The Development and Use of Supplemental Metrics in the Investment Property Industry

Financial statement preparers, investors and financial analysts have long recognized the unique business and economic characteristics of owning and operating investment property. Over a number of years, market forces and industry cooperation has resulted in the development and adoption of supplemental metrics which measure operating results and financial position that more faithfully reflect these characteristics and thus provide more useful information to investors. This Appendix provides more information on the developments of these supplemental metrics and their usage by the global property investment community.

Examples of supplementary measures adopted for REITs and property investment companies around the world include:

US and Canada – funds from operations (FFO)

US REITs calculate funds from operations (FFO), as recommended by NAREIT, by adding real estate related depreciation and amortization expenses back to earnings, giving a measure of the REIT’s performance that more closely reflects economic operating profitability. This is considered to be a better measure of the REIT’s performance than reported net earnings. Canadian real estate companies that own and operate investment property report a similar metric recommended by REALpac.

Exhibit III-A contains a report of the REIT industry published by Barclays Capital. Whilst the report provides a useful overview of the REIT industry (with a US focus), the most relevant sections are:
1. Part Four – Stock Analysis and Valuation – evaluates the different metrics used to assess REIT performance and financial position
2. Part Five – Indices and Exchange Traded Funds – closely related to the above industry metrics which form the criteria for assessing company suitability for the index (see Appendix II)

Exhibit III-B contains a sample piece of research from RBC Capital Markets and their research on RioCan REIT (a Canadian REIT). It discusses FFO and NOI and clearly indicates how these measures are linked to Net Asset Value (NAV) and REIT share/unit value.

Europe – EPRA Earnings and NAV

Each year, EPRA publishes its Best Practices Recommendations (BPRs) which provide a framework for encouraging consistent and relevant financial information for real estate companies that own and operate investment property. EPRA recommends two key measures as described below:
**EPRA Earnings (equivalent to FFO)**

For real estate companies, EPRA Earnings is a key measure of a company’s profitability and of its ability to make sustainable dividend payments to shareholders. This metric represents the level of recurring income generated from core operational activities, including those operations of jointly held investment property. EPRA Earnings represents the earnings from the core operational activities and provides an indicator of the underlying performance of the property portfolio. Therefore, it excludes all income and expense elements, including any changes in the unrealized value of investment property and results from sales of investment properties, that are not relevant to the on-going operating performance of the property portfolio.

**EPRA NAV**

The majority of European companies account for real estate at fair value and it has become common for industry analysts to calculate and publish a ‘triple net’ NAV per share. This is a key performance metric used in the European real estate industry and the majority of European REITs choose to voluntarily disclose this figure based on the balance sheet. The objective of the EPRA NAV measure is to highlight the fair value of equity on a long term basis.

*Exhibit III-C* contains a regular report published by Morgan Stanley which includes performance statistics and key stock valuation metrics for a range of pan-European property companies and REITs. This report includes the two key EPRA measures referred to above – EPRA Earnings and “triple net” NAV (see for example Exhibits 10 - 12 of the report). JP Morgan, Nomura, Kempen & Co, BNP Exane, and UBS are also examples of leading providers of real estate equity analysis whose recommendations and forecasts are based on EPRA Earnings, NAV and FFO, which if not specifically published by property companies are then calculated by analysts.

**Australia/Asia – Funds from operations “proxy”**

To calculate a form of FFO, market analysts in Australia generally adjust the IFRS reported net earnings to eliminate all significant non cash IFRS profit and loss elements. This Adjusted FFO (AFFO) is widely seen as the preferred measure in this region.

*Exhibit III-D* contains an example of a report prepared by Credit Suisse which analyses these key metrics for the Asia/Pacific region.
Exhibit III-A

Barclay Industry Report
REITs

REITs 101: An Introduction

REITs have existed for more than 45 years, but the modern REIT era can be traced to the early 1990s. In the subsequent 20 years, the real estate industry has undergone significant and, we think, irrevocable structural change driven by the shift from privately to publicly owned real estate and the resulting migration of assets and talent into the public markets. During that period, the REIT sector has grown and evolved into a viable and credible investment alternative. Notwithstanding the current credit market and macroeconomic challenges impacting REITs valuations, we believe these trends are sustainable.

- With this report, we present an overview of the REIT industry, including its history and performance, fundamental and sector drivers, and, finally, a stock valuation framework. We are hopeful that experienced investors will use the information contained herein as a reference, while those new to REITs may find it helpful in familiarizing themselves with the industry.

- Outlook for the Group. After outperforming the broader market for seven years through 2006, REITs have underperformed the broader market since early 2007. Investor sentiment turned materially negative in 2007, driven by the perceptual connection to weak housing markets, but the group rallied over in 4Q08 on the heels of the Lehman Brothers bankruptcy and the subsequent credit market shutdown. REITs do face a series of issues—including macroeconomic concerns, weak housing markets, and constrained debt markets—with no directional consensus. Our investment thesis that REITs will likely outperform the broader equity markets in 2009 is predicated on directional improvement in the debt markets, driven in turn by government intervention. Should credit markets loosen, we believe that stocks could rebound considerably, driven by valuation, dividend income, and better-than-expected long-term business prospects. Overall, we believe that the better run, better capitalized equity REITs should be the primary beneficiaries of the current dislocation, and that when we look back one year from now, those stocks should be materially higher.
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REITs have existed for the past 48 years; however, the modern REIT era began in the early 1990s. Emerging from the deep real estate recession of the late 1980s, the industry has grown from an equity market capitalization of $13 billion (1991) to $188 billion at the end of 2008. REITs control $700 billion–$800 billion of commercial real estate assets, representing 15%-20% of the overall commercial real estate market. Furthermore, over the past 15 years, REITs have outperformed the major indices, showing an average annual total return of 8.2% (as of December 31, 2008), in contrast to the S&P 500 (6.4%), Nasdaq (4.8%), and the Dow (8.1%). During this period, REITs have become a viable and credible investment alternative. As a manifestation of this growth and credibility, REITs are now included in several major indices, such as the S&P 500.

Notwithstanding 15 years of outperformance, the past 24 months have proved very challenging. The stocks have fallen 75% on a price basis from their February 2007 peak (versus the S&P 500, which is down 50% over the same period of time), and the overall equity capitalization of the group (via the MSCI U.S. REIT Index) is down 75% from $401 million to $99 million. The incremental dollar into the group has come from macro hedge funds which have a bearish view due to the credit market shutdown and the onset of a global recession. As a result, stocks have been trading at very low absolute levels. Nevertheless, we still believe that most REITs will survive as a viable asset class and warrant investor attention.

What Is the Focus of this Primer?

Industry growth, combined with the view that real estate is a viable alternative investment, has increased institutional investor focus on the REIT sector. The breadth of investor interest in REITs has grown dramatically in recent years, driven by several considerations, including inclusion in the indices, past stock performance, and absolute return potential. Thus, this primer is meant to serve as an introduction to REITs for analysts and portfolio managers new to the space. It presents an industry overview, including its history and performance, fundamental and sector drivers, and finally a stock valuation framework. We also hope that experienced investors in the space will view the material presented in this primer as a useful reference. To that end, we present this report in seven main sections:

- **A REIT Defined (page 8)**. In addition to a formal definition, this section provides a conceptual framework from which to view the REIT sector in relation to the broader securities market.

- **History (page 28)**. This section provides an overview of key trends/events that have shaped the REIT industry/structure into what it is today.

- **Fundamental Overview (page 36)**. This section outlines fundamental real estate drivers, as well as specific considerations for each major property type.
- Stock Analysis and Valuation (page 62). This section provides a guide to REIT security valuation metrics and suggests an analytical framework with which to assess a REIT’s fundamental operating performance, both now and in the future.

- REIT Indices (page 74). This section illustrates the differentiated characteristics of the major REIT indices.

- Current and Future Trends (page 80). This section examines where the industry is likely to go from here.

- Glossary of REIT Terms (page 86). This section defines the terms often used in REIT literature.
A REIT Defined

A Real Estate Investment Trust (REIT) is essentially a corporate entity that owns, operates, acquires, develops, and manages real estate assets. However, REITs are differentiated from other corporate forms by a tax election that eliminates taxes at the corporate level. Most of the company’s taxable income is passed along to investors in the form of dividends; shareholders subsequently pay taxes on those dividends.

Real Estate Investment Trusts

To qualify as a REIT for tax purposes a company must:

- distribute at least 90% of taxable income as dividends;
- derive at least 75% of gross income from qualified investments (real property or mortgage debt);
- derive at least 90% of gross net income from real property, dividends, interest, and gains from security sales;
- invest at least 75% of assets in equity ownership of real property, mortgages, other REIT shares, and government securities and cash;
- ensure that no more than 50% of shares outstanding are owned by five or fewer individuals (the “five-or-fewer” rule);
- ensure that its shares are owned by at least 100 shareholders; and
- ensure that the taxable REIT subsidiary is no larger than 20% of its assets.

Conceptually, a REIT can be viewed much like a mutual fund in that it allows investors to pool capital and invest in a larger, more diversified real estate portfolio. Both REITs and many mutual funds are essentially pass-through vehicles, passing the cash flow from that portfolio to investors. Like a mutual fund, the original REIT structure created in the 1960s was a passive investment vehicle; it prohibited the operation and management of properties by the REIT itself. Over the years, however, legislative and tax code changes have enabled REITs to become actively managed, fully integrated operating companies.

The fact that a REIT is simultaneously both a pass-through vehicle and an actively managed investment vehicle has several implications:

- First, real estate industry fundamentals such as market or portfolio occupancy and rent levels matter, as they directly affect earnings growth, and, in turn, cash flow.
- Second, perhaps contrary to conventional wisdom, management is important. When REITs were passive investment vehicles, all that mattered was asset performance. Now that REITs are bona fide operating companies, management has the power to improve or, conversely, weaken that operating performance, as well as that of the overall
enterprise. Good management will produce significant and efficient returns for the REIT’s portfolio, and guide the REIT through difficult markets.

Third, as a pass-through vehicle, we would argue that the absolute level and composition of a REIT’s investment returns should reflect those of the underlying asset class. We view real estate as a total-return asset, benefiting from steady income and modest growth. Furthermore, historical real estate returns have normalized in the low teens on an unleveraged IRR basis. Similarly, we view a REIT as a total-return security and expect high-single to low-double-digit returns on a normalized basis, from a combination of dividend income and growth in earnings (funds from operations) per share.

All that said, REITs are stocks, and as with the broader market, sentiment plays an important role in actual returns. REITs are relatively illiquid securities; the entire sector trades roughly $4 billion per day, nearly equivalent to the most liquid stocks (e.g., average daily volume for Google is approximately $2 billion).

A More in-Depth Look

Given the essential nature of real estate as an asset class, and REITs as a security, we structured this report in order to touch on both. We begin with an overview of the basics—definitions, recent performance statistics, breakdowns by property types—and then move on to a brief history of the sector. The goal, of course, is to provide a sense of how the REIT sector has evolved into what it is today.

A REIT, by definition, is a real estate company; for us as fundamental analysts, an understanding of the underlying property markets is critical. In section three of this report, therefore, we outline the basic industry drivers. We did not set out to write the definitive real estate textbook; that has been done more effectively elsewhere. In its simplest terms, however, we view real estate as the supply and demand for cubic feet. Fortunately, the demand side of the equation is generally driven by macroeconomic considerations with which most securities analysts are already familiar. As such, in this section, we seek to tie those macro drivers back to the property level for the industry in general as well as focus in on the specific set of drivers/factors that influence the four main REIT property types below.

- Multi-family (Apartments). The multi-family sector is primarily driven by three factors: job growth, demographic trends, and single-family housing affordability. Demographics, of course, include immigration, household formation, as well as absolute population growth.

- Office (Central Business District and Suburban). The office sector is driven primarily by white-collar job growth, which is influenced in turn by the broader service economy.

- Industrial (Warehouses and Distribution Centers). The industrial sector is driven less by job growth, and more by general economic activity, including changes in supply-chain logistics, global trade, and inventory buildup. The asset class tends to be
Fundamental REIT Stock Analysis

Real estate is both an asset class and a security—just as we analyze the asset using fundamental metrics, we apply classic securities valuation tools to the stocks—albeit adapted to account for the nature of the underlying business. As such, we analyze and value REIT stocks based on earnings multiples, asset values, and yield.

- **Earnings Multiples.** We analyze REITs based on two primary multiples: price to FFO (funds from operations) and price to CAD (cash available for distribution), which approximately parallel the price-to-EPS and price-to-cash-flow (EBITDA) multiples used to analyze other types of companies. FFO and CAD should reflect the performance of the underlying portfolio of properties, measured, in turn, by same-store net operating income (SSNOI), a key measure of property-level performance. As with all multiple analyses, it is important to factor earnings growth into the equation. Finally, management's ability to influence these factors may lead to a premium or discounted valuation.

- **Asset Values.** Net asset value is a proxy for book value used in conventional securities analysis. In essence, our NAV calculation estimates the private market breakup value of a company's assets. Given the nature of the calculation, we view this metric as more useful as a relative valuation tool for similar companies at a given point in time, as opposed to being a useful comparative metric over time or in absolute terms. We look at the stocks on a price-to-NAV basis, essentially the real estate equivalent of a price-to-book valuation.

- **Dividend Yield.** By definition, REITs are total-return vehicles. Historically, approximately two-thirds of total returns have come from the dividend (although in recent years price appreciation has taken the lead). Therefore, we look at dividend yields relative to other REITs, in addition to other income alternatives such as the 10-year Treasury bond. That said, there is normally an inverse relationship between yield and earnings growth rates.

Our valuation analysis, laid out in more detail in the "Stock Analysis and Valuation" section, is supported by an analysis of management's ability to facilitate stability and growth, and prudently manage the balance sheet. We track a number of ratios and statistics, with the goal of ensuring that our earnings projections are achievable based on the company's capital structure. In that vein, we view analyzing REITs as similar to analyzing other types of companies, the difference being in the metrics used.
**Current Trends/Future Outlook**

Underlying real estate fundamentals are relatively visible and quantifiable in the near term; the stocks, however, are not trading on fundamentals. Instead, a series of risk considerations overhang the REITs, as well as the broader market. In contrast to past cycles, there appears to be no directional consensus on these issues—reasonable people can look at the same circumstances and reach diametrically opposed conclusions. Finally, there is the recent stock market volatility, a portion of which is due to REITs trading in line with financials. Nevertheless, when one layers the potential impact of these issues on recent broader market volatility, it is difficult to have conviction on REIT sector performance going into 2009.

Some of the current issues that REITs face include:

- Challenges in the debt capital markets, with commercial mortgage markets seized up, leading to questions of when the markets will return to some kind of normalcy.
- Macroeconomic uncertainty, including GDP growth, the price of oil, inflation, Federal Reserve policy, and the health of the consumer.
- Material weakening in the housing markets.
- Anecdotal evidence of cap rates gapping out, while questions linger regarding where asset values will level off.
- Re-equalization of the balance sheet as companies address debt maturities in the context of a scarcity of debt capital.
- Potential privatizations at these levels.
- Restructuring efforts on both the private and public side of real estate.

Notwithstanding current uncertainty, however, we think real estate, and by extension REIT stocks, will continue to be an important asset class for a growing audience of investors. For that reason, we are hopeful that our readers find this primer worthwhile.
Part One: A REIT Defined
Part One: A REIT Defined

Real estate investment trusts (REITs) are pass-through vehicles designed to facilitate the flow of rental income and/or mortgage interest to investors. REITs were created in the 1960s to allow smaller investors the opportunity to pool capital and invest in large-scale commercial properties. The positive aspects of REITs today are a direct result of their structure, which has evolved over time and benefited from a series of tax law and legislative changes. These changes have transformed REITs into actively managed, total-return vehicles that invest in a broad spectrum of real estate assets. The growth of the sector, along with its distinct benefits, has led to wider market acceptance, a trend that we expect to be long-lived.

What Is a REIT?

First and foremost, a REIT is a tax election. A real estate company elects REIT status for tax purposes. In order for a stock to qualify for REIT status and benefit from the elimination of corporate taxes, it must comply with several distribution and income stream requirements, as well as major ownership restrictions, as follows:

- it must distribute at least 90% of taxable income as dividends;
- at least 75% of gross income must come from qualified investments (real property or debt secured by real property);
- at least 90% of gross net income must be derived from:
  1. real property
  2. dividends
  3. interest
  4. gains from security sales

At least 75% of assets must be invested in:

  5. equity ownership of real property
  6. mortgages
  7. other REIT shares
  8. government securities and cash

No more than 50% of shares outstanding can be owned by five or fewer individuals (the “five or fewer” rule):

- the shares must be owned by at least 100 shareholders; and
- the taxable REIT subsidiary can be no larger than 20% of the REIT’s assets.

REITs are not taxed at the corporate level as long as they pay out 90% of taxable income in the form of dividends. Instead, REITs are taxed at the shareholder level, thus avoiding double taxation. In the regular c-corporation structure, the investor is double-taxed: first at the corporate income tax level and then at the individual income tax level. As a
consequence, investors in a public REIT may receive a higher return on their investment, on an after-tax basis, than they would receive in a c-corp.

REITs can be either public or private companies, they can be internally or externally managed, and they can be formed using an UPREIT, DownREIT, or "normal" structure. The structure a REIT elects may have a sizable impact on how the REIT operates.

Internal versus External Management

When forming a REIT, the company must decide whether to be internally or externally managed. Historically, the majority of REITs were externally managed (advised), similar to a mutual fund structure, due to legislative restrictions against active management. The Tax Reform Act of 1986 allowed for active, internal management. The result is that REITs look and function like any other company with employees, a management team, and a board of directors. Now, more than 90% of public REITs are internally advised. The debate over the benefits of internal versus external management is lengthy, but the key issues relate to potential conflicts of interest and the compensation level of the external manager advising the REIT.

Conventional wisdom is that an externally advised structure carries the theoretical imperative to grow the company for the sake of size, rather than EPS. However, a number of the external advisory agreements that exist today are structured to mitigate that concern. First, in most management agreements, base fees are calculated on equity, rather than total assets, which should eliminate the pressure to grow the portfolio rather than profits. Second, most external managers maintain a significant equity investment in the advised entity, which aligns management and shareholder interests.

Compensation of the external manager, on the other hand, is an issue that is commonly debated. The compensation structure of an external management agreement resembles that of what is typically seen in the private equity or hedge fund world. The main components consist of a base fee (normally approximately 1.5% of equity) in addition to an incentive fee, which is usually calculated based on a hurdle rate (for example, 25% of the returns that exceed a 10% FFO return on equity). These fees can vary from company to company, but the underlying structure is usually the same. However, external management agreements also usually include many expense reimbursements, which may vary greatly. Net-net, we believe most investors would prefer an internally advised structure to eliminate any potential conflicts of interest or compensation concerns.

That said, we must also note the potential positives of an external management agreement, namely the experience, platform, and relationships that an external manager often brings to the table. A smaller REIT that may not have the resources to support a large management team may benefit by "outsourcing" management to a larger, more established organization that may provide a broader array of services and existing relationships.
**UPREITs and DownREITs**

The Umbrella Partnership REIT (UPREIT) structure was first used by Taubman Centers in its 1992 IPO. The structure facilitated the growth of the industry by serving as a catalyst to asset sales. This vehicle allows the owners of a property, or portfolio of properties, to "sell" their property interests in a tax deferred exchange for units in a limited partnership, the "Operating Partnership," or OP. The OP is formed simultaneously with the REIT at the IPO, and the REIT subsequently contributes cash proceeds from the IPO to the partnership in exchange for an ownership interest in the OP, which becomes the owner of the properties. The units received by the former property owner are exchangeable into common shares on a 1:1 basis, and collect a dividend equal to that of the common shares. Capital gains taxes are deferred until the unit holder converts those units into common shares. We illustrate the structure in Figure 1.

![Figure 1: UPREIT Structure](Image)

Subsequent to the IPO, the newly public REIT may use OP units as a currency for property acquisitions. This structure benefits the original property owner (who sold the properties to the OP) by providing the opportunity to defer capital gain taxes, collect the earnings in the form of dividends, convert its portfolio into a liquid security, improve its balance sheet, and diversify its portfolio. In addition to being tax-deferred until conversion into common shares, if the partner retains the units until death, his/her estate has the ability to convert the units tax-free.

The REIT benefits by acquiring an interest in the partnership properties and a currency for future acquisition. The UPREIT affords well-established private real estate companies the opportunity to derive the benefits of the REIT structure while maintaining an ownership interest. One concern with the structure is that there might be a conflict of interest between
the owners of the units and the management of the REIT. For example, if the company wishes to sell one of the properties contributed by the partner, the holder of the partnership units, not the shareholders, will be taxed on the sale.

DownREITs have a similar structure to UPREITs except that the operating partnership is usually formed subsequent to the IPO, the purpose being to create partnership units to be used as a currency for acquisitions. Although units in the DownREIT partnership represent an ownership interest in just that partnership, and not the REIT as a whole, the conversion of those units and the dividends paid are similar to that of UPREIT units, in that they are convertible on a 1:1 basis and receive dividends equal to that of common shares.

Lastly, a REIT may be structured without the use of the UPREIT or DownREIT structure. Under this “normal” structure, the properties are owned directly by the REIT, not an operating partnership, the benefit being the elimination of any potential conflicts of interest. But the “normal” structure also eliminates the benefit of using OP units as a currency for acquisition.

**REIT Advantages**

The differentiated structure of a REIT gives it a number of distinct advantages. First, REITs provide increased liquidity, allowing investors to buy and sell shares more easily than they would buy and sell actual real estate. Second, whereas purchasing real estate usually requires a substantial commitment of capital, REITs have no minimum investment requirement. In this way, investors can buy as many or as few REIT shares as they want. Third, unlike other types of real estate, shareholders of a REIT are not held personally liable for debt incurred by the REIT. In addition, those who invest in a REIT benefit from the professional management teams that possess vast industry knowledge and expertise.

**Total Return Vehicle**

Real estate as an asset class is a total-return investment; REITs are viewed in the same way, providing investors with both capital appreciation and current income. REIT stocks over the last 15 years have provided an 8.2% annualized compounded return to investors as of December 31, 2008. Only about 20% of that return is from price appreciation, suggesting that the dividend is an integral portion of the REIT’s total return. Therefore, the more efficiently a REIT can increase its earnings, the higher the return it provides to investors. Since a REIT’s dividend is such a meaningful component of its return, REITs must find innovative ways to increase earnings and, by extension, dividends. In practice, a REIT can increase its profitability either internally or externally. Internal growth is achieved through improvements to the existing portfolio. This can be accomplished through occupancy improvement, rental rate increases, scheduled rent bumps, expense sharing (common area and maintenance), or tenant upgrades, as well as property redevelopments, which can lead to rent raises. External growth, on the other hand, is achieved through property acquisition and development.
Funding Growth

Since REITs are required to pay out 90% of their taxable income to shareholders, they are theoretically left with minimal retained earnings—a lack of capital—with which to acquire and develop new properties. This circumstance would appear to leave REITs with two unpleasant choices: either issue or take on new debt to fund these projects or sell equity, which could dilute existing shareholders. In reality, however, REITs have other options. Since their taxable earnings include the impact of depreciation, REITs can pay out 90% of taxable income with a much lower cash flow ratio. On average, we estimate that REITs actually retain 30%-40% of cash flow. The REIT can then use this undistributed, untaxed cash to fund its external growth.

Alternatively, a REIT can expand its earnings platform by forming joint ventures (JVs) with other investors, acquiring private equity capital. In a typical joint venture, an outside source provides a portion of the capital to fund a specific project, and the REIT uses its management and other resources to manage the property and earn a fee stream. The advantage of a JV is that it allows a REIT to expand its operating platform without having to expend large amounts of capital. Furthermore, it allows a REIT to employ more leverage than it normally would on the balance sheet. Theoretically, such a JV structure should result in higher returns in invested equity for the REIT. Management's ability to generate internal and external earnings growth, given a REIT's capital restraints, should be an important consideration for potential investors.

Types of REITs

Having discussed the basic REIT structure, we turn to the different types of REITs. The NAREIT Composite Index includes equity REITs, mortgage REITS, and hybrid REITs. Equity REITs own property (land and buildings), whereas mortgage REITs focus on real estate debt, through originating and acquiring mortgages and mezzanine loans, as well as debt securities backed by real estate. Hybrid REITs own both real estate and real estate debt. The market is currently dominated by equity REITs, which comprise 92% of the total market capitalization; mortgage REITs total 7%, and hybrid REITs total 1%, as of December 31, 2008.

Equity REITs are typically classified by the types of properties owned. The NAREIT Index is segmented by property types, including office, residential (apartments), shopping centers, and regional malls. In Figure 2, we list the property types by market capitalization and type, and in Figure 4, we list the largest companies by sector.
There are two types of mortgage REITs, commercial and residential. Commercial mortgage REITs invest primarily in loans and securities backed by commercial properties. The companies typically run a matched book of assets and liabilities, with the focus on credit risk management, as opposed to interest rate risk management carried out by the residential mortgage REITs.
Residential mortgage REITs focus primarily on originating and acquiring single-family home loans. The companies thrive during a strong housing market accompanied by a steep yield curve. Beginning in 2005, the stocks suffered as the flat yield curve dissolved profits. This led many residential mortgage REITs to cut dividends—a practice that is not uncommon in the sector and contributes to clearly defined boom and bust cycles. In addition, in 2007, several residential mortgage REITs encountered excessive delinquencies on their loans, which led to a liquidity crisis that forced several out of business. Finally, during 2008’s credit crunch, we saw many mortgage REITs close their doors. Two years ago, there were 38 mortgage REITs; as of December 31, 2008 there are 20.

As of December, 2008, 136 public REITs with an aggregate equity market capitalization of $191 billion (down 56% from $438 billion at the end of 2006) were tracked by the FTSE NAREIT Composite Index. In contrast, the aggregate market capitalization was only about $13 billion in 1991. Meanwhile, the number of publicly traded REITs has decreased by approximately 28% while the market capitalization of the companies in the index has increased by 496%.

Figure 5: Number of Companies in FTSE NAREIT Composite Index, 1971-2008

Source: NAREIT
Notwithstanding rapid growth over the last 16 years, industry experts estimate that REITs have captured only $700 billion–$800 billion (15%–20%) of the overall institutional quality U.S. commercial real estate market. Therefore, we believe there is plenty of potential growth left in the publicly traded REIT market.

Market Acceptance

REIT popularity and credibility have grown significantly over the last decade, leading to inclusion in several of the major indices, such as the S&P 500, S&P 400 Mid-Cap, and S&P 600 Small-Cap. On October 1, 2001, Equity Office Properties Trust, the largest publicly traded office building owner and manager in the United States at the time, became the first REIT to be added to the S&P 500. The same day, Hospitality Properties Trust, an owner and operator of hotels, was added to the S&P 400 Mid-Cap Index. In addition, Colonial Property Trust, a diversified REIT with properties in the office, retail, and multi-family sectors, and Kilroy Realty Corporation, an owner of office and industrial properties in California, were added to the S&P 600 Small-Cap Index. Since then, the number of REITs included in the S&P indices has risen to 63.

In early 2007, Equity Office Properties and Archstone-Smith were bought out by private equity investors, which removed them from the S&P 500, but six additional REITs joined the S&P 500: AvalonBay Communities, Developers Diversified Realty, Host Hotels & Resorts, HCP, Inc., Healthcare REIT, Inc., and Ventas Inc. However, over the last six months, Developers Diversified Realty and General Growth Properties were dropped for size reasons. The number of REITs included in the S&P 500 Index is now 12. In addition, real estate services company CB Richard Ellis was added to the S&P 500 in fourth quarter 2006, bringing the total number of real estate companies to 13. Figure 7 lists the REITs that are currently in the major S&P indices.
REITs

Figure 7: REITs in the S&P Indices

<table>
<thead>
<tr>
<th>S&amp;P 500 Index</th>
<th>% Weight in the Index</th>
<th>S&amp;P 400 Mid Cap Index</th>
<th>% Weight in the Index</th>
<th>S&amp;P 500 Small Cap Index</th>
<th>% Weight in the Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>ARI</td>
<td>0.05%</td>
<td>Alexandria Real Estate Equity</td>
<td>0.32%</td>
<td>Aladdin Health Trust</td>
<td>0.01%</td>
</tr>
<tr>
<td>AMB</td>
<td>0.26%</td>
<td>AMB Property Corporation</td>
<td>0.36%</td>
<td>BoMed Realty Trust</td>
<td>0.35%</td>
</tr>
<tr>
<td>BXP</td>
<td>0.22%</td>
<td>BRE Properties, Inc.</td>
<td>0.22%</td>
<td>Colonial Properties Trust</td>
<td>0.15%</td>
</tr>
<tr>
<td>ISOR</td>
<td>0.22%</td>
<td>Camden Property Trust</td>
<td>0.26%</td>
<td>Camden Property Trust</td>
<td>0.45%</td>
</tr>
<tr>
<td>HCP</td>
<td>0.07%</td>
<td>Cousins Properties Incorporated</td>
<td>0.07%</td>
<td>Diamondrock Hospitality</td>
<td>0.13%</td>
</tr>
<tr>
<td>HCM</td>
<td>0.07%</td>
<td>Duke Realty Corporation</td>
<td>0.22%</td>
<td>EastGroup Properties, Inc.</td>
<td>0.27%</td>
</tr>
<tr>
<td>HFN</td>
<td>0.05%</td>
<td>Elyxity, Inc.</td>
<td>0.08%</td>
<td>Entertainment Properties Trust</td>
<td>0.20%</td>
</tr>
<tr>
<td>HST</td>
<td>0.04%</td>
<td>Equity One, Inc.</td>
<td>0.08%</td>
<td>Equity One, Inc.</td>
<td>0.29%</td>
</tr>
<tr>
<td>KRM</td>
<td>0.03%</td>
<td>Essex Property Trust</td>
<td>0.29%</td>
<td>Extra Space Storage</td>
<td>0.25%</td>
</tr>
<tr>
<td>PCL</td>
<td>0.07%</td>
<td>Federal Realty Investment Trust</td>
<td>0.49%</td>
<td>Freedom Street Properties Corp.</td>
<td>0.25%</td>
</tr>
<tr>
<td>RCO</td>
<td>0.03%</td>
<td>Highwoods Properties, Inc.</td>
<td>0.24%</td>
<td>Home Properties</td>
<td>0.61%</td>
</tr>
<tr>
<td>PSA</td>
<td>0.10%</td>
<td>Hospitality Properties Trust</td>
<td>0.21%</td>
<td>Inland Real Estate Corporation</td>
<td>0.20%</td>
</tr>
<tr>
<td>SPF</td>
<td>0.13%</td>
<td>Liberty Property Trust</td>
<td>0.32%</td>
<td>Kilroy Realty Corporation</td>
<td>0.25%</td>
</tr>
<tr>
<td>VNO</td>
<td>0.07%</td>
<td>Mackinac</td>
<td>0.18%</td>
<td>Kite Realty Group Trust</td>
<td>0.09%</td>
</tr>
<tr>
<td>AIV</td>
<td>0.13%</td>
<td>Macro-City Realty Corporation</td>
<td>0.32%</td>
<td>LaSalle Hotel Properties</td>
<td>0.15%</td>
</tr>
<tr>
<td>AVB</td>
<td>0.06%</td>
<td>National Health Properties</td>
<td>0.41%</td>
<td>NAREIT Equity Yield</td>
<td>0.01%</td>
</tr>
<tr>
<td>BXP</td>
<td>0.07%</td>
<td>Prologis</td>
<td>0.33%</td>
<td>NAREIT Total</td>
<td>0.01%</td>
</tr>
<tr>
<td>BXP</td>
<td>0.07%</td>
<td>Private Storage, Inc.</td>
<td>0.20%</td>
<td>NAREIT Total</td>
<td>0.01%</td>
</tr>
<tr>
<td>BXP</td>
<td>0.07%</td>
<td>Vornado Realty Trust</td>
<td>0.31%</td>
<td>NAREIT Total</td>
<td>0.01%</td>
</tr>
</tbody>
</table>

Source: NAREIT

Why REITs? Over the past few years, REITs have become a viable and credible asset class, and, as a consequence, have attracted a good deal of investor attention. This increased focus on the space can be attributed to a number of factors.

Dividends/Current Income

In general, REITs provide both moderate earnings growth and ample dividends and as such are considered total-return vehicles. Historically, approximately two-thirds of the average REIT total annual return has come from dividends. On average, the dividend is higher than regular equities; since 1995 the average dividend yield for REITs is 6.1%, compared to 1.7% for the S&P 500. With such a substantial dividend, pension funds as well as other institutional investors have historically looked to REITs as an income vehicle.

Figure 8: REIT Dividends versus S&P 500 Dividends, December 1995–February 2009

Source: Bloomberg, NAREIT

April 01, 2009
Commercial Real Estate Performance

A sizable portion of the exceptional performance that REITs enjoyed for the seven-year period leading up to February 2007 can be attributed to the commercial real estate sector itself. With interest rates at historically low levels, investors were willing to pay higher prices for assets, which in turn resulted in higher REIT NAVs and stock prices. Since then, fundamentals have remained solid, albeit moderating, but prices of real estate securities have declined sharply, in part because of the dissipation of the M&A bid on real estate stocks and more recently the credit crunch hitting the capital markets during 2008. Price appreciation has historically contributed approximately one-third of REITs' total returns over the last 20 years; however, price appreciation dominated for much of the past several years until 2007 and 2008 when REITs fell approximately 65% from their peak in February 2007.

Low Correlation with Other Indices

Another factor that helps explain REITs' recent popularity is that historically the industry holds a low correlation with other indices and asset classes. After the tech bubble burst in March 2000, REITs garnered stronger investor interest. That said, the recent market downturn spurred by the credit crisis has increased the correlation between REITs and other indices and asset classes dramatically particularly trading as financials.

Figure 9: REIT Correlation with Other indices

<table>
<thead>
<tr>
<th></th>
<th>5-year</th>
<th>10-year</th>
<th>15-year</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500</td>
<td>0.84</td>
<td>0.57</td>
<td>0.43</td>
</tr>
<tr>
<td>Dow</td>
<td>0.78</td>
<td>0.52</td>
<td>0.48</td>
</tr>
<tr>
<td>NASDAQ</td>
<td>0.74</td>
<td>0.17</td>
<td>0.13</td>
</tr>
</tbody>
</table>

Source: Bloomberg, NAREIT, FactSet

Long-Term Performance

Over the three-year period ending February 28, 2009, the compound average annual total return of the FTSE NAREIT U.S. Composite REIT Index (down 33.6%) has underperformed the S&P 500 (down 16.2%), Nasdaq (down 11.8%), and the Dow Jones Industrials (17.7%). However, this underperformance appears to be a short-term trend. Over the last 15 years, the compounded annual total return of the FTSE NAREIT U.S. Composite REIT Index (8.2%) has outperformed the S&P 500 (6.4%), Nasdaq (4.8%), and the Dow Jones Industrials (8.1%).
Strong Returns Attracted Fund Flows

Notably, REITs were one of few investment alternatives where an investor could get steady double-digit returns for several years up until early 2007, and money flowed into real estate, both at the direct level and from the securities side, as real estate's attractive return potential fueled demand and drove stocks and property values higher. According to AMG data, $23.3 billion flowed into dedicated REIT mutual funds from 2002 through 2006. During the first 10 months of 2007, that trend reversed, with $3.9 billion flowing out of the sector, bringing the six-year net inflows down to $19.4 billion, which is still substantial growth. Manifestations of this liquidity include the merger/acquisition activity of 2006 and early 2007, privatizations, and the formation of institutional joint ventures. However, we caution that it remains unclear whether the recent shift in sentiment will fuel further outflows,
or whether investor allocations have stabilized; we are at an inflection point, in our opinion.

Figure 12: Fund Flows, January 1998-February 2009 ($ in billions)

Conclusion

The REIT structure was originally formed to facilitate broad ownership in pools of passively managed real estate assets. The REIT structure has transformed over the years, converting REITs into what they are today: actively managed, fully integrated operating companies. As total-return vehicles benefiting from a history of solid performance, REITs have garnered additional investor interest and continue to gain traction. Our sense is that the benefits afforded by the REIT structure will facilitate further growth of this evolving industry.
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Part Two: History
Part Two: History

The REIT structure has evolved from a passive investment vehicle to an actively managed, fully integrated operating company. Over the past 50 years, a series of legislative and tax code changes as well as economic cycles have shaped the growth of the REIT industry. After a slow start, the group picked up steam in the early 1970s before the OPEC oil embargo led to rising inflation and an eventual real estate slump. Since that time, the real estate industry, and by extension, REITs, have experienced some well-pronounced boom and bust phases, but over the past several years, the REIT industry has matured into a more stable, liquid, and transparent group. In our view, the real estate industry has been irrevocably transformed over the past 10 years by the migration of assets and talent into the public markets. In that time, we think the public real estate companies have become an important repository of value creation and operating talent. In this section, we discuss key events that shaped the industry over the last 45 years as the REIT structure evolved into a viable and credible asset class.

Figure 13: Timeline of REIT History versus Sector Stock Performance, January 1972-February 2009

An Era Begins

The REIT era was born with the Real Estate Investment Trust Act of 1960. Until the passing of the act, commercial real estate was primarily owned by wealthy individuals, corporations, and institutional investors. This law enabled individual investors to pool capital into a corporate structure and thus reap the benefits of income-producing real estate ownership. REITs afforded smaller-scale investors the ability to own larger-scale assets in a diversified, professionally managed, liquid vehicle.

The 1960 Trust Act was an outgrowth of the Massachusetts Business Trust Act of 1827. A business trust is defined as an entity that is formed to hold property; it is managed by trustees for the benefit of shareholders in the trust. The REIT Act of 1960 essentially applied the same concept to real estate. Conceptually, a REIT is like a mutual fund in that both REITs and mutual funds manage a pool of assets and pass along the cash flows from their portfolios to investors, thereby avoiding paying corporate taxes.
**Growing Pains**

The new investment vehicle was not very popular throughout most of the 1960s. In fact, it took almost five years for the first REIT, Continental Mortgage, to be traded on the NYSE. Throughout most of the decade, only 10 publicly traded REITs were established, with an aggregate market capitalization of just greater than $200 million. The unpopularity of REITs at the time of their inception was, in our opinion, due to the many restrictions the Act placed on companies. For example, at that time a REIT was only able to own property, not manage or operate it.

The first REIT IPO boom occurred from 1969 to 1974, as a number of mortgage REITs (more than 50) were formed. Many larger banks formed mortgage REITs primarily for three reasons: to gain a share of the thriving construction loan market; to originate loans off-balance sheet (to minimize the amounts of reserves that the bank was required to maintain); and to generate fee income from management of the REIT (at this time all REITs were externally managed). The surge in the number of REITs coupled with questionable underwriting standards set the stage for the next 10 challenging years.

**Inflation**

The 1970s were a difficult decade for the economy, and the REIT industry was not immune. Rising oil prices triggered by the OPEC oil embargo in 1973 caused inflation to spike. As a result, the Consumer Pricing Index (CPI) increased 6.3% in 1973, and rose to a peak of 11.3% in 1979. Rising inflation led to higher interest rates, significantly affecting the mortgage REIT industry. While REITs provided mortgage loans at fixed rates, the liability side was funded at floating rates. Floating rates reached a level where REITs faced negative spreads between their assets and liabilities. As a result, and combined with the impact of excess liquidity, many of these companies went bankrupt.

During the first half of the 1980s, the real estate industry recovered from the tough conditions it faced in the late 1970s. However, REITs, viewed as illiquid and unprofitable, were still tainted. The negative investor perception of REITs was compounded by the Economic Recovery Act of 1981, which created a tempting tax shelter for other real estate ownership formats. The act allowed for accelerated depreciation and, by extension, the shielding of taxable income. This shelter applied only to privately owned real estate, not REITs. Subsequently, funds flowed away from REITs and into real estate limited partnerships, which offered high returns on capital brought about by the accelerated depreciation tax shield. A buying spree for real estate then ensued, driving asset prices to all-time highs. Private partnerships also had the ability to pay higher prices for real estate as a result of better after-tax cash positions than REITs. Lastly, many developers felt the need to capitalize on this hot market, creating an abundant amount of supply as a result of excess liquidity, driving down rental rates and planting the seeds of a real estate downturn.

**Tax Reform Act of 1986**

Weakening fundamentals due to excess supply were compounded by the Tax Reform Act of 1986, which eliminated the tax shelters real estate investors enjoyed. Specifically, the depreciation period was lengthened, eliminating the accelerated depreciation and associated tax benefit. As a result, the ability of limited partnerships to deduct interest, depreciation, and passive losses was limited. This caused substantial distress in the private
real estate market as investors could no longer cover their debt service; delinquencies and, in turn, foreclosures increased.

The Tax Reform Act did provide one key benefit for REITs. Until 1986, a REIT was limited to solely owning properties and was restricted from operating and managing them. The Tax Reform Act of 1986 removed those restrictions, allowing REITs to both own and operate properties, giving more control to management and therefore an increased influence on earnings. The act laid the groundwork for REITs to become actively managed, fully integrated operating companies and led to the IPO boom of the mid-1990s.

The robust level of inventory built throughout the 1980s purely for tax reasons rather than a need for space, together with the Tax Reform Act, which removed most of the tax benefit of privately owned commercial real estate, resulted in economically unviable assets and a wave of foreclosures. These factors contributed to the real estate downturn of the late 1980s/early 1990s. During this period, commercial real estate values declined 30%-50%. This crisis affected the REIT market as well. Rising vacancy rates and reduced rents led to declining revenues and high dividend payout ratios, forcing a large number of REITs to cut dividends; in turn, share prices dropped sharply. The total return for REITs in 1990 was negative 14.8% (versus the S&P 500, which was down 3.1% on a total return basis), at the time, the index’s worst annual return since 1974.

Although the REIT recovery and IPO boom did not occur until the early 1990s, some sectors experienced a rebirth even earlier. The health care sector, in particular, experienced this growth in the second half of the 1980s. During these years, an increasing number of health care facility owners looked to monetize their balance sheets, by transferring their properties into a REIT structure. The health care provider then leased back the space from the REIT to conduct its operations. Companies such as Health Care Property Investors, Inc. (1985), Nationwide Health Properties, and Vencor (1989, now called Ventas) went public over the remainder of the decade. This IPO wave continued in the early 1990s as National Health Investors, Omega Healthcare Investors (1992), and Healthcare Realty Trust (1993) went public. Currently, three of the 15 REITs in the S&P 500 are Health Care REITs.

In the early 1990s, however, the REIT recovery began in earnest. From 1991 to 1993, total annual returns for REITs averaged about 23.3% (versus the S&P 500, which averaged total annual returns of 15.6%). A portion of this return can be attributed to a market correction for the stocks after having been heavily penalized in prior years. REITs were able to acquire an abundant number of properties at discounted levels.

More broadly, many real estate companies were facing insolvency in the early 1990s because of a lack of capital to fund new investments. Banks had tightened their lending standards after experiencing an influx of foreclosed properties during the real estate downturn. Therefore, real estate developers sought alternative venues with which to fund their projects. Their solution was to go public, in order to raise the additional capital needed to repay debt to remain solvent and subsequently fund growth. In addition,
management teams felt that by securitizing their portfolios it would make these companies stronger and more competitive; with this, an era was born. Kimco, the largest owner of shopping centers nationwide, went public in November 1991. New REIT structures such as UPREITs and DownREITs provided liquidity to previously illiquid partnerships by solving the capital gains tax issue. In November 1992, Taubman Centers, Inc. became the first public REIT with an UPREIT structure. These factors positioned the REIT industry to experience the strong growth that has put the industry on the map today.

Simultaneously, the Federal Reserve Board was reducing interest rates in an attempt to bring the national economy out of its long recession, which aided REITs in two ways: 1) the cost of debt capital was reduced, contributing to the wave of acquisitions; and 2) the yield on T-Bills dropped to just 3.1% by year-end 1993 from 6.2% in January 1991. REIT dividend yields at the time provided investors a higher income return on a relatively stable asset.

The aforementioned catalysts enabled the REIT industry to take on a new identity in the early 1990s. In 1993 alone, 100 REIT equity offerings (including secondaries) occurred, raising more than $13.2 billion. At the end of 1994, the market capitalization for all equity publicly traded REITs was about $39 billion, compared with $5.6 billion at year-end 1990.

Figure 14: REIT IPO Boom of 1993–96

![Figure 14: REIT IPO Boom of 1993–96](source: NAREIT, Barclays Capital)
Increased investor interest in REITs can further be attributed to the Omnibus Budget Reconciliation Act of 1993. Prior to the Act, there were several ownership restrictions placed on institutional ownership of REITs. However, after the Act was passed, these restrictions were reduced and other changes were made. For example, a pension fund was no longer viewed as a single shareholder, but instead, each member in the fund was counted individually. Therefore, it became easier for pension funds and other institutional investors to own REIT shares, in turn driving demand, causing share prices to appreciate.

In addition to the Omnibus Budget Reconciliation Act of 1993, the Taxpayer Relief Act of 1997 allowed a REIT to provide a small amount of noncustomary services to its tenants. This concept was further enhanced with the REIT Modernization Act (RMA) of 1999, which went into effect in 2001. The Act provided more flexibility as it allowed REITs to create Taxable REIT Subsidiaries (TRS), increasing the potential income sources. Also, the dividend payout requirement was reduced, from 95% to 90% of taxable income, increasing potential retained earnings.

The REIT boom continued throughout the mid-1990s. In 1996, the NAREIT Equity REIT Index produced a total return of 35.3%, followed by a total return of 20.3% in 1997. This growth was largely attributed to higher earnings growth stemming from acquisitions and development. As aforementioned, low real estate values, combined with attractive costs of capital, provided companies with the opportunity to grow their portfolios accretively. Furthermore, the significant demand for real estate caused real estate prices to rise, leading existing portfolios to be revalued upward, which drove share price appreciation.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 cut income tax rates on most dividends and capital gains to individuals to 15% from the ordinary marginal income tax rate (35%). The premise was to eliminate double taxation. However, REITs do not qualify for the tax cut because they generally do not pay corporate taxes; therefore, the portion of REIT dividends taxed as ordinary income pay the ordinary marginal rates. Taking into consideration the various components of REIT dividends (ordinary dividend, capital gains, return of capital, etc.), however, the all-in rate is less. We note, however, that even as the

A REIT has to abide by the five-or-fewer rule, stating that 50% of the REIT cannot be owned by five or fewer individuals, a rule put into effect to prevent large blocks of ownership. It was also required that a REIT must be owned by at least 100 shareholders. Prior to the Omnibus Budget Reconciliation Act of 1993, pension funds and other large institutional investors were counted as a single shareholder, hence limiting their ability to own big blocks of shares.

A taxable REIT Subsidiary provided REITs three basic benefits. First, the ability to provide services to its tenants creates an atmosphere of greater loyalty between tenant and landlord. Second, the REIT can generate more income as it charges for the additional services offered. Third, it enables a REIT to have greater control over the quality of services provided to clients. Even with the reduction in restrictions, there are still guidelines to which the REIT must adhere. A TRS cannot exceed more than 20% of the REIT’s gross assets or income.

Other provisions in the RMA are as follows: The dividend distribution requirement for REITs was reduced to only 90% of taxable income from 95%. The distribution level was returned to the original level that had been established in 1960 after having previously been raised in 1976. The reduction in the mandatory payout for REITs gave the companies more flexibility when it came to paying their dividend and allowed for more retained earnings for investment.
REITs

relative spread between REIT yields and other investment alternatives has narrowed, there
has been no discernible trading impact.

Largest LBO Ever

Over the next several years, a combination of historically low interest rates and
strengthening fundamentals brought upon one of the largest commercial real estate bubbles
in history. In what represented the height of the bubble, on February 9, 2007,
Blackstone’s acquisition of Equity Office Properties, the largest REIT at the time, closed for
$38.3 billion, which was considered the largest leveraged buyout in history. The
agreement was concluded after a two-month bidding war between Blackstone and
Vornado Realty which topped Blackstone’s bid in value, but included partial stock in the
deal. Equity Office Properties choose to take the all-cash bid by Blackstone. The deal
effectively was a way for Blackstone to acquire the assets at a wholesale value and then
sell off large chunks of the portfolio at retail prices.

A Question of Survival

We believe it is fair to say the bull market for real estate broadly—including single-family,
commercial property and real estate stocks—came to an end in February 2007, coinciding
with the closing of the EOF merger and with the bankruptcy of New Century. During the
summer of 2007, fixed income funds that were invested in RMBS first began to disclose
problems that filtered through the capital markets and caused widespread problems in the
debt securitization markets. The group fell 18% in calendar 2007 (versus the S&P 500,
which gained 3.5%). In 2008, several banks either declared bankruptcy or become
forced sellers at distressed prices; REIT stocks were flat for the first nine months of the year,
and then, following the Lehman Brothers bankruptcy filing, risk spreads across all asset
classes gapped out, and REITs began their sharp fall. The driver was widespread market
concern that the credit crisis would eliminate capital flow to real estate for an extended
period of time, if not forever, and force asset values down. The market appeared to be
pricing in an immediate mark to market of all REIT assets and liabilities, resulting in no
implied equity value; stocks began to trade as if the underlying companies were insolvent,
reflected in materially wider REIT credit default swap spreads. We believe the imperative to
mark what is in essence a long duration asset, typically with matched and staggered debt
maturities, is misplaced. Furthermore, the implicit dependence on NAV gives no value to
the company’s franchise or value creation ability. One of the primary advantages of the
REIT structure for the ownership of commercial real estate is the vehicle’s access to equity
and debt capital at the corporate level. Most of the REITs we cover continue to have access
to capital, albeit at more expensive levels than two years ago, and we believe they have
the liquidity to hold onto the bulk of their assets without being forced to sell. This ability to
hold onto assets through the downturn, even if it lasts several years, should render the
insolvency-level valuations moot for most REITs.
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Part Three: Fundamental Overview
REITs are pass-through vehicles, and therefore real estate fundamentals such as occupancy and rent levels matter. Although some real estate property types are more cyclical than others, the phases of their cycles and underlying fundamentals are similar. To better understand how the underlying fundamentals are influenced, and in turn affect REIT performance, we analyze some of the industry’s main drivers. Many macroeconomic factors as well as the overall health of the economy affect the REIT industry generally, while each property type also is affected by specific factors, including job growth, interest rates, and demographics. While we did not set out to write the definitive text on real estate, our intent is to highlight those fundamental drivers that we think have a material impact on the various property types.

**Job Growth**

Job growth affects every property type in some form. The increase in the number of jobs results in more people looking for places to live and has a direct impact on the multifamily sector. More jobs translate into more consumer spending as employees spend their earned income boosting retail. This affects the manufacturing sector, which in turn provides a boost for the industrial sector. However, job (particularly white-collar) growth has the most direct impact on the office sector.

**Interest Rates**

Another key macroeconomic factor that clearly affects real estate is the level of interest rates. Mortgage rates, which historically move in tandem with Treasury interest rates, directly affect the cost of borrowing for new projects. A developer might scale back/slow down development if he or she is faced with higher borrowing costs. On a more global scale, interest rates also affect the overall health of the economy. Historically, the economy has expanded during periods with low interest rates and hence lower borrowing costs. This expansion usually has a positive influence on REITs. Conversely, when rates are high, the economy historically has contracted, negatively affecting REITs.

From a property sector perspective, rates have a direct, meaningful impact. Higher interest rates and mortgage costs make home ownership more expensive, therefore increasing demand for rental units and improving the pricing power of the landlords. Furthermore, when rates are high, the economy generally contracts, leading to slower or negative job growth. As a result, multi-family and office vacancies increase. The retail and industrial sectors are affected peripherally as interest rates have an impact on consumer spending.

**Demographics**

Yet another key macroeconomic factor is demographics. The demographics of a given population have a significant impact on the industry. For example, the density of the population in an area, the expected population growth, the age of the population, and the average household income are all important considerations and directly affect the various sectors of the REIT industry. Population density, growth, and age influence demand for the multi-family and retail sectors. Peripherally, the population level affects the industrial sector.
because the larger the population, the more manufactured goods are consumed by that area. Average household income affects the retail sector as consumer spending is the most important driver in the space. In addition, this demographic plays a vital role in the multifamily sector as affluence is a main driver of housing affordability.

**Supply versus Demand**

Real estate may be thought of as the supply and demand of cubic feet. Job growth, interest rates, and demographics are key demand drivers. If the property market is in equilibrium (supply meets demand), then occupancy and rents should be stable. Conversely, if there is an imbalance of supply and demand, then pricing will be skewed.

If supply exceeds demand, either the result of a drop in demand for real estate with constant supply or overbuilding at a time of constant demand, vacancies will increase, causing a shift of pricing power to the tenant. As a result, asking rents will drop. Conversely, an increase in demand with stable supply, or stable demand coupled with a decrease in supply, would drive declining vacancy. In that scenario, pricing power is shifted to the landlord and asking rents should increase.

The opposing forces of supply and demand manifest themselves in changes of occupancy and rental pricing power. All equity REITs generate a substantial portion of their revenue from rents. Rents are determined by the going rates in the assets’ respective markets. Once a price has been set, the lease term—the duration of the agreement between the tenant and landlord—is determined. The term of lease varies by property type. The shortest term is in the apartment sector (about 12 months), while the longest term is in the retail sector (20-30 years for anchor tenants and 10 years for inline retailers).

Another key factor is portfolio rollover. Rollover is the percentage of the leases in a portfolio that is expiring during any given year. The lower the rollover, the more revenue stability the portfolio has. However, in certain instances this may backfire as a landlord might have several long-term leases locked at below-current-market prices. With minimal rollover, landlords might not be able to capture the revenue upside.

**Real Estate Cycle**

Analysis of the main drivers of the REIT industry can help one better understand the real estate cycle. An imbalance in supply/demand influences the real estate cycle. If there is a drop in demand, a result of an economic decline, vacancies typically rise, leading to lower rents. As a consequence, revenues decline and prices drop. If real estate fundamentals weaken substantially, the industry goes into a recession. As fundamentals improve, usually coinciding with an economic recovery, occupancy increases, leading to an increase in rents and an eventual return to equilibrium. A strengthening economy drives occupancies higher, causing rents to spike. This eventually results in another imbalance. Developers that want to take advantage of positive fundamentals will begin construction projects, which will eventually increase supply. This oversupply, without a change in demand, will cause vacancies to increase, resulting in lower rents and potentially bringing the industry
back into recession. The real estate cycle affects all property types, some more profoundly than others.

Having provided a broad overview of the main industry drivers, we will discuss the specific factors that influence supply and demand for each of the four main property types.

Multi-family REITs

The multi-family industry serves millions of people nationwide, fulfilling a basic need: shelter. Like the other REIT sectors, the opposing forces of supply and demand are key factors affecting the sector's growth prospects. Key demand drivers of the industry include job growth, demographic trends such as household formation, and single-family housing affordability (linked to single-family home prices and mortgage rates).

The Demand Side

The sector's most notable driver of demand is job growth. As the economy expands, jobs are created, driving demand for housing. To illustrate, the multi-family industry decline of 2001-03 can be largely attributed to a considerable loss of jobs over that period. In contrast, one of the contributors to the multi-family market turnaround was the substantial job growth that began in 2004 and continued through 2007. Slowing employment growth, partially driven by layoffs in the residential mortgage, construction and the financial industries, may prove to have a large impact on demand, depending on how the economy fares. Barclays Capital's Economics team expects 3.5 million job losses in 2009 and 1.3 million jobs created in 2010.
Long term, nationwide demographics appear favorable for multi-family housing. As shown in Figure 15, Global Insight projects annual multi-family household formation growth of 400,000 per year for the next decade, a rate of 1.3% per year. Furthermore, the most rapidly growing sectors of the population are those typically consisting of renters, namely echo boomers, baby boomers, and immigrants. Per the National Center for Health Statistics (projection of live birth data), 3.5 million–4.0 million people are projected to turn 18 each year through 2016; the National Multi Housing Council (NMHC) estimates that the 18-to-29-year-old cohort has a 60%-70% propensity to rent. In addition, the Joint Center for Housing Studies approximates that 345,000 immigrant households are formed per year in the United States; the NMHC estimates that this group has an 84% propensity to rent in years one through five (following immigration), declining to a 64% propensity to rent in years five through 10. Lastly, the U.S. Census Bureau projects the number of households will grow by 2.4 million by yearend 2010, averaging 1% growth per year. According to the NMHC, even when home ownership reached record highs in the late 1990s, the number of renters grew faster than the number of total households, driven by lifestyle accommodations, demographic profiles, and strong job growth.

The affordability of single-family homes is another key variable that affects the demand side. As a result of historically low interest rates during the early half of this decade, housing prices and the pace of home sales rose to record levels, negatively affecting the multi-family sector. However, the housing market cooled off in 2006 and effectively collapsed in 2007, conditions which continue through today. Sellers, unable to find buyers in overbuilt markets, are being forced to lower their asking prices significantly, narrowing what remains a high buy-rent spread by historical standards. Moreover, many homeowners do not have the income to justify increased mortgage payments after interest rate resets on adjustable mortgages. Combined, these factors have taken many would-be purchasers out of the for-sale market.
Witten Advisors estimates that, at just under 50%, the percentage discount of the median rent to principal and interest on a median-priced single-family home is at levels not seen since the early 1980s. Renting and buying were at parity in 2004 after a decade of a rental premium; since then, the rental discount has increased rapidly, reflecting the sharp rise in the median cost of a single-family house, to a high of 104% in 3Q06, before falling to the current 48%. Witten estimates that the affordability gap for the trailing 10 years was about 57%. This pricing differential has helped rental demand, but housing prices are falling, indicating that rental rates must fall in order for the rental discount to persist.

Figure 18: Rent versus Buy Spread, 1995–2008

The Supply Side

When analyzing the supply side of multi-family, building permits issued for new construction are a good forward indicator of new supply, as the number of permits issued directly affects the number of eventual construction starts. Excess building typically occurs in tandem with simultaneous downturns in demand, and results in higher vacancies, lower rents, higher concessions, and declines in revenue for landlords. However, over the past decade or so, builders have become more disciplined and are able to better forecast drop-offs in demand and adjust their deliveries accordingly. The cost of construction (material and labor) was also up considerably over the past few years, although it has moderated over the past few months. Therefore, many developers opted to cut back the construction of rental apartments, instead focusing on for-sale development over the last few years, which only recently has become unfeasible.

Multifamily supply has been very stable from 1999 through 2008 at between 190,000 and 230,000 units annually, or an average of 1.6% of existing supply, according to CBRE Econometric Advisors. However, given the economic downturn, CBRE expects completions to fall below 1% of existing inventory for each year from 2009 through 2014, for an average of 107,000 units per year and a low of 59,000 in 2010. Notably, however, there was a coinciding surge in new condominium units and REIS estimates that 316,000 apartment units were removed from the rental supply through condo conversions between...
2003 and 2006. However, many of those units are now re-entering the rental market and developments originally scheduled to be condos are being finished as rentals.

The most recent housing bull market was unusual in that investors who never planned to live in their units took advantage of lax lending standards to acquire assets, in turn fueling appreciation and, ultimately, overbuilding. The subprime fallout led to lower prices and a surge in foreclosures, and investors who purchased single-family houses or condos with the intent to quickly resell them have been left unable to find buyers. The result is about 13 months worth of for-sale inventory on the market at the current sales pace; an expected increase in foreclosures is poised to exacerbate the situation. Many of these unsold condos and single-family homes are now finding their way back to the rental pool, increasing supply. CBRE Econometric Advisors expects new supply to exceed demand in 2009, before low construction levels fall below expected net absorption of about 60,000 units in 2010; absorption is expected to pick up rapidly after that, reaching 200,000 units in 2012. That said, there was negative net absorption in 2008 of 108,000 units, marking the first year of negative apartment absorption since CBRE’s data series begins in 1994. The negative absorption resulted in a 130-basis-point decline in occupancy levels. Looking forward, CBRE expects a 90-basis-point occupancy decline in 2009 and occupancy change to be just under flat for 2010. Rental rates are also expected to fall in 2009 (by 1.3%) before recovering in 2010.

Despite favorable demographic conditions, the rapid increase in unemployment in most markets, which drove negative net absorption in 2008, is expected to be a drag on demand during 2009 and into 2010. Development pipelines and starts across the industry are shrinking, but single-family housing supply will be an overhang. Given these conditions, CBRE Econometric Advisors expects average occupancy increases of just 20 basis points per year, although this is made up of a 90-basis-point occupancy decline to a low of 93.1% nationally at year-end 2010, followed by a 190-basis-point increase through year-end 2014. Furthermore, CBRE forecasts average rental rate increases of 1.6% through 2014, lower than historical inflation rates.
We expect that job losses, which have traditionally been correlated with apartment absorption, will continue throughout 2009, driving negative absorption at the same time as the struggling for-sale housing market causes shadow rental supply, in the form of vacant for-sale single-family houses and condominium units. That said, we continue to see variability across markets. During 4Q08, for instance, the San Francisco Bay area, Seattle, and some Texas markets remained relatively healthy, helped both by relatively stronger job performance and less single-family housing market deterioration. New York, however, which had until recently been one of the strongest markets in the country, began to see financial sector unemployment pressure rent levels; AVB said that market rents in New York declined 10%-15% during the quarter, while PPS took a substantial occupancy hit in the market. Charlotte is another market with concentrated financial services exposure, and PPS witnessed a 430-basis point occupancy decline in that market. Oversupplied markets, such as Las Vegas, Phoenix, much of Florida, and pockets of Southern California, continue to show weakness, and given for-sale housing weakness in those markets, it will be some time before they find a bottom. Nevertheless, we believe that the drastic reduction in development projects from both public and private owners of multi-family real estate will eventually lead to an undersupply of apartments and thus a pronounced multi-family recovery when job markets begin to improve. We believe that the improvement may begin in mid-to-late 2010.

Correlation to the Housing Market?

Historically, the multi-family housing market has been modestly counter-cyclical to the single-family housing market. Otherwise put, when the housing market is strong, the multi-family market typically slows and vice versa. A closer look at this phenomenon yields the following analysis: A rising interest rate environment tends to negatively affect new and existing single-family home sales, which in turn positively affects the multi-family sector. Conversely, when the economy slows or enters a period of recession and the rate of job...
growth slows, interest rates typically pause or decline, making housing more affordable and renting less attractive on a relative basis.

For the past year, however, the severe downturn in the for-sale housing market has coincided with deterioration in the multi-family rental market. The for-sale housing sector led the economy into recession, and supply overhang from that market has exacerbated the impact of increasing unemployment on the multi-family rental market.

**Figure 21: Sales of New and Existing Single-family Homes — 1968–2008 (annual rate, in 000s)**

![Sales of New and Existing Single-family Homes — 1968–2008](image)

*Source: U.S. Census Bureau, National Association of Realtors*

**Figure 22: Average Rate for Single-Family Mortgage Loans — Monthly Basis, 1989–2009**

![Average Rate for Single-Family Mortgage Loans — Monthly Basis, 1989–2009](image)

*Source: Federal Reserve Bank*
Industrial REITs

We have historically considered the industrial sector to be relatively stable and defensive, by virtue of its traditional lease structure, short development cycle, correlation of demand with broader economic direction, and relative ease of financing. It includes distribution centers, bulk warehouse space, light-manufacturing facilities, and R&D facilities.

There are several components to the industrial centers' traditional lease structure. Largely, the terms of the lease depend on whether the project was speculative or build-to-suit. A speculative developer has less leverage; in order for the space to get filled, the average lease term for speculative development is shorter (three to five years), with cheaper rents. For a build-to-suit property, the tenant is already identified, mitigating lease-up risk. As a result, typical build-to-suit leases have higher rent and a longer term (about seven to 10 years). Triple-net leases are common as the tenant pays operating costs, real estate taxes, and utilities, and tenant improvement costs are relatively low. Most leases have renewal options and rent increases as part of their original lease.

Supply

On the supply side, industrial REITs benefit from short development cycles, which tends to prevent overbuilding. Since 1992, only 2.9 billion sq. ft. were added to industrial inventories, representing a 1.5% increase annually. Construction escalated in the late 1990s as the economy was expanding at record levels during the tech bubble, before receding as demand declined in the early 2000s. Construction escalated again in 2004 through 2006 as the economy once again accelerated, but levels peaked well below those of the prior cycle. As would be expected given the economy's current slowdown, construction activity decelerated in 2007 and 2008, falling to 168.9 million sq. ft. in 2008 from a cyclical peak of 191.4 million sq. ft. in 2006. CBRE Econometric Advisors projects completions to slow further over the next several years (matching declining absorption), demonstrating the industrial sector's ability to quickly limit new supply as the economy experiences a recession.

Figure 23: Industrial Market Completions, 1980-2014E

Source: CBRE Econometric Advisors
Demand

The primary demand drivers for the industrial space are global trade, and both U.S. and global economic expansion. We track global trade flow and port usage, both U.S. and global GDP growth, and the ISM report on business (both manufacturing and non-manufacturing), each of which are highly correlated with demand for distribution warehouse space.

U.S. and global Gross Domestic Product (GDP) are valuable tools for tracking industrial real estate demand. GDP is defined as the market value of all final goods and services produced within a certain area over a period of time. The basic components of GDP are as follows: consumption, investments, government spending, and net exports. Our sense is that the level of GDP growth is a good indicator of the direction of the economy; with the economy’s globalization, both U.S. and global GDP growth are important factors for industrial demand.
The Institute for Supply Management (ISM) manufacturing and non-manufacturing indices provide a real-time outlook of U.S. economic expansion. The indices are based on a national survey of purchasing executives of approximately 300 industrial companies. A reading greater than 50% signals that the economy is expanding. Conversely, a reading lower than 50% signals that the economy is contracting.

Figure 26: ISM Manufacturing and Non-Manufacturing Indices, July 1997-February 2009

Source: Institute of Supply Management

Our current positive outlook on industrial stocks is despite a weak near-term fundamental outlook; supply is correcting, but not fast enough to offset the dramatic demand declines being felt globally. While the ISM data points to a modest rebound in recent months, both the manufacturing and non-manufacturing index paint a picture of a slowing U.S. economy. The IMF data show a slowdown in 2008 continuing into 2009 in all three metrics, with U.S. GDP and global trade expected to turn negative in 2009; this should weigh significantly on demand for distribution warehouse space. Industrial absorption turned negative in 2008 for the first time since 2001-02, and CBRE Econometric Advisors expects absorption to remain negative through 2010. In total, CBRE forecasts negative absorption of 292.2 million square feet over the three-year period. New completions are expected to slow, but remain positive, exacerbating the demand decline.

Figure 27: U.S. Industrial Absorption — Forward Projections, 1991-2014E

Source: CBRE Econometric Advisors
**Occupancy and Rental Rates Declining**

As a result of the weakening industrial demand, U.S. industrial occupancy fell to 88.6% at year-end 2008 from 90.5% at year-end 2007, the first decline since 2003. As would be expected given the expected negative absorption over the next several years, CBRE Econometric Advisors forecasts that occupancy will continue to soften through 2010, bottoming at 86.0% before beginning to recover. As occupancy levels fall, so too will rental rates. According to CBRE Econometric Advisors, U.S. industrial rents grew an average 0.2% in 2008, but are expected to fall for the next three years before rebounding in 2012. We expect the public industrial companies to continue to outperform the general market due to their focus on stronger markets and higher-quality assets.

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**Figure 28: U.S. Industrial Occupancy, 1990–2014E**

![Occupancy Graph](image)

*Source: CBRE Econometric Advisors*

**Figure 29: U.S. Industrial Rent Change, 1990–2014E**

![Rent Change Graph](image)

*Source: CBRE Econometric Advisors*
Scaling Back Development

During the last upcycle (roughly 2005–07), industrial REITs took advantage of the strong underlying industrial fundamentals, surging global demand for new space, and substantial liquidity (both equity and debt) by growing their global development businesses. This proved to be very profitable because of the strong underlying fundamentals, the rising prices (and margins), and the prevailing business model that allowed the REITs to capture an upfront developer's profit in addition to management/incentive fees from the third-party entities that ended up owning the assets. Heading into 2008, pricing had begun to move away from the developers, meaning that profit margins would be squeezed, reducing the expected gains from the development business. However, what became clear was that development pipelines became over-extended, and over-leveraged, leading to a dramatic scaling back of activity going forward. Both Prologis and AMB maintain a global portfolio, while winding down existing development projects, and will continue to generate management fees from existing third-party funds they manage. However, incentive fees and development profits are likely a thing of the past, at least for the foreseeable future.

Office REITs

The key demand driver for the office sector is white-collar job growth. During the 1990s, the economy—especially technology—was expanding rapidly, creating a surge in demand for office space. Rents spiked in certain areas of the country as technology companies increasingly pursued scarce office space. Once the dot-com bubble burst, the overall economy went into a recession. This significantly affected job markets across the country, resulting in a major downturn for the office sector in many large cities like Boston, Denver, New York, and San Francisco. As a result of the economic slowdown, the country lost 817,000 office jobs in 2001 and 2002, leading to three consecutive years of falling occupancy, and four years of declining rents. Beginning in 2003, however, job growth returned, absorption turned positive, occupancies increased and rental rates spiked, especially in key urban markets. The upcycle peaked in 2007, which ended with a nationwide office occupancy of 87.4%.

Demand turned negative again in 2008, with the loss of 261,000 office jobs, driving average occupancies down to 86.0%. Expectations are that the slowing economy—especially in the financial services market—will lead to further job losses, declining absorption, falling occupancy levels, and rental rate declines. Some of the markets that were the strongest during the recent upcycle, are expected to be among the most challenged during the downturn.
New Supply: Not the Problem

The other key driver for the sector is the amount of office space available to lease in a given market. When there is a steady demand with a balanced amount of supply, the office space is in a state of equilibrium. A spike in demand with stagnant supply will result in higher occupancy, and pricing power will shift to the landlord. Conversely, with stable demand and a spike in supply, vacancies will increase, and pricing power will shift to the tenant, eventually leading to lower rents.

When excess space is developed by companies when demand is strong, oversupply can result if demand slows before the space hits the market. Unlike the industrial sector, the office sector has a lengthy construction period, which can be attributed to a long delay from the time a permit is received to the actual completion of the building. Even if there is a sizable drop in demand, a project can be too far along for the builder to abort it. These
circumstances can often lead to an oversupply of inventory. However, in densely populated commercial areas, this tends to be less of a problem as fundamentals correct themselves much faster than in other areas.

Since 1990, only modest supply has been added to the office market. During the 1990s, only 400 million sq. ft., averaging about 1.7% increase annually, was added to office inventories. Most of that space was added between 1999 and 2002, on the heels of the strong demand of the 1990s, but notable well below the peak construction levels of the mid-1980s. Looking ahead, office construction levels are expected to continue to decline.

Figure 32: U.S. Office Completions, 1980-2014E

Source: CBRE Econometric Advisors

**Occupancy and Rents Falling**

In 2008, 17.8 million sq. ft. of office space was absorbed nationwide, lagging office completions of 76.4 million sq. ft. and therefore driving occupancy down to 86.0% at yearend (a 140-basis-point decline versus 87.4% at yearend 2007; average rental rates grew 3.7% in 2008, down from 9.8% in 2007 [all according to CBRE Econometric Advisors]. CBRE Econometric Advisors projects that the United States will have negative office absorption of 50.0 million sq. ft. in 2009, average occupancy will fall another 280 bps to 83.2%, and rents will fall 5.4%.
Still a Positive Mark-to-Market

Despite a modest decline in average rental rates in late 2008 (1.2% in 4Q08 according to CBRE Econometric Advisors), and expected continued declines throughout 2009 as identified in Figure 34, we expect many office landlords to continue to see positive rental rate increases on new leases signed throughout 2009. This phenomenon is due to the significant market rental rate increases experienced over the past four years, coupled with the fact that office leases tend to be relatively long term in nature (five to 10 years, on average), meaning the rents on expiring leases were signed at low levels. Positive mark to market is not universal; CBD office markets are likely to have more of a cushion than suburban markets because rents in those markets increased more, on average, over the past few years. Current embedded mark to market will dissipate over time as new leases are signed, and especially as market rates continue to fall.
Retail REITs

The retail REIT sector, which is driven in the near term by retailer demand for space and in the longer term by consumer spending, is relatively stable due to its long-term leases. The performance of the industry can be attributed to the nature of the industry's two main drivers: 1) the amount of retail space available for lease; and 2) the demand for that space. Retail real estate comes in three main forms: regional malls, shopping centers, and outlet malls.

Shopping Centers

Shopping centers historically have been a popular area for real estate investment, in part because these properties can be less expensive (depending on size and format), and, therefore, easier to assemble into a portfolio than other types of real estate. We believe that the shopping center sector is a stable and mature industry.

In the late 1920s, department stores proliferated throughout cities nationwide. However, the development of trains and the subsequent proliferation of autos and highways encouraged migration to the suburbs. This demographic shift established the platform for shopping centers. A number of today's leading players have roots that date as far back as the 1920s, including New Plan (acquired by Centra Properties in 2007), Weingarten Realty, and Federal Realty. In 1962, New Plan, as a c-corporation, and Federal Realty, as a REIT, were the first real estate companies to take their portfolios public.

We categorize shopping centers into the following formats: 1) neighborhood centers, 2) community centers, 3) power centers, and 4) main street retail. Each format has its own set of business economics that depends largely upon its typical tenant base and those tenants' sensitivity to changes in discretionary spending. Hence, each format has its own distinct set of risk/return characteristics.

Figure 35: Shopping Centers - Shopping Center Formats

<table>
<thead>
<tr>
<th>Format</th>
<th>Size (square feet)</th>
<th>Trading Radius</th>
<th>Number of Anchors</th>
<th>Typical Anchors</th>
<th>Economic Sensitivity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Neighborhood Shopping Center</td>
<td>30,000 - 150,000</td>
<td>3 miles</td>
<td>1 or more</td>
<td>Kroger, Publix, Albertsons, Safeway</td>
<td>Least sensitive</td>
</tr>
<tr>
<td>Community Shopping Center</td>
<td>100,000 - 350,000</td>
<td>3-6 miles</td>
<td>2</td>
<td>Kohl's, Home Depot, Lowe's, Wal-Mart</td>
<td>Sensitive</td>
</tr>
<tr>
<td>Power Center</td>
<td>250,000 - 600,000</td>
<td>5-10 miles</td>
<td>3 or more</td>
<td>Best Buy, Bed Bath &amp; Beyond, Lowe's, Staples, Home Depot, Barnes &amp; Noble, Toys &quot;R&quot; Us, Borders</td>
<td>More Sensitive</td>
</tr>
<tr>
<td>Main Street Retail</td>
<td>50,000 - 250,000</td>
<td>5-15 miles</td>
<td>none</td>
<td></td>
<td>Very Sensitive</td>
</tr>
</tbody>
</table>

Source: ICSC

There has been steady growth (albeit at a decreasing rate) in the size of the shopping center universe since the 1970s. Historically, the average annual new supply had been 153 million sq. ft. from 1978 to 2006, before tapering off as economic climate weakened. We project that new supply will steadily decline over the next few years as...
developers wait out the economic downturn. A total of 74.4 million sq. ft. are projected for delivery through 2012, well below historical levels.

Figure 36: New Construction — Less than 800,000 sq. ft. (in millions of sq. ft.)

Source: National Research Bureau, ICSC, CoStar, company documents, Shopping Center World

**Regional Malls**

The second property type for retail is the regional mall. The U.S. regional mall sector has evolved and is now a mature industry property type by the conventional business school definition.

- **Urban and Suburban Development.** Although the nation's first enclosed regional mall was built in the 1950s, its roots can be traced to the department stores of the late 19th century. The predecessor of the department store was the mail order catalog company, specifically companies such as Sears, Roebuck & Co. and Montgomery Ward. However, the culture of consumption changed as the Industrial Revolution pulled workers from farms to factories and cities. At that time, Alexander's and the Grand Depot opened; these were known as the first "department stores." Department stores soon proliferated in cities, but the population soon started to migrate to the suburbs as a result of innovations in transportation. Department store companies therefore expanded to the suburbs in the 1930s and 1940s, building large freestanding stores where real estate was cheap and parking was available.

As more people migrated from cities to suburbs, regional malls sprouted along new highways. Development of malls continued until the late 1980s. The 1980s, hailed as the boom years for retail development, saw more retail formats created. As a result of bank deregulation early in the decade, S&Ls were able to extend loans for new commercial real estate development. As a result of all this lending, overbuilding occurred. This overbuilding caused vacancy rates to rise sharply, which eventually led to the real estate
market downturn at the end of the decade. Notably, this phenomenon was not limited to retail real estate, but extended essentially to all property types.

As a result of the real estate downturn, S&Ls went bankrupt because the property they owned was worth a fraction of its purchase price. To rebound from the bank crisis in the late 1980s, construction lenders tightened credit standards and began requiring more equity from developers. This set the stage for public REIT explosion in the 1990s as many private developers turned to the public market; the UPREIT structure, as mentioned earlier, alleviated the tax burden of many private players.

Regional mall construction boomed for 40 years, but after several decades of exponential growth, the mall sector has been undergoing a period of consolidation. Over the past 15 years, the industry has consolidated both on an asset level and in terms of ownership concentration. By some estimates, the number of operating malls in the country has declined to under 1,500 today, driven by structural change in the industry and consumer preference.

- Limited New Supply. As previously mentioned, the U.S. regional mall sector is a mature industry. In addition, the industry has seen a major drop in supply since the early 1990s. The historical annual average for new construction has been 22 million sq. ft. over the last few decades (1978-2006). We expect the level of activity to decrease in the upcoming years and, based upon data provided by CoStar, we believe that 7.4 million sq. ft. of mall square footage is under construction or being proposed for completion in 2009, while only 1.1 million sq. ft. of mall square footage is under construction or being proposed for 2010 as developers pull back dramatically in response to the credit crisis.

Figure 37: Regional Mall Deliveries (in thousands of sq. ft.)

- Source: National Research Bureau, ICSC, CoStar, company documents, Shopping Center World
Demand Drivers

The demand drivers for both regional malls and shopping centers are very similar. The most notable demand driver for the retail sector is retailer demand for space, a function of retailer profitability and growth objectives. On a macroeconomic basis, this driver relies on overall long-term consumer spending trends.

The relationship between consumer spending and the success of a particular center is intuitive. The tenant seeks out a location that will afford it the greatest sales per square foot. When consumer spending is high, average locations will generally afford the retailer a meaningful level of sales and allow it to operate at a healthy profit margin. An above-average location will usually afford the retailer a solid above-average profit margin. Of course, when consumer spending is being restrained by external factors, such as bad weather and high gas prices, the opposite result will occur.

The landlord may also try to capture sales upside by factoring in a percentage of sales component to the rent charged. As sales increase, this variable component of rent will increase and, therefore, the REIT's NOI will increase, resulting in a higher real estate valuation. Thus, increased consumer spending generates increased sales, which generate increased rent, which provides increased NOI and valuation.

There are several indicators we use to gauge consumer spending. The first indicator is retail sales. The second is the Consumer Confidence Index (CCI). The index is a useful measure for future retail sales as it takes into account current consumer opinion on the economy and future expectations as well. That is, if the index provides a high reading, it means that the average consumer feels the economy is in good shape and that he or she will spend discretionary income as a result of that confidence.

Conversely, if the reading on the index declines, it can be inferred that the average consumer feels cautious about the economy and might pull back on his spending, resulting in a dropoff in retail spending.
We also look at consumer expenditures as they relate to wage growth. In 2008, real disposable income increased at an annualized rate of 2.2%; real personal consumption expenditures (PCE) increased 0.2% on the same basis. We think that spending patterns are important to consider, and we have observed that U.S. retail sales as a percentage of personal consumption expenditures have declined to 45% from 58% as medical services, legal services, personal hygiene, and insurance have become more substantial contributors (see Figure 39).
Figure 40: U.S. Retail Sales Losing Share in Real Personal Consumption Expenditures

Retail Sales (% of PCE)

Source: BLS, Barclays Capital
Sales per square foot, a measure of asset productivity, has accelerated over the past three decades. Sales per square foot is highly correlated with rental rate growth. With so many retailers expanding store locations and adding new concepts to their spaces, particularly in the stronger malls and better-located shopping centers, demand for space has intensified. As a consequence, rental rates for retail real estate have risen.

Figure 41: Effective Rent of Shopping Centers, 1990–2012E

Retail properties also tend to benefit from long lease durations (typically seven to 10 years) especially during economic downturns. Leases are typically structured with regular rent bumps throughout the life of the lease in order to account for expected inflation. In cases where retailers decide to close stores prior to lease expiration (outside of bankruptcy cases), the retailer will be obligated to compensate the landlord with a lease termination fee, which will help cushion the drop-off in revenue in the near term as landlords attempt to fill the newly vacant space.

Looking Forward. Our chief concern regarding retail REITs is that store closings could materially impact the demand for space, in turn leading to a substantial decline in occupancy and rental rates. Consumer confidence levels are near record lows and there is diminishing access to consumer credit. Since the start of the recession in December 2007, non-farm payroll have fallen by approximately 3 million. Although there is speculation that a new administration will push through additional stimulus relief packages quickly, we are concerned that potential government action will be neither fast nor substantial enough to spur consumer spending enough to deter retailer bankruptcies and additional store closings. Currently, the ICSC estimates that 148,000 stores closed in 2008 and believes another 73,000 stores will shutter in the first half of 2009. These closures would reflect levels not seen since 2001.
Despite retail real estate operating metrics coming off strong levels (occupancy in the low-to mid-90s, rent growth on new leases in the teens), a prolonged consumer/economic slowdown appears more likely than not at this juncture and we believe it could have significant adverse effects on rental rates and occupancy levels. That said, the market appears to be pricing in a near worst-case scenario, which we believe is unwarranted. In 2009, we project a 1.4% FFO per share decline from the mall REITs and a 21.4% decline from the shopping center REITs. In comparison, we project a 9.4% decline from our coverage universe.
Part Four: Stock Analysis and Valuation
Part Four: Stock Analysis and Valuation

We evaluate REIT stocks just as we would other equities: we utilize earnings multiples, asset values, dividend yields, and earnings growth rates. However, some GAAP accounting concepts are less relevant for REITs. Therefore, the industry has developed different metrics more consistent with real estate's characteristics as a long-term, total-return asset class. In this section, we first define the metrics that we use to assess REIT performance, and then we explore the real estate-specific factors and fundamentals that determine portfolio-level performance, and, in turn, stock performance. Furthermore, we note that management plays a key role, just as it does in any other type of company, as management is responsible for executing the proper strategies to drive earnings growth.

Our valuation analysis, which is laid out in more detail further, is supported by an analysis of management's ability to facilitate stability and growth, and prudently manage the balance sheet. We track a number of ratios and statistics, with the goal of ensuring that our earnings projections are achievable based on the company's capital structure. In that vein, we view analyzing REITs as quite similar to analyzing other types of companies, the difference being in the metrics used.

Valuation Metrics

Investors initially viewed REITs primarily as an income vehicle and, as such, the dividend yield played a primary role in relative valuation. However, as perception of REITs has shifted toward that of a total-return vehicle—and not simply an income vehicle—multiples and growth rates have taken on greater importance. We use several valuation metrics to value REITs on both a stand-alone and relative basis, including: price to FFO (funds from operations), price to CAD (cash available for distribution), price to NAV (net asset value), and dividend yield. FFO and CAD should reflect the performance of the underlying portfolio of properties measured, in turn, by same-store net operating income (SSNOI), a key measure of property-level performance. As with all multiple analyses, it is important to factor earnings growth into the equation.

Price to FFO and price to CAD are earnings and cash-flow-driven multiples, respectively. These metrics approximately parallel price-to-EPS and price-to-cash-flow (EBITDA) multiples used to analyze other types of companies. The most widely recognized earnings metric for REITs, however, is FFO. FFO is reported by the vast majority of REITs—and accounts for the bulk of our estimates, and those tracked in First Call. We also provide annual CAD estimates, which are more akin to free cash flow and which we utilize as the basis for our price targets. However, many companies do not report CAD, and First Call does not track CAD estimates. Net asset value estimates the private market break-up value of a REIT's portfolio, and is not widely reported or tracked. FFO, CAD, and NAV are specific to the REIT sector and are described in more detail below.

1) Funds from Operations (FFO)

FFO is the most common metric used to assess REIT performance. It is defined as:
GAAP net income, excluding gains (or losses) from debt restructuring and sales of properties, plus real estate-related depreciation and amortization and after adjustments for unconsolidated partnerships and joint ventures.

FFO is essentially an operating EPS figure eliminating the impact of real estate depreciation, which is a major non-cash charge and should therefore be added back. Historically, FFO multiples have ranged from the high single digits to the high teens. Multiples reached all-time highs in early 2007 due to several factors, including investors pricing in the recovery in real estate fundamentals, a surge in REIT mergers and acquisitions, and an overall greater interest in REITs, which drove increased demand of this relatively small and illiquid sector. As of February 2009, multiples had contracted 61% from those highs. Figure 42 illustrates FFO multiples over time for the overall REIT sector and then for the four main property types.

Figure 42: REIT Historical Forward Multiples — Overall Average, 1996–2009 Year-to-Date

Source: Barclays Capital
2) Cash Available for Distribution (CAD)

We define CAD as follows: FFO - recurring, nonrevenue-generating capital expenditures and adjustments for straight-lining rents.

CAD is a more accurate indicator of a REIT's profitability than simple FFO, because FFO ignores maintenance capital expenditures and is skewed by the GAAP straight-lining of rents, in our view. As such, CAD multiples are arguably a better valuation parameter to use when comparing companies. Our concern, from a methodological perspective, is how to calculate CAD consistently across different property sectors. We believe that to calculate CAD deductions properly (namely, on a normalized long-term basis), it is necessary to have a detailed understanding of the company and the sector. We provide CAD estimates for the companies in our coverage universe on an annual basis, as quarterly fluctuations are harder to predict. Further, many companies do not report CAD and it is not tracked by First Call. That said, we view CAD as the most appropriate valuation tool, if applied consistently within a sector.

3) Net Asset Value (NAV)

We view NAV as a proxy for book value statistics used in conventional securities analysis. In essence, our NAV calculation estimates the private market breakup value of a company's assets, under the somewhat artificial assumption that it is an orderly liquidation. We are quick to acknowledge that calculating a company's NAV is more art than science. In addition, we acknowledge that this exercise may not be appropriate for what is, in
REITs

essence, an infinite-life entity. Nevertheless, we believe that it provides a good indication of relative value, particularly in a bearish equity market, assuming that the methodology is applied consistently across REITs within a given property sector.

We begin by applying the appropriate property-specific capitalization rate to the company’s projected 12-month forward (earnings potential) net operating income (NOI) by sector. To arrive at our cap rate for a REIT, we take into account the geographic concentration of its portfolio and the age and overall quality of its assets. We start with a nominal cap rate (most private market participants buy and sell properties on those terms) and translate it into an economic cap rate. An economic cap rate is typically lower than its nominal equivalent because it is applied to NOI, after recurring capital expenditures. Most buyers actually account for required capital expenditures when determining their offers. However, we believe it is the best proxy to use in valuing a real estate portfolio. Historically, REIT stocks have traded at price-to-NAV ranges from approximately 80% to 120% of NAV. We do not view a historical time series NAV analysis as relevant, due to changing real estate fundamentals; however, we view P/NAV levels as a good measure of relative value within a sector at a given point in time. In Figure 44, we show the detailed NAV calculation for Mack-Cali Realty as an example.
### Current Mack-Cali Realty Net Asset Value (1)

<table>
<thead>
<tr>
<th>Assumed NOI Contribution from (3):</th>
<th>NOI Before Interest</th>
<th>Current Value</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Cap Rate</td>
<td>Economic Cap Rate</td>
</tr>
<tr>
<td>Office Properties</td>
<td>7.73%</td>
<td>6.27%</td>
</tr>
<tr>
<td>Off/Flex Properties</td>
<td>7.50%</td>
<td>7.50%</td>
</tr>
<tr>
<td>Industrial Properties</td>
<td>8.00%</td>
<td>8.00%</td>
</tr>
<tr>
<td>Third Party Mng't</td>
<td></td>
<td>6.33%</td>
</tr>
<tr>
<td>Total NOI</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### Balance Sheet Items:

<table>
<thead>
<tr>
<th>% of Carrying Value (4)</th>
<th>B/S Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and Cash Equivalents</td>
<td>34,340</td>
</tr>
<tr>
<td>Investment in Securities and Unconsolidated JVs</td>
<td>115%</td>
</tr>
<tr>
<td>Construction in Progress</td>
<td>110%</td>
</tr>
<tr>
<td>Land Held For Future Development</td>
<td></td>
</tr>
<tr>
<td>Other Assets</td>
<td>135,863</td>
</tr>
<tr>
<td>Total Assets</td>
<td>$329,272</td>
</tr>
</tbody>
</table>

**Gross Market Value of Assets**
- $3,602,063

**Total Liabilities Outstanding**
- $2,695,560
- Mortgage Debt and Tax exempt debt: $531,126
- Line of Credit: $161,000
- Unsec Debt: $1,533,349
- Other Liabilities: $289,084
- Preferred: $25,000

**Minority Interest**
- 786

**Net Market Value of Assets**
- $3,091,687

**Common Shares & Units Outstanding**
- 80,857

**Current Value Per Share**
- $38.24

**Valuation Measures:**

- **Price Per Share**: CLI
  - $19.56
- **Price/Current Value**: 51.2%
- **Total Firm Value/Gross Market Value of Assets (5)**: 73.0%
- **Implied nominal cap rate**: 11.0%

---

1. CLI's current value is based on 12/31/08 balance sheet, and 4Q08 NOI annualized.
2. Economic cap rate is used, as NOI includes a deduction for recurring capital expenditures.
3. Deducts $66.2 million in recurring capital expenditures from CLI's next 12 months estimated NOI.
4. Unless otherwise specified, amount is 100% of carrying value.
5. Total enterprise value = market value of common equity plus total liabilities.

---

### 4) Dividend Yield

In addition to the metrics described in Figure 44, we use dividend yield as an analytical tool. Dividends remain an important component of REIT total returns (historically accounting for approximately two-thirds of the total), although in the past few years dividends have represented a much smaller portion of overall returns. We look at dividend yields relative to other REITs, in addition to other income alternatives such as the 10-year Treasury bond.
Since 1995, REIT dividend yields have averaged about 6.19%, versus 4.90% for the 10-year Treasury bond and 1.78% for the S&P 500. In addition, there is normally an inverse relationship between yield and earnings growth rates.

**Figure 45: REIT Dividends versus S&P Dividends versus 10-Year Treasury Yield**

<table>
<thead>
<tr>
<th>Date</th>
<th>NAREIT Equity Yield</th>
<th>S&amp;P 500 Dividend Yield</th>
<th>Ten-Year Treasury Yield</th>
<th>Differential</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec-95</td>
<td>7.51%</td>
<td>3.30%</td>
<td>5.51%</td>
<td>2.20%</td>
</tr>
<tr>
<td>Mar-96</td>
<td>7.55%</td>
<td>2.14%</td>
<td>6.32%</td>
<td>1.23%</td>
</tr>
<tr>
<td>Jun-96</td>
<td>7.29%</td>
<td>2.26%</td>
<td>7.17%</td>
<td>0.98%</td>
</tr>
<tr>
<td>Sep-96</td>
<td>7.03%</td>
<td>2.22%</td>
<td>7.70%</td>
<td>0.68%</td>
</tr>
<tr>
<td>Dec-96</td>
<td>6.05%</td>
<td>2.04%</td>
<td>6.46%</td>
<td>0.69%</td>
</tr>
<tr>
<td>Mar-97</td>
<td>6.12%</td>
<td>1.91%</td>
<td>6.91%</td>
<td>0.80%</td>
</tr>
<tr>
<td>Jun-97</td>
<td>6.06%</td>
<td>1.75%</td>
<td>6.56%</td>
<td>0.51%</td>
</tr>
<tr>
<td>Sep-97</td>
<td>6.45%</td>
<td>1.71%</td>
<td>7.91%</td>
<td>1.45%</td>
</tr>
<tr>
<td>Dec-97</td>
<td>6.48%</td>
<td>1.63%</td>
<td>6.89%</td>
<td>0.57%</td>
</tr>
<tr>
<td>Mar-98</td>
<td>5.55%</td>
<td>1.46%</td>
<td>6.66%</td>
<td>1.09%</td>
</tr>
<tr>
<td>Jun-98</td>
<td>6.73%</td>
<td>1.46%</td>
<td>6.53%</td>
<td>1.17%</td>
</tr>
<tr>
<td>Sep-98</td>
<td>6.88%</td>
<td>1.46%</td>
<td>6.46%</td>
<td>1.42%</td>
</tr>
<tr>
<td>Dec-98</td>
<td>7.47%</td>
<td>1.34%</td>
<td>6.84%</td>
<td>1.63%</td>
</tr>
<tr>
<td>Mar-99</td>
<td>7.90%</td>
<td>1.23%</td>
<td>7.11%</td>
<td>2.74%</td>
</tr>
<tr>
<td>Jun-99</td>
<td>7.34%</td>
<td>1.22%</td>
<td>6.11%</td>
<td>1.28%</td>
</tr>
<tr>
<td>Sep-99</td>
<td>6.27%</td>
<td>1.30%</td>
<td>5.99%</td>
<td>1.28%</td>
</tr>
<tr>
<td>Dec-99</td>
<td>8.70%</td>
<td>1.14%</td>
<td>6.44%</td>
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<tr>
<td>Mar-00</td>
<td>8.30%</td>
<td>1.13%</td>
<td>6.01%</td>
<td>2.29%</td>
</tr>
<tr>
<td>Jun-00</td>
<td>7.01%</td>
<td>1.14%</td>
<td>5.02%</td>
<td>1.99%</td>
</tr>
<tr>
<td>Sep-00</td>
<td>7.45%</td>
<td>1.15%</td>
<td>5.80%</td>
<td>1.65%</td>
</tr>
<tr>
<td>Dec-00</td>
<td>7.52%</td>
<td>1.15%</td>
<td>5.11%</td>
<td>2.41%</td>
</tr>
<tr>
<td>Mar-01</td>
<td>7.48%</td>
<td>1.36%</td>
<td>4.91%</td>
<td>2.57%</td>
</tr>
<tr>
<td>Jun-01</td>
<td>5.84%</td>
<td>1.27%</td>
<td>4.51%</td>
<td>1.33%</td>
</tr>
<tr>
<td>Sep-01</td>
<td>7.43%</td>
<td>1.45%</td>
<td>4.58%</td>
<td>2.85%</td>
</tr>
<tr>
<td>Dec-01</td>
<td>7.14%</td>
<td>1.36%</td>
<td>4.60%</td>
<td>2.50%</td>
</tr>
<tr>
<td>Mar-02</td>
<td>6.44%</td>
<td>1.31%</td>
<td>4.42%</td>
<td>2.04%</td>
</tr>
<tr>
<td>Jun-02</td>
<td>6.21%</td>
<td>1.45%</td>
<td>4.61%</td>
<td>1.80%</td>
</tr>
</tbody>
</table>

Source: Bloomberg, NAREIT

Due to the importance of the dividend as a portion of total return, the security of that dividend is tracked closely. A common way of monitoring the sustainability of the dividend is via the payout ratio (dividend/FFO per share or dividend/CAD per share). FFO and CAD payout ratios have declined over time as management focus has shifted from paying a high dividend as possible to retaining as much income as possible to fuel growth, while still being able to maintain dividend growth. This is consistent with the shift from REITs as income vehicles to total-return vehicles. We view a CAD payout ratio of approximately 60%-85% as appropriate. A payout ratio above 90% may put the sustainability of the dividend into question. That said, a payout ratio over 100% may just represent a temporary shortfall due to nonrecurring events and, as such, may not be an accurate indicator of future coverage.

**Dividend as Source of Capital**

More recently, in late 2008, the Internal Revenue Service provided relief for many capital starved REITs and issued temporary guidance that permitted REITs to distribute stock instead of cash to satisfy the 90% payout rule for all REITs. The dividend distribution does not allow the stock portion to be greater than 90% of the total payout. Previously, a REIT had the choice to pay out up to 80% of its dividend in stock with a private letter ruling from the IRS.
Qualitative Considerations

and had to permit its shareholders the choice of receiving either cash or stock up to the maximum allocation. The newly issued guidance extends only to distributions declared with respect to taxable years ending on or before December 31, 2009.

Beginning in late 2008, a number of REITs began to take advantage of the ruling and declared stock as a portion of its 2009 dividends in order to preserve cash. In addition, some larger companies which were perceived to be in relatively better health with respect to its balance sheet (VNO and SPG) also included stock as a part of its 2009 projected dividends.

Underlying Portfolio Performance Drives Earnings

Equity REIT revenues are derived primarily from rental income. Revenue growth is driven internally primarily via occupancy growth, rent increases upon lease rollover, percentage rent participation (retail), scheduled rent bumps, property refurbishments, and sale and reinvestment (capital recycling). The structure of leases is critical, as much of a company's revenue growth may be dictated by the rent bumps stipulated in its leases (especially true for net lease companies), or by the percentage rent agreements for retail companies. External growth is driven by acquisitions, development, and expansion.

Location

Location is obviously a key factor in determining rental rates and rental rate increases. Central Business District (CBD) office properties generally command a higher rent than suburban office; proximity to public transportation or other amenities can increase pricing power for a landlord. Retail properties that are well-positioned with respect to major traffic arteries or population centers or other synergistic retailers will generally command higher rents. Rental rates for other property types are also heavily influenced by similar factors. Furthermore, a REIT's overall portfolio may benefit from either its geographic concentration or diversification, depending on market conditions. For example, over the past several years, those REITs with high concentrations of office properties in New York or Washington, D.C. have benefited disproportionately compared to geographically diversified office REITs, as those two markets have experienced greater occupancy and rental growth than the average market in the United States.

Portfolio Quality

Portfolio quality (both buildings and tenants) also matters. When analyzing a REIT's earnings growth opportunities, it is important to assess the quality and condition of its real estate assets to assess the magnitude of rents the properties will be able to garner, and what types of capital expenditures (upkeep and remodeling) will be required in the future. Moreover, higher-quality tenants provide a more reliable income stream; a common metric observed is percentage of average base rent represented by investment-grade tenants.

Characteristics of Local Markets (Demographics)

Characteristics of local markets (demographics) are important. Property-level performance will also be influenced by the demographics of the local market, including age levels,
household formations, wage levels, etc. Changing demographics can point to opportunities or challenges for a REIT and aid in evaluating earnings potential.

**Lease Terms**

Lease terms also play a role in determining earnings growth. Many leases have stipulated rent increases that play a large part in rental growth. In addition, the length of leases and the timing of the expiration (rollover) of those leases are critical, as leases may expire during times of low rental rates or high rental rates, based on the stage of the real estate cycle. The amount of leasing volume will determine overall occupancies and, as such, is paramount to a REIT's success.

All of these factors combined determine the level and growth of property-level revenues, which, combined with property operating expenses, determine SSNOI, the key metric for property-level performance. Property-level expenses include real estate taxes, utilities, insurance, property management expenses, and recurring capital expenditures (carpeting, blinds, etc.). Expenses for a REIT include general and administrative costs (similar to that of other companies) and interest expense, which can be quite large as properties are financed with debt (overall REIT leverage currently averages about 65%, but historically has ranged between 40% and 50% debt to total market cap). Controlling these varied expenses is paramount as a REIT's existing income stream is largely fixed (dictated by its leases).

Earnings growth is a critical element in valuing a REIT. Rent growth, coupled with moderate expense increases, should lead to positive earnings growth. Management savvy will have an impact on the level and acceleration of this growth, which should be reflected in valuation multiples (P/CAD, P/FFO). The dividend yield often has an inverse relationship with the level of earnings growth (for example, net lease companies typically have higher dividend yields and lower growth than other REITs, reflective of their long-term leases and limited ability to grow earnings at a rapid rate). An increasingly important component of a REIT's earnings is gains on development, especially in the industrial sector. This may provide a REIT with considerable gains; however, the realization of this income is inherently lumpy.

In addition to growing rents and occupancy, REITs grow revenues via acquiring and/or developing additional properties. In simple terms, acquisition is accretive if the going-in cap rate (unlevered cash yield) is above the cost of debt. Development, which is inherently more risky, should generate yields several hundred basis points above acquisitions. A company's development pipeline can be an important source of growth and should be monitored closely. A large development pipeline can be quite beneficial when properties are selling for above replacement cost. That said, if real estate prices or rents fall while the properties are being developed, a company may fall short of its initial return projections.

All of these factors (existing portfolio growth and expansion via acquisition and development) contribute to the growth of earnings and dividends. The rate and success of that growth is largely influenced by management.
Just as in any other type of company, management is critical. We believe that investing in REITs is essentially investing in management. Now that REITs are actively managed companies, as opposed to passive pools of real estate assets, the quality of management plays a meaningful role in determining the growth of the company. Therefore, we evaluate REIT management teams based on track record, experience, strategy, relationships in the industry (access to deals), and balance sheet management skills. In addition, the level of insider ownership is important, as it aligns the interests of management and shareholders. Of note, real estate historically has largely been a family business; however, that is changing, with more family-run companies being acquired and run by professional managers.

Real estate is a capital-intensive industry; therefore, it is important for a company to have access to a variety of capital sources in order to fund investment. However, the level of debt that REITs maintain has declined over the years and now generally hovers at 30%-50% (of total market cap). With today's declining prices, REITs trade at a debt-to-total market capitalization of 60%. Many REITs also seek projects where returns are only justified by employing higher levels of debt; therefore, some REITs pursue these investments in off-balance-sheet joint ventures where higher leverage can be used. Generally, REITs have restrictions (covenants) placed on them, which restrict debt levels. Standard REIT debt covenants include a maximum of 60% leverage, no more than 40% of total assets comprised of secured debt, a minimum of 1.5x fixed charge coverage, and unencumbered assets of at least 1.50% of unsecured debt. As a result, REITs, in general, maintain relatively conservative capital structures.

Because REITs must pay out at least 90% of taxable income, they generally retain approximately 35%-40% of cash flow—primarily a result of the depreciation tax shield. In the current environment, cash flow retention has become more paramount. As such some companies such as Simon Property Group have decided to pay out their dividend in stock, allowing the company to further retain more capital.

The main components of a REIT’s capital structure are debt (credit facilities, unsecured debt, secured debt, property-level debt, and joint venture debt), common stock, operating units, and preferred stock (Figure 46). Although capital structures and debt levels vary from REIT to REIT, Figure 46 illustrates the capital structure of Simon Property Group as an example.
Credit Facility

Many REITs initially fund property investment via short-term credit facilities, which typically have maturities of one to two years, with extension options for an additional one to three years. Interest on these facilities is usually floating-rate, based on a spread over a short-term index rate (usually 30-day LIBOR). Once a company accumulates a meaningful balance on its credit facilities, it will usually roll that short-term debt into something more permanent, such as long-term, fixed-rate debt or equity.

Secured Debt

REITs may utilize property-specific mortgage debt or debt secured by a pool of properties, usually up to a loan-to-value (LTV) level of approximately 80%, but more commonly between 40% and 70%. Property-specific debt financing is more common among net lease companies as the long-term nature of the leases makes them more easily match financed via property-specific mortgages. The amount of secured debt that a REIT may issue will often be influenced by the ratings agencies, due to certain requirements dictating the acceptable levels of secured debt that a company may maintain in order to qualify for a specific credit rating. Moreover, the cost of debt may influence the amount of secured versus unsecured debt.

Unsecured Debt

REITs may also issue unsecured debt, which by definition is not backed by any property interest or any other specific collateral, but is senior to all equity and other subordinate...
debt. Maturities usually range from five to 10 years. In the current environment however, unsecured debt has been almost completely shut off to companies due to historically wide spreads.

Preferred Stock/Convertible Preferred Stock

Many REITs issue preferred stock; however, it is usually a much smaller portion of the capital structure.

Trust Preferreds

These securities are becoming more common as of late, and are different from regular preferred securities. The securities have a 30-year term, a fixed rate for 10 years that subsequently floats based on a spread to LIBOR, and are callable after five years. The securities are issued by a trust that has been created for the sole purpose of issuing these securities.

Operating Partnership Units

REITs formed via an UPREIT or DownREIT structure may issue Operating Partnership (OP) units in exchange for properties. OP units are exchangeable into common stock on a one-for-one basis, receive dividends, and have voting rights just like common stock. OP units provide a currency to the REIT to make property acquisitions without the seller incurring an immediate tax liability. The seller may defer the tax liability until the OP units are converted to common stock.

Common Stock

The principal component of a REIT's capital structure is common stock. Due to the fact that REITs must pay out 90% of taxable income as dividends, a REIT generally periodically taps the equity markets to grow. As such, REIT follow-on equity issuances are common.
Part Five: Indices and Exchange-Traded Funds
Real Estate Indices

A number of indices are available to investors to monitor REIT stock performance, including the NAREIT Composite and Equity Indices, Wilshire Real Estate Securities Index, Global Property Research 250 Index, Cohen and Steers Realty Majors Index, and S&P REIT Composite Index. Historically, the Morgan Stanley REIT Index (RMS), now called the MSCI US REIT Index, was the index of choice for several reasons. However, the NAREIT Equity and Composite Indices have also become more widely accepted, in our opinion.

RMS versus NAREIT

In March 2006, FTSE, the global index provider, took over the calculations of the NAREIT Domestic Real Estate Index Series, which were renamed the FTSE NAREIT US Real Estate Index Series. We focus primarily on the FTSE NAREIT Equity Index and the FTSE NAREIT Composite Index. We also track the performance of the RMS. The reason for focusing on the NAREIT Equity and Composite Indices is their comprehensive nature (the Equity Index includes all publicly traded equity REITs, while the composite contains all publicly traded equity and mortgage REITs), in addition to the availability of data. The RMS had been the index of choice, as it has dominated the industry since its coming of age in the early 1990s. However, MSCI, a subsidiary of Morgan Stanley, overtook administration of the index in summer 2005, introducing a real-time, price-only index (RMZ) while maintaining the RMS total-return index priced only at the end of each trading day. Subsequently, the availability of index data became more challenging. Meanwhile, data on the NAREIT Equity and Composite Indices are more readily available.

The NAREIT Composite Index is comprised of all 135 publicly traded REITs on the NYSE, the Nasdaq National Market System, and the American Stock Exchange. The Composite Index includes 10 residential mortgage REITs and 10 commercial mortgage REITs. In addition, NAREIT maintains an Equity REIT index that excludes these 29 mortgage REITs; both indices are market-cap-weighted (float adjusted), calculated on a total-return basis, and include a number of smaller companies. The NAREIT Equity Total Return Index can be found on Bloomberg under the symbol “FNERTR” (Index); the NAREIT Composite Index can be found on Bloomberg using the symbol “FNCOTR” (Index). Price-only versions of these indices are maintained as well.

The RMS is relatively comprehensive, although it excludes mortgage REITs. The index represents approximately 85% of the US REIT universe. We believe that many money managers will continue to use the RMS; however, we think that use will diminish due to the difficulty in obtaining index data.

The following is a list of other REIT indices that are widely followed:

GPR 250 Global Index

The Global Property Research 250 Index is a free-float weighted index that tracks the performance of 250 of the most liquid property companies worldwide. The index includes only companies with a free-float market capitalization greater than $50 million. The index and its constituent data can be found on Bloomberg under the symbol “G250GLOB”.
We think that this index will become more relevant as investment managers become more active in real estate investment overseas, and as more and more countries adopt REIT or REIT-like corporate structures.

**S&P REIT Composite**

The S&P REIT Composite was established in 1997. The index includes 100 companies that were chosen for their liquidity and together represent a diversified portfolio. The composite contains about 80% of the U.S. REIT capitalization. Although the index is spread across diversified property types and key regions throughout the country, Mortgage REITs are not included. To qualify for inclusion in this index, companies must possess a minimum of $100 million in unadjusted market capitalization. The index can be found on Bloomberg under the symbol “SPREIT” (Index).

**C&S Realty Majors Index**

The Cohen & Steers Realty Majors Index, formed in 1998, has the fewest constituents of its peers. The Index, which is rebalanced quarterly, seeks large and liquid REITs of all property types and geographic locations that address the most significant issues facing the industry today. In addition, there is an 8% maximum index weight for any company in the index. As with most of its peers, only equity REITs are included in the C&S Realty Majors Index. The index can be found on Bloomberg under the symbol “RMP” (Index).

**Wilshire REIT Index**

The Dow Jones Wilshire REIT Index was established by Wilshire Associates in September 1991. It is a subset of the Dow Jones Wilshire Real Estate Securities Index (RESI). The main difference between the REIT Index and the RESI Index is that the REIT Index does not include real estate operating companies (REOCs), whereas the RESI Index does. In addition, the index is a subset of the DJ Wilshire 5000 Composite Index. The index can be found on Bloomberg under the symbol “DVRITF” (Index).

The companies included in the index must own equity and operate commercial and/or residential real estate. Mortgage REITs, health care REITs, and other nonREIT real estate companies, as well as companies that have more than 25% of their assets in direct mortgage investments, are not included in the index. In addition, companies must have a total market capitalization of at least $200 million at inclusion. Furthermore, the index is float-adjusted as it restricts corporate holding, as well as government, employees, and family holdings.

**Dow Jones REIT Composite Index**

The Dow Jones REIT Composite Index was established in late December 1991 and includes all publicly traded U.S. REITs. Unlike most of its peers, the index includes mortgage and hybrid REITs. The only requirement to be a member of the index is that the company must maintain its REIT tax election status. The index and its constituent data can be found on Bloomberg under the symbol “RCIT” (Index).
Real Estate Exchange Traded Funds (ETFs)

Exchange Traded Funds (ETFs) offer public investors an undivided interest in a pool of securities and other assets and thus are similar in many ways to traditional mutual funds, except that shares in an ETF can be bought and sold throughout the day like stocks. The ability to purchase and redeem ETFs on a live basis has provided many investors arbitrage alternatives when investing in various subsectors such as real estate. We estimate that there are currently 16 ETFs related to the real estate sector. Each concentrates on some type of geography, subsector and/or company size. One even provides a leveraged return, either long or short.

Figure 48: Real Estate ETFs

<table>
<thead>
<tr>
<th>ETF Name</th>
<th>Ticker</th>
</tr>
</thead>
<tbody>
<tr>
<td>iShares FTSE EPRA/NAREIT Global Real Estate ex-US Index Fund</td>
<td>ICGL</td>
</tr>
<tr>
<td>iShares FTSE EPRA/NAREIT Asia Index Fund</td>
<td>IFAS</td>
</tr>
<tr>
<td>iShares FTSE EPRA/NAREIT Europe Index Fund</td>
<td>IFEU</td>
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<tr>
<td>iShares FTSE EPRA/NAREIT North America Index Fund</td>
<td>IFNA</td>
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<td>iShares FTSE NAREIT Industrial/Office Capped Index Fund</td>
<td>FIO</td>
</tr>
<tr>
<td>iShares FTSE NAREIT Mortgage Plus Capped Index Fund</td>
<td>REM</td>
</tr>
<tr>
<td>iShares FTSE NAREIT Real Estate 50 Index Fund</td>
<td>FTY</td>
</tr>
<tr>
<td>iShares FTSE NAREIT Residential Plus Capped Index Fund</td>
<td>REZ</td>
</tr>
<tr>
<td>iShares FTSE NAREIT Retail Capped Index Fund</td>
<td>RTL</td>
</tr>
<tr>
<td>iShares Cohen &amp; Steers Realty Majors Index Fund</td>
<td>ICF</td>
</tr>
<tr>
<td>iShares Dow Jones U.S. Real Estate Index Fund</td>
<td>IYR</td>
</tr>
<tr>
<td>streetTRACKS Wilshire REIT Index Fund</td>
<td>RWR</td>
</tr>
<tr>
<td>Vanguard REIT VIPERS</td>
<td>VNRQ</td>
</tr>
<tr>
<td>S&amp;P Developed ex-U.S. Property Index Fund</td>
<td>WFS</td>
</tr>
<tr>
<td>Cohen &amp; Steers Global Realty Majors ETF</td>
<td>GRI</td>
</tr>
<tr>
<td>UltraShort Real Estate ProShares</td>
<td>SRS</td>
</tr>
</tbody>
</table>

Source: Barclays Capital
The growth in real estate-related ETFs has allowed more fast money investors enter the real estate space thereby increasing the volatility of the sector. Without doubt, 2008 was the most volatile year REITs have had. Figure 49 displays the daily returns of the RMZ Index since 1995, which tended to remain between -2% and 2% up until late 2007; since then, the returns spread far beyond those levels. There were several reasons for the significant volatility in 2008, including lower liquidity than other sectors, but the two factors that stood at the fore during 2008, and which we believe will continue to affect REITs for at least the next few months, are 1) hedge fund redemptions and other forced sellers; and 2) leveraged ETFs. The forced selling, largely caused by redemptions and margin calls, exacerbated the steep selloff last fall. In addition to funds focused on REITs that saw redemptions and were forced to sell, some real estate funds that invested more broadly saw REITs as their most liquid investment and thus sold them to meet redemptions. The leveraged ETF factor stems from requirements that leveraged long and short ETFs keep a steady margin ratio at the close of each day’s trading; if REITs gained or lost materially during the course of the day, a leveraged ETF whose margin levels were affected (long ETFs on down days, short ETFs on up days) would be forced to trade in the same direction as the market in order to fix its leverage ratio for the close of trading. Often during 2008, when REITs had already made a significant move in one direction, the last half hour of trading saw another leg in the same direction, which significantly aggravated existing volatility. Leveraged ETF volume may subside, and fund redemptions and forced selling may slow, but in the near term we expect continued volatility.

Figure 49: Unprecedented U.S. REIT Volatility – 13 Years of Daily RMZ Returns

In summary, although there are many indexes available to REIT investors, we focus on the NAREIT Equity and Composite Indices, while we also track the RMS and the IYR.
Part Six: Current and Future Trends
In the wake of Lehman Brothers' September 15, 2009 bankruptcy filing, risk spreads across all asset classes gapped out, and by the end of that month REITs began their sharp fall. Roughly flat for the first nine months of the year, REITs fell 37.4% during 4Q08, as measured by the NAREIT Equity REIT index—lagging the broader markets considerably (the S&P 500 fell 21.9% in 4Q08)—and ultimately declining 37.7% for full-year 2008 (versus 37.0% for the S&P 500). The year's low came intraday on November 21, the week of the annual NAREIT convention, when the RMZ (the price-only version of the MSCI REIT Index) hit 306.91, down about 60% year to date. The driver was widespread market concern that the credit crisis would eliminate capital flow to real estate for an extended period of time, if not forever, and force asset values down. The market appeared to be pricing in an immediate mark to market of all REIT assets and liabilities, resulting in no implied equity value; stocks began to trade as if the underlying companies were insolvent, reflected in materially wider REIT credit default swap spreads.

We believe the imperative to mark what is in essence a long duration asset, typically with matched and staggered debt maturities, is misplaced. Furthermore, the implicit dependence on NAV gives no value to the company's franchise or value creation ability. One of the primary advantages of the REIT structure for the ownership of commercial real estate is the vehicle's access to equity and debt capital at the corporate level. Most of the REITs we cover continue to have access to capital, albeit at more expensive levels than two years ago, and we believe they have the liquidity to hold onto the bulk of their assets without being forced to sell. This ability to hold onto assets through the downturn, even if it lasts several years, should render the insolvency-level valuations moot for most REITs.

The 38% decline in REITs in 2008 actually reflects a slight December recovery from the sector's negative sentiment and selling. After touching bottom in mid-November, the RMZ traded up 66% to close 2008 at 509.21. We are not technical analysts, and so we will not speculate on whether 306.91 will stand as the low of this bear market or whether REITs might retest the level; we simply believe that investors should expect continued day-to-day volatility in the near term. We are, however, fundamental analysts, and as such we believe that REITs remain cheap at current levels: on an absolute price per sq. ft. basis, on an implied-cap-rate basis, on an earnings-multiple basis, and on the basis of their dividend yields. In the long term, then, we think that REITs could offer defensive upside potential. Barry Knapp, Barclays Capital's U.S. Portfolio Strategist, estimates that the S&P 500 will decline 16% during 2009; at yearend, we expect REITs to have outperformed the broader equity markets.

How to Play

Not all REITs are created equal; risk/reward profiles vary throughout sectors and specific stocks. We continue to believe 2009 will be a stock, not a sector, picking exercise. In general, we would group the stocks into the following categories: 1) large-cap, defensive names in high-quality markets; 2) mid-cap, less defensive names that nonetheless have reasonably low leverage and portfolios in high-quality and secondary markets; and 3)
highly levered REITs that face near-term debt maturities. For the past year, we have favored
the first group. We felt they were the best-positioned to weather the downturn based on
business model and asset quality as well as balance sheet strength. We continue to
recommend this segment. As debt markets improve, however, our investment strategy may
shift to incorporate the relatively less defensive names farther out on the risk spectrum. We
think that this "middle bucket" may begin to offer better risk-adjusted returns. Nevertheless,
on average, we believe that current levels represent compelling entry points for most REITs.

Liquidity Remains Key

We continue to stress the importance of financial flexibility and access to liquidity when it
comes to stock picking. Whether the capital environment improves somewhat or not during
2009, those companies with balance sheet and liquidity advantages should outperform, in
our view. Our 1-Overweight ratings are largely liquidity driven; we continue to recommend
names such as Simon Property Group (SPG), Boston Properties (BXP), Vornado Realty Trust
(VNO), Kimco Realty (KIM), and AvalonBay Properties (AVB) on that basis.

Risks to the Call

The primary risk to this call is that the debt markets do not begin to normalize during 2009.
Our belief that government interaction will help fuel a return of lending and capital flows
throughout the broader economy—including commercial real estate—truly underpins our
entire investment thesis herein. If that does not occur, it is unlikely that the market will find
REIT equity securities attractive on a relative basis, minimizing the upside potential. Another
important risk is that ongoing economic weakness causes a deeper decline in operating
property fundamentals than we forecast. As we will discuss further, we believe most of the
companies we cover have the capacity to withstand deep NOI declines; however, falling
cash flows puts pressure on debt coverage, dividend coverage, and valuations—both in
terms of net asset values and earnings multiples. Moreover, as aforementioned, a negative
outcome for General Growth Properties would not bode well for valuations in the sector, in
our view. While the long-term performance of the sector should not be determined by
General Growth’s issues, short-term performance likely will be. Most importantly, we stress
that this is not a near-term call; we expect ongoing volatility, and not necessarily relative
outperformance, from the group at least for the next several months. In that context, the
stocks could move lower in the short term. But we believe that investors with a 12- to 18-
month outlook should be rewarded.

The Technical Backdrop – Other Trends to Watch

Without doubt, 2008 was the most volatile year REITs have had. Figure 48 displays the
daily returns of the RMZ Index since 1995, which tended to remain between -2% and 2%
up until late 2007; since then, the returns spread far beyond those levels. There were
several reasons this year for the significant volatility, including lower liquidity than other
sectors, but the two factors that stood out the most during 2008, and which we believe will
continue to impact REITs for at least the next few months, were 1) hedge fund redemptions
and other forced sellers; and 2) leveraged ETFs. The forced selling, largely caused by
redemptions and margin calls, exacerbated the steep selloff this fall. In addition to funds
focused on REITs that saw redemptions and were forced to sell, some real estate funds that
invested more broadly saw REITs as their most liquid investment and thus sold them to meet
redemptions. The leveraged ETF factor stems from requirements that leveraged long and
short ETFs keep a steady margin ratio at the close of each day’s trading; if REITs gained or
lost materially during the course of the day, a leveraged ETF whose margin levels were
affected (long ETFs on down days, short ETFs on up days) would be forced to trade in the
same direction as the market in order to fix its leverage ratio for the close of trading. Often
during 2008, when REITs had already made a large move in one direction, the last half
hour of trading saw another leg in the same direction, which significantly aggravated
existing volatility. Leveraged ETF volume may subside, and fund redemptions and forced
selling may slow, but in the near term we expect continued volatility.

Broader Trends Expected to Continue

Despite the current uncertainty in the financial markets, we expect three broader REIT trends
to continue over the long term.

Migration of Corporate Real Estate Assets to the Public Markets

The real estate industry has been irrevocably transformed over the past 10 years by the
migration of assets and talent into the public markets. In that time, we think REITs have
become an important repository of value creation and operating talent. In our opinion, the
institutional credibility of REITs will drive industry change—and sector growth—going
forward. Real estate, which by some estimates comprises 25%-30% of corporate assets in
the United States, will continue to migrate into the public domain, but in contrast to the past
10 years when those properties essentially came out of the private real estate companies,
increasingly they will likely come from Corporate America.

Greater Acceptance of REITs as an Asset Class

Over the past several years, many studies have been conducted regarding REIT historical
performance and correlation of that performance to broader market indices and other
investment alternatives. The general conclusion has been that REITs provide not only a
diversification benefit, but also return enhancement to a diversified portfolio. Perhaps due
to this realization (in addition to the strong performance of REITs over the past several
years), REITs have become more accepted as an asset class and, as such, are held by a
broader investor constituency. In that vein, there has been an increase in the number of
REIT mutual funds, in addition to increased allocations to real estate by pension funds.
Having said that, many non-dedicated long only funds have since left the group. As the
credit markets begin to stabilize, however, that trend will likely reverse.

Global Proliferation of REIT and REIT-Like Structures

Over the past several years, there has been a vast proliferation of REIT and REIT-like
structures globally. Figure 50 highlights the countries that have enacted REIT or REIT-like
structures prior to 2000, from 2000 to 2005, and where enactment of REIT-like structures
is currently under consideration.
Long-Term Upside Potential

Ultimately, we believe that commercial real estate markets will stabilize. We do not think that the capital markets are shut permanently to real estate. The anticipatory nature of the equity markets is one reason we think REITs will lead that real estate recovery. Another is our view that REITs are among the better-capitalized and more liquid participants in the real estate markets, which should lead to attractive investment opportunities in the face of declining private market asset values. At their lows, we believed that REITs were pricing in scenarios where capital markets would be shut for years, where large numbers of tenants would file for bankruptcy protection, and where cap rates would rise materially and asset values decline. Even taking into account the subsequent December rebound, we believe that those downside scenarios remain essentially priced in. Given our fundamental view that rents and occupancies will decline manageably and that the capital markets are not completely shut, we think that the expectations priced into the stocks are more dire than will prove to be the case over the next year to two. As a result, we think that the stocks should move higher by the end of the year.

An important imperative, in our view, is to differentiate between REITs and real estate more broadly in terms of both fundamentals and valuation. We acknowledge that the market is challenging for commercial property owners, both in terms of property operations and capital availability; real estate generally will likely be in a world of challenge for the next two to three years. On the other hand, REITs generally operate with lower leverage than privately held real estate, and on average own higher-quality properties. Unlike public REITs, where the stock price can be used to effectively mark the assets and liabilities to market, that cannot happen in the private market unless or until assets are sold, or debt comes due. In other words, those properties with higher leverage and weaker cash flows, on average, have not yet been repriced, whereas public REITs already have. As such, private market asset values are likely to fall going forward, when transaction volume accelerates. REIT securities led the asset class lower, due to their inherent liquidity advantage relative to direct real estate; similarly, we believe REIT securities should lead the asset class higher upon a recovery.
For more detail on our current view, please see our publication, “Real Estate – The Year Ahead: Our View”, dated January 22, 2009.

Figure 51: REIT Stocks Under Coverage

<table>
<thead>
<tr>
<th>Company</th>
<th>Ticker</th>
<th>Rating</th>
<th>Price</th>
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<tbody>
<tr>
<td><strong>RESIDENTIAL</strong></td>
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<tr>
<td>Apartments</td>
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<tr>
<td>Apartment Investment and Mgmt</td>
<td>AVA</td>
<td>3-UW</td>
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<td>AvalonBay Communities, Inc.</td>
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<td>Camden Property Trust</td>
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<td>Essex Property Trust, Inc.</td>
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<td><strong>COMMERCIAL</strong></td>
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<td>Office</td>
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<td>Alexandria Real Estate Equities</td>
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<td>SL Green Realty Corp.</td>
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<td>Vornado Realty Trust</td>
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<td>ProLogis</td>
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<td>1-OW</td>
<td>$6.50</td>
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<tr>
<td><strong>OTHER SECTORS</strong></td>
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</tr>
<tr>
<td>CB Richard Ellis, Inc.</td>
<td>CBG</td>
<td>2-EW</td>
<td>$4.03</td>
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<td>Lexington Realty Trust</td>
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</tr>
<tr>
<td>Winstrop Realty Trust</td>
<td>FUR</td>
<td>2-EW</td>
<td>$6.91</td>
</tr>
</tbody>
</table>

Source: Barclays Capital
Part Seven: Glossary of REIT Terms
The following is a glossary of terms often referenced in REIT literature. Many of the definitions are courtesy of NAREIT. More information on REITs can be found at www.reit.com.

**Cash Available for Distribution (CAD)**

We calculate CAD by subtracting from Funds from Operations (FFO) both 1) normalized recurring expenditures that are capitalized by the REIT and then amortized, but that are necessary to maintain a REIT’s properties and its revenue stream (e.g., new carpeting and drapes in apartment units, leasing expenses and tenant improvement allowances); and 2) “straight-lining” of rents. This calculation also is called Adjusted Funds from Operations (AFFO) or Funds Available for Distribution (FAD).

**Capitalization Rate**

Capitalization rate (or “cap” rate) for a property, determined by dividing the property’s net operating income by its purchase price. Generally, high cap rates indicate higher returns and greater perceived risk.

**Cost of Capital**

Cost to a company, such as a REIT, of raising capital in the form of equity (common or preferred stock) or debt. The cost of equity capital generally is considered to include both the dividend rate as well as the expected equity growth either by higher dividends or growth in stock prices. The cost of debt capital is merely the interest expense on the debt incurred.

**DownREIT**

Structured much like an UPREIT, but the REIT owns and operates properties other than its interest in a controlled partnership that owns and operates separate properties.

**EBITDA**

Earnings before interest, taxes, depreciation, and amortization. This measure is sometimes referred to as Net Operating Income (NOI).

**Equitization**

Process by which the economic benefits of ownership of a tangible asset, such as real estate, are divided among numerous investors and represented in the form of publicly traded securities.

**Equity Market Cap**

Market value of all outstanding common stock of a company.
Equity REIT

REIT which owns, or has an "equity interest" in, rental real estate (rather than making loans secured by real estate collateral).

Funds from Operations (FFO)

Most commonly accepted and reported measure of REIT operating performance. Equal to a REIT's net income, excluding gains or losses from sales of property, and adding back real estate depreciation. (See page 62 [check] for a discussion of FFO.)

Hybrid REIT

REIT that combines the investment strategies of both equity REITs and mortgage REITs.

Implied Equity Market Cap

Market value of all outstanding common stock of a company plus the value of all UPREIT partnership units as if they were converted into the REIT's stock. It excludes convertible preferred stock, convertible debentures, and warrants even though these securities have similar conversion features.

Leverage

Amount of debt in relation to either equity capital or total capital.

Mortgage REIT

REIT that makes or owns loans and other obligations that are secured by real estate collateral.

Net Asset Value (NAV)

Net "market value" of all of a company's assets, including but not limited to its properties, after subtracting all of its liabilities and obligations.

Positive Spread Investing (PSI)

Ability to raise funds (both equity and debt) at a cost substantially less than the initial returns that can be obtained on real estate transactions.

Real Estate Investment Trust Act of 1960

Federal law that authorized REITs. Its purpose was to allow small investors to pool their investments in real estate in order to get the same benefits as might be obtained by direct ownership, while also diversifying their risks and obtaining professional management.

Real Estate Investment Trust (REIT)

Company dedicated to owning, and in most cases, operating income-producing real estate, such as apartments, shopping centers, offices, and warehouses. Some REITs also engage in financing real estate.
REIT Modernization Act of 1999

Federal tax law change whose provisions allow a REIT to own up to 100% of stock of a taxable REIT subsidiary that can provide services to REIT tenants and others. The law also changed the minimum distribution requirement to 90% from 95% of a REIT's taxable income—consistent with the rules for REITs from 1960 to 1980.

Securitization

Process of financing a pool of similar but unrelated financial assets (usually loans or other debt instruments) by issuing to investors security interests representing claims against the cash flow and other economic benefits generated by the pool of assets.

Straight-Lining

Real estate companies such as REITs "straight line" rents because generally accepted accounting principles require it. Straight-lining averages the tenant’s rent payments over the life of the lease.

Tax Reform Act of 1986

Federal law that substantially altered the real estate investment landscape by permitting REITs not only to own, but also to operate and manage, most types of income-producing commercial properties. It also stopped real estate “tax shelters” that had attracted capital from investors based on the amount of losses that could be created.

Total Market Cap

Total market value of a REIT’s (or other company's) outstanding common stock and indebtedness.

Total Return

A stock’s dividend income plus capital appreciation, before taxes and commissions.

UPREIT

In the typical UPREIT, the partners of the Existing Partnerships and a newly formed REIT become partners in a new partnership termed the Operating Partnership (OP). For their respective interests in the OP ("units"), the partners contribute the properties from the Existing Partnership and the REIT contributes the cash proceeds from its public offering. The REIT typically is the general partner and the majority owner of the OP Units.

After a period of time (often one year), the partners may enjoy the same liquidity of the REIT shareholders by tendering their units for either cash or REIT shares (at the option of the REIT or OP). This conversion may result in the partners incurring the tax deferred at the UPREIT’s formation. The unitholders may tender their units over a period of time, thereby spreading out such tax. In addition, when a partner holds the units until death, the estate tax rules operate in such a way as to provide that the beneficiaries may tender the units for cash or REIT shares without paying income taxes.
In September 20, 2008, Barclays Capital acquired Lehman Brothers' North American investment banking, capital markets, and private investment management businesses. During this transition period, we have endeavored to provide our respective conflicts of interest disclosures on a combined basis. All ratings and price targets prior to the acquisition date relate to coverage under Lehman Brothers Inc.

Important Disclosures:

**Avalonbay Communities Inc. (AVB)**

**US$ 43.83 (30-Mar-2009)**

1-Overweight / 1-Positive

**Rating and Price Target Chart:**

**Source: FactSet**

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For explanations of ratings refer to the stock rating keys located on the back page.

Barclays Capital and/or an affiliate makes a market or provides liquidity in the securities of Avalonbay Communities Inc.

Barclays Capital and/or an affiliate trades regularly in the shares of Avalonbay Communities Inc.

Risks Which May Impede the Achievement of the Price Target: Near-term risks to our target price include the ability to finish and lease developments, a prolonged economic slowdown, an increase in job losses, and migration of fund flows away from REITs generally.

Other Material Conflicts: Barclays Capital Inc. is associated with specialist firm Barclays Capital Market Makers who makes a market in Avalonbay Communities stock. At any given time, the associated specialist may have "long" or "short" inventory position in the stock; and the associated specialist may be on the opposite side of orders executed on the Floor of the Exchange in the stock. Barclays Capital Inc. and/or an affiliate makes a market in the securities of this company.
Important Disclosures Continued:

**Boston Properties Inc. (BXP)**

Rating and Price Target Chart:

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For explanations of ratings refer to the stock rating keys located on the back page.

Barclays Capital and/or an affiliate makes a market or provides liquidity in the securities of Boston Properties Inc.

Barclays Capital and/or an affiliate trade regularly in the shares of Boston Properties Inc.

Risks Which May Impede the Achievement of the Price Target: Near-term risks to our target price include more significant rental rate and asset value declines than expected in urban markets, potential future bankruptcy related lease vacancies, weaker than expected development yields, inability to access capital, and funds flow away from REITs generally.
Important Disclosures Continued:

Kimco Realty Corp. (KIM)
Rating and Price Target Chart:

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Currency=US$

For Explanations of Ratings Refer to the Stock Rating Keys Located on the Back Page.

Barclays Capital and/or an affiliate makes a market or provides liquidity in the securities of Kimco Realty Corp.
Barclays Capital and/or an affiliate trade regularly in the shares of Kimco Realty Corp.

Risks Which May Impede the Achievement of the Price Target: Near-term risks to our target price include a slowdown consumer spending, tenant bankruptcy/store closings, inability to lease development projects, risk of financing development projects, and funds flow out of REITs generally.

Other Material Conflicts: Barclays Capital is associated with specialist firm Barclays Capital Market Makers who makes a market in Kimco Realty stock. At any given time, the associated specialist may have "long" or "short" inventory position in the stock; and the associated specialist may be on the opposite side of orders executed on the Floor of the Exchange in the stock. Barclays Capital and/or an affiliate makes a market in the securities of this company.
**Important Disclosures Continued:**

**Simon Property Group Inc. (SPG)**

**Rating and Price Target Chart:**

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**Currency=US$**

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**FOR EXPLANATIONS OF RATINGS REFER TO THE STOCK RATING KEYS LOCATED ON THE BACK PAGE.**

Barclays Capital and/or an affiliate makes a market or provides liquidity in the securities of Simon Property Group Inc.
Barclays Capital and/or an affiliate trade regularly in the shares of Simon Property Group Inc.

**Risks Which May Impede the Achievement of the Price Target:** Near-term risks to our target price include a slowdown consumer spending, tenant bankruptcy/store closings, inability to lease development projects, risk of financing development projects, and funds flow out of REITs generally.
Important Disclosures Continued:

Vornado Realty Trust (VNO)

Rating and Price Target Chart:

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For explanations of ratings refer to the stock rating keys located on the back page.

Barclays Capital and/or an affiliate makes a market or provides liquidity in the securities of Vornado Realty Trust.
Barclays Capital and/or an affiliate expects to receive or intends to seek compensation for investment banking services from Vornado Realty Trust within the next 3 months.
Barclays Capital and/or an affiliate trade regularly in the shares of Vornado Realty Trust.
Vornado Realty Trust is or during the past 12 months has been an investment banking client of Barclays Capital and/or Lehman Brothers Inc. and/or one of their affiliates.

Risks Which May Impede the Achievement of the Price Target: Near-term risks to our target price include a slowdown of the New York and Washington DC office markets, lower than expected development yields, inability to raise and/or invest incremental capital, and funds flow away from REITs generally.
Important Disclosures Continued:

Other Material Conflicts

Avalonbay Communities Inc. (AVB): Barclays Capital Inc. is associated with specialist firm Barclays Capital Market Makers who makes a market in Avalonbay Communities stock. At any given time, the associated specialist may have "long" or "short" inventory position in the stock; and the associated specialist may be on the opposite side of orders executed on the Floor of the Exchange in the stock. Barclays Capital Inc. and/or an affiliate makes a market in the securities of this company.

Kimco Realty Corp. (KIM): Barclays Capital is associated with specialist firm Barclays Capital Market Makers who makes a market in Kimco Realty stock. At any given time, the associated specialist may have "long" or "short" inventory position in the stock; and the associated specialist may be on the opposite side of orders executed on the Floor of the Exchange in the stock. Barclays Capital and/or an affiliate makes a market in the securities of this company.

Sector Coverage Universe

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<th>Price Date</th>
<th>Stock / Sector Rating</th>
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<td>Post Properties Inc. (PPS)</td>
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<td>Regency Centers Corp. (REG)</td>
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<td>SL Green Realty Corp. (SGL)</td>
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<td>Vornado Realty Trust (VNO)</td>
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