ratings are also affected by such more qualitative factors as governance, the aggressiveness of management strategy, sector leadership, our expectations of business and financial plans and the like.

Our quantitative model focuses on four measures that have proved to be particularly important to estimating the creditworthiness of commercial property firms.

Core Rating Drivers for Property Firms

There are six core factors that drive Moody’s real estate company rating outcomes. Each core factor has qualitative and quantitative sub-factors that Moody’s considers, too. The table below outlines these six core factors, the reasons behind their relevance, and metrics used in conjunction with them. In specific, we map the qualitative aspects to the quantitative metrics outlined in our “Key Ratios for Rating REITs and Other Property Firms” report. We further examine each core factor in detail in the following sections. It is best to review this section in the context of the entirety of this report. The core rating factors include:

1. Liquidity and Funding
2. Leverage and Capital Structure
3. Market Position and Asset Quality
4. Profitability and Sustainability of Cash Flows
5. Internal Operating Environment
6. External Operating Environment

Based on our ratings model, Moody’s Rating Driver Grid (Appendix 2) and an application of the Rating Driver Grid to a hypothetical US retail REIT (Appendix 3), factors one through four referenced above tend to have greater effects on the ratings outcome than do factors five and six.

3. See Appendix 2 for a summary of Moody’s rating driver grid and Appendix 3 for an application of the rating driver grid to a hypothetical US REIT.
LIQUIDITY AND FUNDING

Analytical Underpinning

• A company's ability to service and repay debt — especially under adverse operating conditions — is correlated with its liquidity and funding sources/structure.
• Due to the capital-intensive nature of commercial real estate, and REITs' minimal cash retention capacity, liquidity and funding issues take on particular relevance.

Key Metrics

• Funding Capacity
• Funding Structure
• Free Asset Base
• Dividend Payout Ratio

Key Considerations

• Adequacy of liquidity sources, especially size, usage and structure of bank lines.
• Funding Structure:
  - Debt maturity laddering
  - Dividend coverage

Key Considerations by Rating Categories

Our assessment of a REIT's or REOC's liquidity consists of an examination of the relationship between its sources of liquidity, such as borrowing capacity, cash balances, operating cash flow and unencumbered assets, and its intermediate-term fixed obligations, including capital expenditures. The firm's debt maturity structure is a focus because the bunching of maturities can present liquidity challenges. The more that debt maturities are spread over time, the more financial flexibility a firm will have. Multi-year committed bank lines from core relationship banks with covenants that are not likely to be tripped in adversity (MAC clauses and ratings triggers being distinctly negative characteristics) can enhance financial flexibility and serve as a stable source of funding. However, these facilities are best viewed as temporary liquidity sources. Heavy reliance on these facilities is risky for property companies given the long-term nature of the assets, and inherently limited cash retention capacity in the case of REITs.
When examining a REIT or a REOC, we also examine covenants related to bank facilities, bonds and the like that may limit liquidity to the REIT or REOC in a stress situation, or that could restrict the sale or encumbrance of a REIT’s portfolio. We also evaluate a REIT’s or REOC’s access to (and track record in) debt and equity markets. Because REITs distribute most of their cash flow, a firm’s ability to repay its debt is a direct function of its ability to raise cash. For REITs and REOCs, properties that are free and clear of mortgages are also sources of alternative liquidity, via property-specific debt, or even sale.

LEVERAGE AND CAPITAL STRUCTURE

**Analytical Underpinning**
- Unencumbered assets add to financial flexibility and bondholder recovery protection
- High leverage drains cash resources and particularly heightens vulnerability to operating reversals
- REIT’s requirement to pay most, if not all, of taxable income reduces internal capital generation
- Debt covenants may limit the range of leverage and capital structures, and support free assets underpinning bonds

**Key Metrics**
- Capital Structure — Total leverage and secured debt levels
- Debt covenant package
- Stock Market Valuations and Bond Pricing

**Key Considerations**
- Overall leverage
- Relative secured debt levels, amount of encumbered assets and cash flow

**Key Considerations by Rating Categories**
The liquidity, earnings volatility, cash-retention capacity and capital-intensive characteristics of REITs and REOCs are important characteristics that drive leverage analysis. Appropriate leverage levels for a given rating vary from case to case. For instance, having more stable income streams (such as from long-term triple-net leases on high-quality buildings with investment-grade tenants) can support more leverage at a given rating level.

Many REITs have stated objectives of maintaining leverage within certain ranges, the ranges partly driven by bond and bank loan covenants. Moody's analysis tends to measure leverage against the potential value of assets or gross book value, rather than total market capitalization, given the volatility of equity markets, though the market's determination of a firm's value is examined, too. To strengthen and diversify their capital structures, some REITs and REOCs issue preferred stock. Moody's usually views preferred stock as "debt-like" and folds it into our quantitative analysis as such.

The balance between secured and unsecured debt is another important analytical consideration. For the unsecured bondholder, the existence of a pool of unencumbered assets (the larger, more diverse and high quality the better) adds to a REIT's financial flexibility. The presence of mortgage debt (including non-recourse, though such debt can provide some flexibility, mostly limited to extreme stress) effectively subordinates unsecured bondholders and decreases a REIT's or REOC's financial flexibility. The larger the ratio of unencumbered assets to total debt, and in particular, total unsecured debt, the more flexibility a given REIT generally has in repaying its unsecured debt at maturity, and a higher recovery in the event of default would be more likely. We measure this by percentage of NOI by percentage of value and by number of properties. It is also useful to examine the maturity structure of mortgages, which speaks to liquidity needs, and the likelihood a firm can take steps to unencumber itself.

When looking at secured debt, a distinction between recourse and non-recourse is made. In Moody's opinion, non-recourse debt is less likely to jeopardize a stock of unencumbered assets in a given property portfolio, reflecting the ability to walk away from the obligation without many direct consequences. However, debt is still debt, and Moody's anticipates that most REITs and REOCs would fulfill obligations — including non-recourse obligations — in most circumstances.

Significant financial and strategic flexibility is lost through mortgage finance. First, mortgaged assets are more difficult to sell, partly because of restrictions or penalties related to transference. Even when there are no such obstacles, purchasers of mortgaged properties consider the impact of assumed debt on their overall borrowing mix, and measures such as interest costs and maturity laddering. Because the property and the mortgage are joined at the hip, both need to be appealing to make a sale work, and a bad mortgage on a good property decreases the property's value and salability. Second, mortgage agreements typically restrict the ability of an owner to reposition properties; this makes "fixing" problem properties even more challenging. Also, recasting the first mortgage to raise the LTV can be difficult, if not impossible, and the same applies to obtaining a second mortgage — much of the value of the asset gets sequestered, and the asset cannot be used as a source of alternative liquidity. In some mortgage structures, even finding someone to call and discuss the issue with is difficult. These factors make the mortgaged asset less flexible, thus impairing asset liquidity and constraining a firm's ability to reposition or finance its portfolio.

Moody's examines and stresses the level of variable-rate debt, the goal being to determine to what extent a firm's cost of funds is vulnerable to rising or falling interest rates, and how rates are correlated to cash flows from assets. Some assets "reprice" rapidly due to short-term leases (such as apartments). To the extent lease rates float in similar manners to debt, the level of floating rate debt that can be carried at a given rating level will vary. For property companies, most variable rate debt comes from the revolver, and high revolver usage also impairs liquidity and financial flexibility. In specific, it diminishes the ability to close quickly on acquisitions, fund development or other capital expenditures, and serve as bridge financing for other cash needs. It is important to separate the discussions of variable rate and term structure.


Moody's Rating Methodology 5
The requirement that REITs disburse most, if not all, of their net income as dividends reduces internal capital generation and therefore fundamentally crimps leverage capacity. Some REITs have negative cash retention — uncommon among investment-grade firms — once dividends and capex are considered, though dividend reinvestment plans have often been sources of capital, such as for many Australian property trusts ("LPTs"). It is important to examine firms' actual payouts, which can exceed cash-generating capacity (due, perhaps, to a profit downturn that a firm believes will correct itself soon so that a dividend cut is not needed) and thus further crimp financial flexibility. Moody’s REIT ratings methodology also includes analyses of what could jeopardize a company’s REIT status. This varies by nation and includes involvement in prohibited activities, improper dividend payouts or concentrated ownership. Such an event would adversely affect a company’s financial strength because failure to qualify as a REIT would usually subject the company to severe tax or other penalties, and may be an event of default or acceleration under borrowing arrangements. REOCs, because they do not have to meet the requirements that REITs must meet, can engage in a wider range of real estate-related and other activities and can better manage their dividends, although they do not enjoy REITs’ favored tax treatment.

Moody’s analysis also includes a review of a property firm’s stock market valuations and bond pricing. We examine a property firm’s relative stock performance against peers; relative Price/Earnings multiple and trends in the multiple (for REITs we use Funds from Operations as the proxy for earnings); and debt and credit default spreads. Stock market performance also speaks to capital access, as well as shareholder pressures and expectations being placed on management. If a firm’s stock price or P/E is weak, management might be tempted to boost leverage, buy risky assets, or otherwise shift the firm’s risk profile to rectify the situation. Also, a low stock price can deter management from issuing common stock. Given that REITs are structurally unable to retain much, if any, cash, this is an especially important point. Bond and CDS pricing provide benchmarks for how bond investors are viewing the company and the likelihood of capital access.

MARKET POSITION AND ASSET QUALITY

Analytical Underpinning

- Different property types have varying degrees of risk
- Market leadership results in more pricing power and better deal flow
- Institutional-quality, well-leased and tenanted assets have higher liquidity, more cash flow stability and greater leverageability

Key Metrics

- Size and Asset Market Value
- Asset, Geographic & Tenant Diversification
- Development Activity

Key Considerations

- Market share/leadership:
  - Size and growth rate
  - Strength of franchise/brand
- Portfolio diversity:
  - Geographic
  - Tenant and industry
  - Asset
  - Asset type
  - Economic
- Development activity
- Asset modernity, functionality, location

6. Payout rules vary by nation.
7. Funds from Operations (FFO), as defined by NAREIT, is GAAP net income less gains/losses from asset sales, plus depreciation and amortization related to real estate, adjusted for unconsolidated partnerships and joint ventures, extraordinary items, cumulative effect of changes in accounting principles and discontinued operations.

Moody’s Rating Methodology
Key Considerations by Rating Categories

The inherent riskiness of different property classes has a significant effect on our ratings of REITs and REOCs. One of the key attributes Moody's look for is stability of cash flows and values. Stable cash flows increase our confidence that the debt can be serviced on a timely basis, and stable values enhance the ability to sell or to refinance properties in order to have the capital available to meet debt service and grow the business.

In specific, we look at a firm's geographic, tenant, industry and economic diversification, and lease structures, to help assess the overall quality of a REIT's or REOC's portfolio. Geographic diversification allows a firm to weather economic challenges in certain regions or cities vs. others. However, being diversified just by geographic footprint does not necessarily imply effective diversification, as different geographic markets can be correlated as they relate to economic and industry factors. For example, high vacancies for an office REIT due to a challenging technology or telecommunications environment could affect a REIT's cash flows with properties located in Northern California, Boston and Northern Virginia. Some leases, such as in Argentina, can be broken by the tenant at short notice. Other leases are long term, triple-net and fixed, perhaps with intermittent scheduled rate increases. Still others are long term with upwards-only rate revaluations; this is typical of the UK. Such differences in lease structures can affect property quality.

A diversified portfolio (by size, geography and tenant base) located in densely populated areas, in central or close-in suburban areas of major cities, is usually more stable. In general, Moody's believes that high-quality properties, commonly referred to as "Class A", offer the best protection. These assets enhance the flexibility of a REIT or REOC because there is a wider universe of tenants, and debt and equity investors. Liquidity in all its dimensions is better: Class A assets tend to have a higher likelihood of being more attractive and marketable than Class B and Class C assets at the time of sale or refinance. That is not to say, however, that Class B properties do not provide good protection, especially if the REIT or REOC specializes in the class and property sector. For example, in the USA Class A multi-family properties suffered more performance pressure than did their Class B counterparts during the early 2000 recession because the tenants in Class A apartments were more apt to be homebuyers, especially with the historically low interest rates. Class B tenants are more renters-by-necessity.
Moody’s analysis includes an examination of a REIT’s or REOC’s property investment portfolio and the relevant markets in which its assets, or operators, are located. Matters such as occupancies, lease expirations, market rents, regulatory trends, and the physical condition and competitiveness of the properties are also evaluated, as are each property’s location dynamics, tenant or operator mix and quality, supply prospects and barriers to competition that can protect the property from economic value erosion. We also assess the likely performance of a REIT’s or REOC’s portfolio under adverse scenarios, such as high vacancy rates and low rents, as well as differing capex needs. We further examine known and potential environmental and regulatory liabilities. Moody’s seeks to understand the effects of both national and regional economic trends on the property portfolio, and the extent to which the REIT or REOC can manage its position. We also examine the REIT’s or REOC’s economic role in the context of national and regional economic development.

REIT AND REOC SECTOR DIFFERENCES
Cash flow characteristics vary by property type, and the quality of individual real estate assets varies, too, even within sectors. The table below indicates property types from most stable to least stable. Though this ranking is most applicable to the USA, it is indicative of other property markets, too. However, risk characteristics of different property sectors can and do vary by sector and subsector by nation. For example, housing is heavily government influenced in most nations, and this can markedly affect apartment values. Also, zoning, development approvals, property lease laws, and industry structures affecting the mix and quality of tenants, to name but a few factors, all affect the volatility of cash flows and values of various property sectors, and all of these factors can vary by nation, and by region within a nation. Due to risk/quality overlaps between sectors, and the presence of distinct subsectors, this ranking is only broadly indicative.

| Avg. Std. Deviation of REIT Return on Invested Capital and Average Assets |
|-----------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|
|                        | Retail                      | Multifamily                 | Industrial                   | Office                      | Health Care                 | Lodging                    |
| Avg. Std. Deviation (ROIC) | 0.80                        | 1.60                        | 2.40                         | 3.20                        | 4.00                        |                             |
| Avg. Std. Deviation (ROAA) | 0.00                        | 0.80                        | 1.60                         | 2.40                        | 3.20                        | 4.00                        |

Note: Standard deviation of Return on Average Assets (ROAA) volatility over a period of time. ROIC calculated as EBITDA as a percentage of Average Assets (Annualized Data from 1993 to 2004).

Source: Moody’s and SNL Financial. The calculations of standard deviation of ROIC and ROAA are based on year-end data from 1998 to 2004.
For lodging, healthcare and commercial mortgage REITs in particular, to be placed in the same rating categories as the other property sectors requires them to employ more conservative capital structures and higher levels of liquidity and performance.

**SUSTAINABILITY OF CASH FLOW AND EARNINGS**

*Analytical Underpinning*

- High, consistent returns, with revenue growth, indicate an attractive business segment, good management and a sound business plan
- Lease structures are indicative of earnings predictability

**Key Metrics**

- Earnings Momentum
- Fixed Charge Coverage
- Gross Margins

**Key Considerations**

- Operating margins, efficiency
- Volatility of returns
- Earnings growth rate

**Key Considerations by Rating Categories**

The commercial real estate industry is cyclical and capital-intensive by nature, and real estate cash flows are therefore volatile. Operational cash flows are ultimately reflective of the quality of a REIT’s portfolio (see above) and of its management’s ability to create and enhance the value of its assets. In general, cash inflows are affected by such factors as the quality and type of the real estate portfolio, lease structures, tenant quality, the prospects for rental growth, borrowing, asset sales, equity issuance and occupancy rates. Cash outflows include debt service, asset acquisitions, taxes, asset maintenance, dividend requirements and capital improvements.
The consequences of the low level of retainable cash at REITs are multifold. Retained cash flow endemically is thin and cannot, therefore, be used to fuel growth, or service debt. The only way to grow is to constantly raise capital — equity and/or debt, or through asset sales. Similarly, the only way to repay debt, under normal conditions, is through refinancing — again, capital access. These inherent characteristics are important when analyzing the financial flexibility of a REIT. Retained cash, in the case of REOCs or REITs paying (relatively) low dividends, has many positive attributes, from strengthening bondholders' position (more cash is available for debt repayment and long-term growth) to providing a lower cost of capital for the REIT. To the extent REITs are able to achieve greater earnings retention there is a better cushion for bondholders. Many REITs use dividend reinvestment programs (DRIPs) as a means to encourage shareholders to reinvest in the company. The extent to which DRIPs are successfully utilized varies from company to company and region to region. In Australia, for example, DRIP acceptances are often in the 40%-50% range, and have provided a significant source of funding for many LPTs, which is the Australian term for a REIT.

REITs' dividend requirement is a major cash flow analytical factor, as are their asset sale restrictions. In most cases, REITs still tend to pay dividends well in excess of the minimum tax requirement, depleting the cushion that results from depreciation and amortization.

In the case of US REITs that are structured as UPREITs (Umbrella Partnership REIT) — whereby the REIT owns an interest in an Operating Partnership, which in turn owns the real estate assets — most all of the unitholders of the operating partnership have contributed assets to the REIT. Often these asset contributions, for tax purposes, have sales restriction arrangements incorporated into the contribution agreement. These sale restrictions arrangements usually restrict the REIT from selling the contributed asset for a certain amount time (sometimes many years) unless the party that contributed the property agrees to the sale or the sale is conducted as a tax-free exchange. These restrictions, especially during a stressful operating environment, can restrict a REIT's ability to access quality cash flow from its portfolio. In other cases, the REIT is required to maintain secured debt against the property — again to protect the tax status of the contributor. This, too, hurts a REIT's flexibility. These characteristics become especially problematic if the contributing party is also a REIT manager or Board member, with conflict of interest concerns.

**INTERNAL AND EXTERNAL OPERATING ENVIRONMENT**

**Analytical Underpinning**
- Company track record is an indication of future performance under adverse operating conditions
- Ownership/corporate structure/governance indicate factors motivating management's actions; checks and balances
- Depth of organization relates to company's ability to respond to changing market and operating conditions, and affects the scalability of a company
- Management vision and risk appetite suggest potential volatility in growth, earnings and capital structure
- Economic environment plays a role in funding ability and cash flow stability
- Property market fundamentals influence current and future performance and cash flow stability
- Competitive position suggests property firm's ability to weather adverse market conditions

**Key Metrics**
- Historical financial statement analysis
- Corporate governance assessment
- Risk management assessment
- GDP, job growth, yield curve data
- Local property market conditions and supply
- Size and asset market value

**Key Considerations**
- Management strategy, risk appetite and governance
- Depth of organization – MIS, personnel skills and size
- Joint ventures and Fund businesses
Key Considerations by Rating Categories

INTERNAL OPERATING ENVIRONMENT

The dynamics of the commercial property industry require Moody's to consider, for instance, the nuances of particular property types, as noted above. Just as critical is Moody's consideration of each issuer on its unique merits. We look to the internal operating environment for a particular issuer and focus on track record, corporate structure, management vision, risk appetite, joint ventures, fund businesses, and covenant considerations, which are discussed below in greater detail.

Company Track Record

How long the business has been operated as a REIT or REOC is factored into Moody's analysis. RETIs and REOCs that have been around for several years have demonstrated management's relative ability to weather adverse real estate and capital market conditions, as well as provided insight into their risk temperaments. Many RETIs and REOCs do not have a long history operating as public companies, and in these cases we look at how successfully management has operated as a company before converting to a public REIT or REOC.

Ownership/Corporate Structure

Major inside ownership is often viewed as a stabilizing factor to the extent that senior management is motivated to develop the company conservatively and with a long-term vision. Also of importance is the management structure of a given REIT or REOC. Is the REIT or REOC self-managed or externally advised? Is it fully integrated? Self-managed and fully integrated (meaning the firm is responsible itself for most key functions, such as development, acquisitions, underwriting, asset management, asset sales, finance) RETIs and REOCs tend to have the most operational flexibility and less potential for conflicts of interest. For example, potential conflicts may arise when a company is externally managed pursuant to a management agreement that was not negotiated at arm's length, or when the management company manages or leases properties on behalf of third parties or itself. Management agreements are also examined to determine the motivations of managers, and whether, for example, managers are paid by size, short-term performance or long-term performance.

For US RETIs, the distinction between the traditional REIT versus the UPREIT structure is also considered. In assessing an UPREIT, we seek to understand the legal and accounting aspects of the structure and potential for structural subordination, the strategic rationale, and particularly any potential conflicts of interest.

**Depth of Organization**

Moody's analysis incorporates our evaluation of the REIT's or REOC's operating skills and technological development. This relates to how well the firm approaches operating challenges (such as tenant bankruptcies or new supply) and opportunities (such as replacement of tenants, large acquisitions and strategic mergers) in order to maximize the value of its property portfolio and business platform. We also focus on management's ability to shift resources, including the firm's informational and technological infrastructure, in response to changing market conditions. The quality, depth, and relevance of the information made routinely available to management are of particular interest.

Moody's examines how long the senior management has been a team, as well as its management style and temperament, depth and succession plans. This is especially significant when the most senior managers are approaching retirement age and have had dominant roles, such as founding the company and maintaining key relationships with tenants and financing sources. The composition, quality and independence of a REIT's board, and the relationships among board members and management, are important to explore, and can sometimes be crucial rating drivers.

**Management Vision and Risk Appetite**

We review the nature, realism and success of management's long-term strategies, including plans for growth. As a means to supplement internal revenue growth, many companies actively engage in acquisition and development. Moody's assesses the related risks in the context of the REIT's or REOC's resources, capital structure and operating strategies. Our analysis considers risk factors such as market risk, project risk, and management's track record with regards to adding value. A company that grows too quickly may experience integration challenges and weaker underwriting if it has not properly enhanced its internal controls. With regards to development, Moody's considers the size and mix of the pipeline relative to the company's asset base, as well as history of completing projects on time and on budget. In addition, Moody's distinguishes between those projects that are at least partially pre-leased and those that are more speculative. Insofar as a strategy appears to be aggressive, we more closely seek to understand how management intends to implement such a strategy. Management's track record is also scrutinized when assessing their ability to create and enhance the value of property assets and accessing the capital markets.

**Joint Ventures and Fund Businesses**

Joint ventures and fund businesses provide other means of capital access for REITs and REOCs and diversification of earnings, but are complex structures and create varying degrees of transparency and risk issues. In addition, a REIT's or REOC's earnings quality can be diminished if a large proportion of earnings is being generated by these structures. All the same, joint ventures and fund businesses provide a mix of rating-positive and ratings-negative characteristics, with the exact balance being a function of particularities for the deals, and the overall percentage of such deals in the REIT. In modest amounts, and for the right reasons, JVs and funds can be a plus. Funds, however, which tend to be institutional investment vehicles in which the REIT takes a small stake, and from which the REIT generates development, promote, management and similar fees, can best be seen as a distinct line of business, as opposed to JVs, which are more means of executing acquisitions, attracting capital, leveraging the business strategy or reducing the concentration of individually large assets.
Transparency varies with the type of joint venture or fund. In general, REITs tend to participate in co-investment JVs, which have relatively good transparency, and are, for the most part, evaluated on a pro rate, consolidated basis. These co-investment JVs are usually intermediate-term arrangements in which risks are shared based on the ownership percentage, often with large institutional partners. The REITs retain the management and leasing fee income generated from the properties, and generally have a defined exit strategy for the venture. Moody's views REIT's JV development agreements with private developers as less transparent. Under a development agreement, the JV develops the property and, after the property has been stabilized, sells the property back to the REIT. These JV developments are usually shorter term arrangements in which risks are not shared equally and the REIT is usually committed to buy the property. REITs that are involved with development joint venture agreements are commonly evaluated on a fully consolidated basis, as they are really financings.

Moody's is concerned with these alternative strategies for growth, and continues to monitor the trajectory of these revenues as a percentage of total revenues, and analyze their stability. As part of the analysis of performance, we take a material haircut on income that is derived from development fees and any gains or fees from merchant building, as this type of income is more volatile than cash flow generated by the core asset-owning business of the REIT. Over time and with a stronger track record, these haircuts are reduced, but such cash flows are generally inherently less dependable than cash flows from rent.

Real estate funds are typically multi-investor vehicles, which include some level of modest co-investment and sometimes merchant building by the REIT. The REIT also provides advisory services which generate fee income from development, asset management, leasing and property management. The funds business is new to REITs, and they have not yet proved themselves as sustainable businesses. As funds tend to have finite lives, they do not have the revenue reliability of wholly owned assets, and we do not count earnings as recurring. Should a REIT develop a track record in the funds business, we would be able to count a portion of revenues as recurring, but it will take several years, and a demonstrated franchise and capacity to consistently create new funds, for this to happen. Although these fund structures provide other means of capital access for REITs and REOCs and diversification of earnings, real estate fund structures particularly contribute to transparency challenges. Also, there are potential conflict issues to consider between the REIT, which has its own assets and business, and those of its fellow fund investors. These funds liquidate at some point, and equity stakes in funds are highly illiquid until then. Fund structures can also take up much management time — especially senior management, a cost that often is ignored in profit computations. The fund business is also, at its heart, a new business line, and it is not yet clear that REITs will be successful in it. Can they keep creating new funds to replace those winding up? And do the costs — all of the costs — generate a competitive risk-adjusted return vis-a-vis wholly owned assets?

Joint Ventures (JVs)

Most REITs are considering, or have commenced, joint ventures to enhance investment returns through fees and promote structures. In many respects they are similar to funds, though usually less risky. Debt maturity schedules that do not incorporate the REITs’ exposure to JV-level debt misrepresent the REITs’ liquidity and leverage. Although JV structures usually allow for the REIT to retain control over the daily operations of the properties, as a practical matter, the REIT does have to consult with its JV partners on asset management matters. This can crimp the REITs’ flexibility, and distract management's attention. JVs also tend to be burdened with mortgages (like funds structures), further subordinating bondholders and using scarce secured debt capacity. While in some cases a JV is needed due to the desires of existing owners, and can also be a diversification vehicle for particularly large assets, for the most part JVs are means of issuing perceived-to-be-cheaper “letter stock” and to boost nominal returns at the expense of transparency, higher real risk and control.
Investments Outside the Home Market

More REITs and REOCs around the world are expanding outside their home markets, often through JVs or funds, which can create governance, management, legal, currency, political, liquidity, tax, exit and cash flow complexities. There are also the benefits to consider: diversification, growth, leveraging a skill base into new markets, and better serving key tenants with worldwide operations. Moody’s subjects these investments to a high level of scrutiny as it relates to earnings potential and risk/reward balance, and their effects on a REIT along the lines outlined above, as well as transparency, control, FX and tax matters. At this stage of development, we see international activities as a moderate risk. However, the strategic benefits and returns will need to be robust to compensate for the risks.

Covenant Considerations

Covenants play an important role in Moody’s rating process, and they support ratings, which encompass both the likelihood of default and the loss content should default occur. However, the analysis focuses first and foremost on the fundamentals of the business.

What covenants can do

We believe that covenants place meaningful parameters on the amount of risk that bondholders bear. Covenants also provide management with risk guidelines. Managements’ strategies and goals may change over time, but covenants, generally, will not. Covenants can trigger a recapitalization or acceleration while the firm likely retains material value in its property portfolio, which should enhance recovery values for debt holders, including preferred stockholders. Also, if there is a major restructuring of a firm, its covenants may cause it to take out affected creditors.

What covenants do not do

Covenants seldom protect companies against event risk. REITs’ bond covenants are not liens, and the bondholder has no control over the mix, quality or character of the unencumbered pool. Also, REITs are vulnerable to poor governance, risky and suddenly changed business or financial strategies, adverse regulatory and tax shifts, malfeasance and similar ills to which all operating businesses are exposed. Strong covenants do not make a weak firm or business model strong, and Moody’s cannot dictate or require covenants.

We monitor covenant calculations, and regularly evaluate the level of cushion a property firm has before tripping a covenant. In the USA, most bond covenants relate to leverage limits, minimum unencumbered asset levels and minimum debt service coverages. However, our evaluation of covenants has an impact on the rating and the notching between different classes of rated securities. We also make a clear distinction between bank line covenants and bond covenants. Bank line covenants apply for a shorter term and are also easier to amend and/or renegotiate. Firms’ attempts to loosen covenants may indicate a rise in risk appetite, and this “signaling” characteristic is an important matter.

Moody’s also notes the presence of any rating triggers or material adverse change (MAC) language in credit agreements. Such clauses are uncommon in the USA, but more prevalent in countries such as Australia. Moody’s evaluates the risk that MAC clauses or rating triggers will be invoked, as such circumstances would limit access to the credit facility.

EXTERNAL OPERATING ENVIRONMENT

External operating risks can include national and regional economies, the overall availability of commercial real estate credit, development, tax policy, regulation, and FX and political risks. We focus on three key areas in this section: economic environment, property market fundamentals and leadership position.

Economic Environment

Real estate is a cyclical industry, generally lagging its national/local economy. Moody’s looks to trends in GDP, job growth, inflation and interest rates to indicate future space demand, or lack thereof. For instance, job growth is more closely linked to the health of the multifamily and office sectors. The movement of interest rates, up or down, influences a property firm’s ability to compete for acquisitions and its rate of growth, inter alia.

9. REITs rules in various countries (such as Japan and Singapore) also act like covenants, e.g., leverage and development.

10. Moody’s notes that a handful of US REITs have added their public bond covenants from underwriting, e.g., leverage and development.

The health of the capital markets directly affects REITs in particular, given their inherent need for external sources of capital. Cap rates and interest rates have diverse effects on REITs' and REOCs' businesses. Moody's has seen that in an environment where interest rates are low and in turn cap rates are low, REITs and REOCs tend to be net sellers of properties. In an environment of low cap rates a REIT's traditional model of capital recycling (selling older or non-strategic properties and using the proceeds to buy/build newer properties or properties in strategic locations, supplemented with debt and equity issuance) can be disrupted because accretive acquisitions are difficult, if not impossible. In this environment, REITs tend to be net sellers of assets to leveraged buyers, and on the flip side face an expensive real estate market. This environment forces them to perhaps execute non-accusive acquisitions, de-leverage in preparation for a more appealing acquisition market later on, shift the business model's risk up via JV's, funds and similar structures to boost nominal returns, or buy back shares and thus leverage up. While asset sales can demonstrate liquidity and high value of investments, they may come at the expense of lower intermediate-term yields on capital, and portfolio quality (better assets are sold).

Moody's monitors such economic factors and the effects of these factors on a REIT's capital recycling plans and overall business risk. We view the use of sales proceeds to de-lever as a temporary credit positive, but monitor ultimate composition and quality of a REIT's portfolio as result of being a net seller.

**Property Market Fundamentals**

Moody's ratings incorporate a level of tolerance for shifts in market fundamentals within each rating category. Trends in property market fundamentals will impact ratings if we anticipate pressures or benefits will be material and long-lasting, particularly with unanticipated shifts. We examine trends in the following key areas: market vacancies; trends in rental rates, concessions and occupancy costs; supply/demand conditions, in specific development pipelines and rate of new supply deliveries; and absorption trends. We also note demand drivers within local and regional markets, noting if there are particular concentrations in tenants or industries.

**Competitive Position**

An important focus is whether the REIT or REOC is the "landlord of choice" in its core markets, and whether this leadership position translates into a more profitable competitive position for firms. This leadership may be by type of asset, by location, or both. For example, Sun Hung Kai enjoys an excellent leadership position in multiple property types in Hong Kong, but only focuses on that location. Simon Property enjoys a strong franchise in regional malls and outlet centers in the USA, and Westfield has great strength in regional malls in Australia and New Zealand, and a good position in the USA. Some property types also lend themselves more to stable, profitable leadership than do others. Regional malls and self-storage, for example, have more capacity for franchise-building; it has proved difficult in many markets to generate real price-making leadership in office and apartments. The competitive leadership that is most supportive of high ratings is leadership in multiple asset types in multiple geographic markets, with that leadership translating into higher performance measures, such as occupancy and rate, and getting the first and last look on deals. The watchword is diversity with depth. Moody's focuses on a firm's economic, industry, sub-market and tenant diversification, too, in order to assess leadership resiliency and depth.

**Real Estate Accounting Treatments in the Credit Analysis**

As part of our analysis, Moody's adjusts an entity's financial statements to arrive at their true economic substance. In certain instances, Moody's believes that the accounting does not reflect the economic substance of a transaction and, as a result, we adjust reported financial amounts to more closely reflect our view of the economics.

The four primary adjustments include our treatment of preferred stock 12, pro-rata or full consolidation of joint ventures, adjusting the historical cost basis of assets, and the desegregation of certain operations classified as "discontinued" under Statement of Financial Accounting Standards ("SFAS") No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" from operating results.

Preferred stock has many characteristics of debt since investors are "promised" a fixed dividend. In addition, we believe, over the long term as interest rates change, preferred stock will be redeemed to adjust a REIT's or REOC's cost of capital. As a result, the debt-like characteristics tend to override the equity characteristics. When analyzing leverage, preferred stock basket allocation for debt is included in the numerator of the leverage (i.e., debt plus preferred stock divided by gross assets). For the calculation of fixed charge coverage, preferred stock dividends are folded into fixed charges, especially given REITs' dividend requirements.

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Joint ventures are generally treated as equity method investments\textsuperscript{13} under US GAAP. Equity method investments are reported on the balance sheet at the net investment, less any dividends paid, and adjusted for the company’s proportional share of the JVs’ net income or loss from the time of the investment. The JVs’ income statements are also aggregated into one line item on the investor’s income statement and represent the company’s proportional interest in the ventures’ current period net income or loss. Moody’s believes this presentation tends to understate leverage and overstate operating performance. Our approach reverses the effect of equity method accounting and adjusts a company’s outstanding debt and EBITDA for either its pro rata interest in the venture, or the venture is consolidated in total. Moody’s evaluates the terms of the joint venture, as well as its strategic importance and long-term commitment, to determine whether to consolidate it fully or on a pro rata basis. International Financial Reporting Standards permit pro rata consolidation\textsuperscript{14} in many instances, and as a result an adjustment is unnecessary.

Moody’s believes that US GAAP financial reporting can distort the true value of real estate companies’ assets by representing them on a historical cost basis. In some nations, including those adopting International Accounting Standards (IAS), assets are (or will be upon the introduction of IAS in 2006) regularly revalued. This, too, can create distortions, the level of which depends on how often a company revalues its assets, and the dependability of the revaluations. Also, some firms using historical values turn their assets over often, resulting more or less in market values, whereas some others have owned assets for years, whose historical costs are well below market values. In an attempt to reduce this distortion, and create a truer comparison among companies, Moody’s values assets accounted for under US GAAP on a gross basis (adjusting upward for accumulated depreciation) in leverage calculations, as well as on a market value basis, using conservative adjustments. These adjustments facilitate comparisons among property companies. In addition, for those companies revaluing real estate assets with a resulting income statement impact, we eliminate the unrealized income statement impact in our analysis. This treatment is similar to that of realized gains and losses in the calculation of FFO.

SPAS No. 144 requires that the historical and current revenues and expenses, including gain or loss on sale, of a “component” of an entity (a component is considered to comprise operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the larger entity) held for sale or that has been disposed of, be classified as discontinued operations. For REITs this requirement normally results in properties held for sale or sold being classified as discontinued operations. As selling properties is a regular part of many REITs’ normal business operations, this results in a significant amount of each period’s earnings being classified as discontinued operations, with annual restatements to prior years for comparability. Moody’s believes the “discontinued” classification of these activities makes it difficult to determine a REIT’s real estate property business performance and therefore we combine discontinued operations related to these core activities with the operating income from real estate properties that continue to be owned but are not classified as held for sale.

Related Research

Special Comments:
Observations Of Governance In U.S. REITs, September 2005 (94031)

An Application of Moody’s Tool Kit: The Analysis of Preferred Securities Issued by US Real Estate Investment Trusts (REITs), May 2005 (92580)

Characteristics Of A Basket: C Perpetual Preferred, May 2004 (86981)

Rating Methodologies:
Key Ratios For Rating REITs And Other Property Firms, December 2004 (91014)


REIT Rating Methodology: Notching for Differences in Priority of Claims and Integration of the Preferred Stock Rating Scale, August 2001 (69700)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

\textsuperscript{13} APB Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock."

\textsuperscript{14} FRS 31, "Financial Reporting of Interests in Joint Ventures."

Moody’s Rating Methodology
Appendix 1

Types of Real Estate Entities

• **REOCs.** A Real Estate Operating Company (REOC) is a general purpose corporation that is involved in the commercial real estate business as an owner/manager/developer. It is not constrained by regulation, and can enter or exit any line of business at will. A REOC, unlike a RETT, has no set dividend obligation, and is subject to corporate income tax.

• **REITs.** There are several forms of Real Estate Investment Trust around the world, with differences in what they are called, what their powers are and how they are regulated. As a general rule, RETIs:
  - Focus solely on the real estate business as investors or lenders
  - Focus on passive income from rents on properties, or mortgage interest
  - Must pay out as dividends substantially all of their taxable income
  - Do not pay corporate taxes
  - Are publicly and widely held firms

Differences among RETIs in various nations tend to be along the following lines:
• The type of legal entity, e.g., corporation or trust
• The extent to which non-passive or non-real estate activity is permitted
• Whether the REIT is internally managed or externally managed
• Whether there are limits on leverage or development activity

A failure to comply with requirements could disqualify a company from RETT status. In turn, this would subject the company to negative tax events, or the tripping of debt covenants. Because of this, our RETT ratings include analyses of what could jeopardize a company’s RETT status. Such an event would adversely affect a company’s financial strength.

Regional Risk Considerations

Moody’s employs the same analytic approach to evaluating real estate companies worldwide. However, RETIs and REOCs in each nation have their own laws and regulations, and market practices and nuances which reflect the local political, social and economic climates. These include the character of bank relationships, the size and diversity of property markets and the character of market leadership, governance and capital structures, international activity, planning permission/zoning, leasing structures and accounting. Moody’s incorporates these regional factors into its rating process.
Appendix 3

Hypothetical US REIT Rating Analysis Using Rating Driver Grid

Following is an example of how Moody's Rating Driver Grid can be used to analyze creditworthiness and determine the ratings for REITs and REOCs. For illustrative purposes, the criteria for “A”, “Baa” and “Ba” ratings have been included, along with recent data on this hypothetical firm. Moody's also uses past trend data, and rolling averages, to generate insight into REITs' past performance, as well as pro forma information, including pro forma data under different stress scenarios, to determine the likely direction of the firm, the latter being particularly important. Qualitative matters are important inputs to Moody's ratings — especially our judgment on whether we think the REIT is going to get better or worse, with what level of certainty, and why. Qualitative assessments also figure into the “scoring” of some criteria in the Rating Driver Grid. For example, in determining access to capital markets, Moody's assesses of the predilections of management to issue common stock, as well as comparative stock prices and P/Es, past success at securities issuance, and market tone. It is similar for determining the franchise for this retail REIT we are using as an example, which includes customer, tenant and vendor reputation and relationships, as well as the size and character of the REIT's property footprint. By using Moody's Rating Driver Grid, you can not only determine where a REIT would likely be rated, but also the characteristics most likely to drive an upgrade or downgrade.

For this US REIT, assumed to be an owner/operator/developer of regional malls and community shopping centers, we have a firm with an excellent market position and sound performance record, but with a comparatively weak balance sheet and unusually high development risk appetite for a retail REIT. Also, its range of scores on the factors is not very wide — low-A to high-Ba — and this lack of any glaring weaknesses tends to argue for a higher rating than a simple average would indicate. The REIT's liquidity is good on most measures, and although more liquidity resources would be a plus, it is not a dominant rating driver, and the relative value of better liquidity diminishes as it improves.

Secured debt is an important variable for Moody's, and it is high for this REIT — perhaps tied to the high level of JVs — but this is not uncommon for a REIT with many regional malls in its portfolio. Thus, the high relative burden of secured debt in our factor weighing is attenuated here. Leverage is comparatively high; this is also correlated to the high level of secured debt. Furthermore, given the comparatively robust nature of the asset class, and this REIT's high asset quality, a higher level of leverage is tolerable.

Franchise, asset quality and diversity for this REIT are a plus — a big plus — reflecting the high value of franchise in our rating approach, as well as the defensive traits and value franchise enjoys in the mall property space. Diversity is also a key rating matter, as history has demonstrated that concentrations create acute vulnerabilities to market change. Franchise and diversity tend to be "gateway" variables for achieving an "A" rating. The REIT's excellent asset quality gives material comfort on the re-financeability of its assets, the liquidity of its assets, occupancy trends, and the outlook for the level and stability of earnings.

These qualities are also reflected in the REIT's sound operating performance across all measures. The firm has strong earnings margins with modest to low profitability volatility — a plus. While the REIT's management is deemed excellent — consistent with its franchise and size — with at least a "good" grade being almost a necessity to achieve investment grade — the REIT is heavily exposed to JVs and funds. This is a drag in most cases, and in this one, too, but given the many malls the REIT owns, and the tendency to greater ownership concentration in the mall space, it is likely that some of these JVs reflect individually large assets that were JV'd in order to achieve greater diversity, or because the other owners did not want to sell, and we expect that these JVs will be eliminated over time.

22 Moody's Rating Methodology
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