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NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®

December 15, 2010

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EC4M 6XH
United Kingdom

Technical Director
File Reference No. 1850-100
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, Connecticut 06856-5116

Subject: Leases Exposure Drafts

Dear Sir/ Madam:

The National Association of Real Estate Investment Trusts® (NAREIT) welcomes this opportunity to respond to the request for comments from the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) (the Boards) on the Boards' Leases Project Exposure Drafts (EDs).

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service those businesses. NAREIT is strongly committed to improving the relevance and usefulness of financial reporting and routinely provides input on proposals issued by the FASB, IASB and Securities and Exchange Commission (SEC).

We commend and support the Board's efforts to continue to develop high-quality accounting standards and particularly support the Board's efforts to achieve convergence of U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS).

♦ ♦ ♦

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NAREIT is a member of the Real Estate Equity Securitization Alliance (REESA) that submitted a comment letter on behalf of its global members in response to the invitation to comment on the EDs. NAREIT supports the views expressed in the REESA letter. This NAREIT comment letter provides additional support for certain of the views expressed in the REESA comment letter and provides supplemental comments.

Executive Summary

Views Related to Investment Properties Reported at Fair Value

- NAREIT strongly supports the IASB conclusion to exclude from the proposed standard lease income from investment property reported at fair value.
- We urge the FASB to accelerate the examination of a standard under U.S. GAAP similar to International Accounting Standards No. 40 *Investment Property* (IAS 40) that would require or allow reporting investment property at fair value and result in comparable investment property company financial statements around the globe.
- The FASB standard should be issued no later than the issuance of the joint Leases standard and the effective dates should coincide.
- See letter in Attachment I that provides support of these views by major real estate industry investors and analysts in North America, continental Europe and the United Kingdom.

Views Related to Investment Property Reported at Cost

NAREIT believes that the proposed accounting applied to lessors of investment property obscures the economics of lease transactions between landlords and tenants. Therefore, we do not think that either of the proposed lessor accounting models results in improved accounting for leases by lessors of investment property. We respectfully recommend that these lessors continue to report lease revenue as currently prescribed for operating leases.

If the Boards reject this recommendation, we recommend the following modifications to the proposed performance obligation approach to lessor accounting:

- Require that all measurements required by the standard represent management's best estimate based on all related factors and eliminate the "probability-weighted average approach"
- Provide for reporting total rental income pursuant to landlord/tenant leases as rental income rather than bifurcating payments as interest income and principal payments on a lease receivable
- Exclude amounts of potential contingent rentals from the measurement of lease assets and liabilities

- Exclude rents that would be paid under options to extend the lease term from the measurement of lease assets and liabilities
- Amortize the lessor's performance obligation (PO) in a manner that would result in straight-line aggregate lease revenue (interest income on the lease receivable and amortization of the PO) over the term of the lease. Likewise, amortize lessee's right-of-use (ROU) asset so that the aggregate charge to earnings (amortization of the ROU asset and interest on the lease liability) would result in an aggregate straight-line charge to earnings over the term of the lease.
- Require that service components of leases with both service and lease components be accounted for on a basis that is consistent with the proposals in the Boards' exposure draft *Revenues from Contracts with Customers.*

As indicated in paragraph BC 56 of the IASB ED, "investment property analysts have told the IASB [and the FASB] that these [IAS 40] requirements [total rental income] provide useful information, especially when the fair value model in IAS 40 *Investment Property* is used. *In particular, they say that total rental income is an important measure for investment property analysts* [emphasis added]" under either the cost or fair value approach.

Based on these analysts' views, NAREIT believes that the proposed lease accounting would significantly adversely affect the usefulness of financial statements of companies that report investment property at cost unless the modifications above are made to the proposed accounting; particularly the modification to allow the reporting of total rental income.

Discussion and Recommendations

Views Related to Investment Properties Reported at Fair Value

Scope-out of lessors of investment property reported at fair value

We do not believe paragraph 7 of the IASB ED fully reflects the IASB conclusion described in paragraph BC57 – "the IASB proposes that the lessor requirements would not apply to a lessor that accounts for investment property at fair value in accordance with IAS 40". Paragraph 7 appears to limit this exclusion to investment property leased in the position of a lessee. In Europe these leases are termed "head leases" and in other countries they may be referred to as "master leases". NAREIT requests that paragraph 7 of the IASB ED clarify that the exclusion from the proposed lessor accounting applies to all investment property reported at fair value – whether the property is held under a lease or as an owner.

FASB examination of a standard that would require or allow investment property to be reported at fair value

We urge the FASB to accelerate the examination of a standard under U.S. GAAP similar to IAS 40 that would require or allow real estate companies that create and enhance property values through acquisition, development, leasing and operating investment property to report such property at fair value and, thereby, result in comparable investment property company financial statements around the globe.

We strongly suggest that the Board base the scope of the standard on the predominance of investment property compared to other assets held by a company and/or whether the ownership and operation of investment property is part of the company's core business.

The primary criteria for companies to be scoped out of the standard should focus on the amount of investment property assets compared to the total assets of the entity. For example, entities with income producing real estate that represents less than 25% or 50% of the entity's total assets measured on the cost basis of the property could be scoped out. This criterion would certainly scope out virtually all conglomerates and financial institutions whose core business does not include investing and operating investment real property.

If the Board concludes that small entities should be scoped out of the standard, a second criterion could be that an entity with total assets of less than, say, one hundred million dollars ($100 million) should not be subject to the standard.

NAREIT believes that basing the scope of the standard first on the nature of the asset and then defining criteria to scope out certain entities would:

- Be consistent with the Board's general principle to eliminate industry specific standards
- Scope into the standard all entities with investment property that represents a significant amount of assets in relation to their total assets
- Scope out those companies when owning/operating income producing real estate is not a substantial part of the company's core business
- Include real estate entities that would be comparable to similar entities that report property at fair value under IFRS.

Additional comments regarding the FASB's investment property project

We have observed the Board's discussions regarding a standard that would either allow or require reporting investment property at fair value and have noted comments from Board members that, to some degree, support reporting these properties at fair value based solely on the assumption that the value of the property will be realized through sale. This is a very narrow view of the relevance of reporting income producing property at fair value.

Investment property represents a capital resource to an entity. While most real estate companies regularly sell properties to realize value created and enhanced through professional development, leasing and management, the value in these properties also

represents a valuable capital resource. This capital can be realized through direct asset financing, the sale of partial interests in a property, contributing properties to a joint venture or partnership or through the use of the property value in securing corporate level financing. We believe it is important that the Board recognize this broader view of the relevance of reporting income producing properties at fair value.

Further, when the investment quality of these companies is analyzed, the companies' net asset value, including the fair value of the investment property assets, represents a critical factor in the analysis. The value of investment property is based on the aggregate bundle of rights represented by the property. Attachment II describes the use of the fair value of investment property in the analysis of the investment quality of an investment property company.

Views Related to Investment Property Reported at Cost

While NAREIT strongly supports the IASB's conclusion to scope out lessors of investment property reported at fair value, we are not clear whether or not a similar scope-out will be provided under U.S. GAAP. We provide the following comments with respect to the proposal as it relates to leases of investment property reported at cost.

Leases of Investment Property do not Represent Financing and the Proposed Accounting would Re-characterize, in Financial Statements, Real Estate Companies as Finance Companies

The characteristics of real estate leases are fundamentally different from those of equipment leases.

There are several factors that inherently distinguish real estate leases from leases of equipment. Most importantly, the lessors of real estate are actively involved in the strategic, as well as the continuous, asset management of the leased properties. This asset management is far different than financing the acquisition of equipment by means of a lease. Real estate rentals depend primarily on the on-going management of the asset – changing the tenant mix, moving tenants to fully utilize space and reconfiguring and renovating space. In contrast to lessors of most other leased assets, such as a depreciating piece of equipment, lessors of real estate have the ability to maximize investor *total returns* by taking advantage of value-enhancement opportunities available through active and constant asset management.

Secondly, leasing real estate is an investment activity and not a financing activity. A real estate lease agreement between a lessor and a tenant is the result of a market driven negotiation, which is closely related to the demand and supply for physical property. There is generally no interest rate implicit in a real estate lease and no residual value is assigned to individual leases.

Thirdly, a typical real estate lease agreement will generally cover only a small portion of the useful life of the leased asset, since the useful life for real estate typically far exceeds the useful life for other types of leased assets such as equipment. Multiple leases will be executed over the useful life of the investment property, since real estate assets are longer lived assets. This factor

is in significant contrast to leases that are of a financing nature when the lease covers a substantial portion of the useful life of the shorter lived asset.

Further, the residual value of an entire investment property generally represents a much greater portion of the asset than does the residual value implicit in equipment leases. In a great many cases, the fair value of an investment property exceeds the total cost of the property.

The perpetual and irreplaceable nature of land, coupled with its immobility, is yet another key feature that distinguishes real estate leases/ground leases from leases of other assets.

Because of the significant differences between the business and economic characteristics of real estate leases and equipment leases, NAREIT believes that the lessor accounting for real estate leases should be distinguished from the accounting for equipment leases so that the accounting would reflect the unique economic characteristics of real estate leases and provide critical information on the face of the financial statements of companies that own and operate portfolios of investment property.

The impact of the proposed accounting on the income statements of companies that report investment property at cost would not provide a faithful representation of income related to lease transactions between landlords and tenants. Therefore, NAREIT believes that the proposed lease accounting would significantly adversely affect the usefulness of financial statements of companies that report investment property on a cost basis.

As indicated in paragraph BC 56 "investment property analysts have told the IASB [and the FASB] that these [IAS 40] requirements [total rental income] provide useful information, especially when the fair value model in IAS 40 *Investment Property* is used. *In particular, they say that total rental income is an important measure for investment property analysts* [emphasis added]".

Applying the proposed lessor accounting under the performance obligation approach to lease revenue related to investment property reported at cost would not provide total rental income due to accounting for the interest element related to the lease receivable. Total rents paid under a tenant lease would be apportioned between interest income and the amortization of the lease receivable. In addition, the straight-line amortization of the performance obligation along with interest income on the lease receivable would result in decreasing revenue over the term of a lease. This would clearly not represent the underlying business intention of the landlord and tenant; nor would it reflect the economics of the lease arrangement. Further, including potential contingent rents and revenues during lease extension periods would exacerbate this anomaly – see discussion of these issues in the comment letter submitted by REESA on December 15, 2010.

NAREIT believes that the proposed accounting applied to lessors of investment property will obscure the economics of lease transactions between landlords and tenants. Therefore, we do not think that either of the proposed lessor accounting models would result in improved accounting

for leases by lessors of investment property. We respectfully recommend that these lessors continue to report lease revenue as current prescribed for operating leases.

If the Boards reject this recommendation, we provide the following recommendation with respect to the proposed performance obligation approach to lessor accounting:

Require that all measurements required by the standard represent management's best estimate based on all relevant information and eliminate the "probability-weighted average approach"

The ED requires the use of a probability-weighted average approach to determining the cash flows used as a basis of measuring the lease receivable and performance obligation. Many NAREIT companies are lessors under literally thousands of leases. To use a probability-weighted average approach to measure contingent rent would not be operational or would result in purely mechanical calculations. For example, for a company with 5,000 leases and assuming that five outcomes would be reasonable, the company would be required to consider 25,000 possibilities in order to complete the 5,000 weighted average calculations at each balance sheet date.

At the same time, real estate entities have a great deal of experience translating lease terms and current market data into financial projections. These projections are regularly used to develop merger and acquisition pro formas, financing proformas, fair value estimates and earnings and cash flow projections used to manage the company. NAREIT believes that management's single best estimates of the elements that undergird cash flow projections will more faithfully represent current lease information. We therefore strongly urge the Boards to eliminate the requirement to use the probability-weighted average approach in the final standard.

Views Related to Impact of the Proposed Accounting on Lessees/Tenants

In addition to the comments above that primarily relate to the impact of the proposed accounting on real estate lessors/landlords, NAREIT is concerned regarding the impact on the income statements of real estate tenants. While we support the recognition of a liability for rental obligations required under the terms of a lease, we do not believe the pattern of charges to a lessee's income statement provides a faithful representation of the lease transaction. As more fully explained and illustrated in the comment letter submitted by Bill Bosco on September 30, 2010, NAREIT believes that the severe front-ending of "lease costs" (the aggregate of interest expense on the lease liability and straight-line amortization of the right-of-use (ROU) asset) in a lessee's income statement obscures the economics of the business transaction between landlords and tenants.

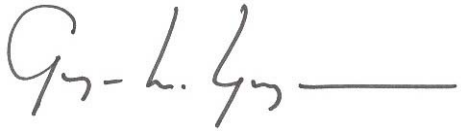
This result is exacerbated by the proposed inclusion of contingent rent and revenue during lease extensions. Both contingent rent and options to extend a lease are elements of the underlying business transaction. For example, a landlord charges a base minimum rent plus "overage rent" in order to capture a portion of a tenant's sales as sales increase over the term of the lease. This

underlying element of the business transaction would be misrepresented by requiring the lessee/tenant to front-load this contingent rent charge.

NAREIT agrees with the *Alternative View* of Stephen Cooper that "the proposed treatment of options and contingent rentals would overstate financial leverage and would not provide useful information".

Please contact me at gyungmann@nareit.com or 202-739-9432 if you would like to discuss NAREIT's comments.

Respectfully submitted,



George L. Yungmann
Senior Vice President, Financial Standards

5 November 2010

International Accounting Standards Board
30 Cannon Street
London, EC4M 6XH
United Kingdom

Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, Connecticut 06856-5116

Re: Exposure Draft - Leases

Dear Sir/Madam,

We are pleased to submit this letter on the International Accounting Standards Board's (IASB) and Financial Accounting Standards Board's (FASB) (collectively "the Boards") Exposure Drafts; Leases. We are submitting these comments on behalf of the undersigned investors and property sector analysts. As major investors into property and investment property companies (including REITs) we have a strong interest in ensuring that the reporting of financial information related to investment property is relevant and transparent.

Exclusion for lessors of investment property reported at fair value

We are fully supportive of the conclusion reached by the IASB to exclude from the proposed lease accounting standard companies that report investment property at fair value. Further, we support the FASB's examination of a standard under U.S. GAAP that would mirror International Accounting Standard No. 40, *Investment Property* (IAS 40). Such a standard would enable convergence of standards for accounting for investment property world-wide; and ensure relevant, comparable and transparent reporting by investment property companies globally.

The current IFRS for investment property accounting, IAS 40, is well supported by industry financial statement preparers reporting under IFRS and industry financial statement users who rely on those statements. It requires a property company to disclose the fair value of its property and reports full rental income in the profit and loss account. The full amount of rental income is fundamental to investors in assessing the performance and investment quality of investment property companies. Removing this metric pursuant to the proposed leases standard would represent a step backward in terms of investment property companies communicating effectively to investors, financial analysts and other financial statement consumers.

The investors identified below would be pleased to meet with the Boards or staff to discuss in more detail the views of users of the financial statements of investment property companies.

If you would like to discuss this matter with us, please contact either Gareth Lewis at gareth.lewis@epra.com or George Yungmann at gyungmann@nareit.com.

We thank the FASB and IASB for the opportunity to comment on the Boards' Exposure Drafts with respect to this very important project.

Respectfully submitted,

Investment institutions

Name	Organisation	Property AUM (€million)	Email
John Robertson	RREF	35,500	CONTACT DETAILS PROVIDED SEPARATELY
Marc Halle	Prudential Real Estate Investors	31,100	
Guido Bunte	Cornerstone Real Estate Advisers	25,300	
Marcus Shepherd	Aviva	25,100	
Roger Quirijns	Cohen & Steers	22,300	
Martin Moore	PRUPIM Real Estate Investment Management	19,000	
Rafeal Torres Villalba	APG All Pension Group	18,000	
Mark Abramson	Heitman	15,300	
Hans Op 't Veld	PGGM Investments	13,400	
Rod O'Connor	Colonial First State	12,900	
Theodore Bigman/ David Smetana	Morgan Stanley Investment Management	12,100	
Matthijs Storm	ING Clarion Real Estate Securities	12,000	
Patrick Sumner	Henderson Global Investors	10,900	
Bill Hughes	Legal & General Property	10,900	
Andrew Jackson	Standard Life Investments	10,400	
Craig Mitchell	Dexus	9,800	
Emily Mousley	Hermes Real Estate Inv Management	6,500	
Stephen Tross	Bouwinvest	5,300	
James Rehlaender	European Investors, Inc	5,100	
Danny Agnoletto	ING Real Estate Investment Management	5,000	
Jan Willem Vis	BNP Paribus Investment Partners	3,000	
Stuart Martin	First State Investments (UK)	2,850	
Graham Burnett	Universities Superannuation Scheme (USS)	2,300	
Mark Townsend	Asset Value Investors	1,800	
Daniela Lungu/ Jeremy Anagnos	CBRE Investors Global Real Estate Securities	1,600	
Jos Short	Internos Real Investors	1,500	

Investment institutions contd.

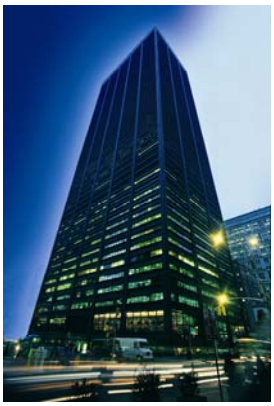
Barden Gale /Michael McGillis	JER Partners	1,450	CONTACT DETAILS PROVIDED SEPARATELY
Adrian Pozzo	CBUS	1,400	
Simon Hedger	Principal Global Investors	1,300	
Steven Brown	American Century Investments	866	
Chris Turner	Thames River Capital	860	
Vincent Bruyère	Degroof Fund Management Company	250	
Martin Allen	REECH	100	

Investment analysts

Name	Organisation	Email
John Lutzius, Mike Kirby	Greenstreet Advisors	CONTACT DETAILS PROVIDED SEPARATELY
Harm Meijer	JP Morgan	
Dirk Boer	Kempen & Co	
Bart Gysens	Morgan Stanley	
Jan Willem van Kranenburg	Royal Bank of Scotland	
Paul Pulze	Evolution Securities	
Kai Klose	Berenberg Bank	
Alex Moss	Macquarie Capital (Europe) Limited	
Bruno Duclos	Credit Agricole Cheuvreux	
Steve Bramley-Jackson	Credit Suisse	
Ruud van Maanen	ABN AMRO	
Michael Slater/Frank Haggerty	Duff & Phelps Investment Management	
Quentin Freeman/Kim Wright	UBS	
Andrew Cox	Numis Securities Limited	
Valerie Guezi	Exane BNP Paribas	
Simon Wheatley	Goldman Sachs & Partners Australia Pty Ltd	
Leigh Gavin	Frontier Investments	

GREEN STREET
ADVISORS

Green Street Advisors' NAV-based Pricing Model



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Green Street Advisors' NAV-based Pricing Model

Overview: Our NAV-based pricing model has served as our primary tool for valuing REITs since 1989. The model separately evaluates the two key determinants of value for a REIT: the net value of its real estate portfolio and the ability of management to add to (or detract from) that value.

Why use NAV? By separating the analysis of the net value of the portfolio from the present value of future investment opportunities, investors are better able to value the entire entity. REITs happen to be one of the few investment vehicles that lend themselves well to an exercise of this sort, as the existence of an active and liquid market for real estate accords an opportunity to derive a reasonably precise estimate of the net value of in-place assets.

The Link between NAV and Share Values: The model generates warranted premiums to asset value by assessing each REIT on a variety of key variables. REITs that stack up well on these variables should trade at relatively large premiums to asset value (and vice versa). Franchise value, the most important of these variables, is objectively assessed by measuring the value creation track record for each REIT, although subjective input as to whether past performance is a good predictor of future performance also plays a big role. The other variables in the model include corporate governance, share liquidity, overhead and leverage. Warranted asset value premiums generated by the model are applied to our estimate of NAV to generate warranted share prices for each REIT.

How We Use this Model: At any given point in time, roughly 25% of the companies we follow are ascribed Buy ratings, 50% are rated as Holds, and 25% are Sells. Because of that discipline, the model is designed to provide relative valuation conclusions, and is neutral with regard to overall REIT valuations, as well as property sector valuations. While our NAV-based model is our primary tool for assessing relative valuations across companies, we use a Discounted Cash Flow (DCF) model as a back-up approach.

Limitations: We utilize other approaches toward assessing overall REIT valuation (see our REIT Pricing Thermometer, published each month in the Real Estate Securities Monthly) and property sector valuation (see Property Sector Valuation, published every six months). These other approaches are designed to help investors who are more focused on absolute valuation levels and/or relative valuations across property sectors.

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Green Street Advisors' NAV-based Pricing Model
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Section One
Overview

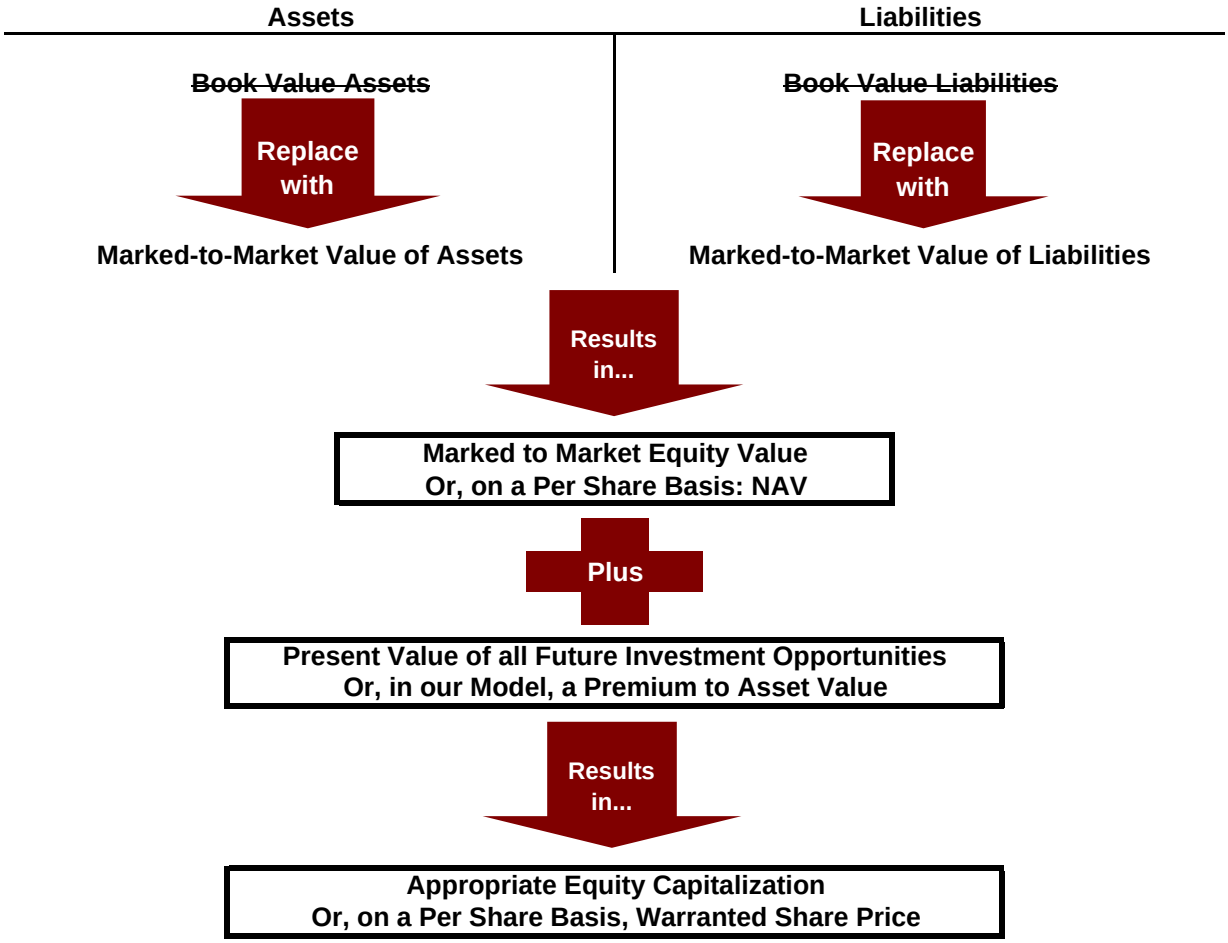
Section One - Overview
The Basics

Introduction
Our NAV-based pricing model has served as our primary tool for valuing REITs since 1989. The model is based on the logic that REIT valuation can best be assessed by analyzing separately the two key components of value: 1) the net value of the in-place assets and 2) the present value of future investment opportunities.

The Model is Designed to…
Identify the cheapest and most expensive stocks, measured on a relative basis, in each sector.

Assumptions:
Overall valuation of REITs, in aggregate, is appropriate.
Valuation of each property sector is appropriate relative to other sectors.
The value of any REIT can be calculated as follows…

REIT Balance Sheet



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Section One - Overview

A Step-by-Step Summary of How Our NAV-Based Pricing Model Works

Our NAV-based pricing model takes a methodical and consistent approach toward valuing REIT stocks. Each of the primary steps outlined below is discussed in its own section of the report that follows.

Step One - Calculate Asset Value and NAV

For each REIT in our coverage universe, we do the following:

- Derive an estimate of marked-to-market asset value.
- Derive an estimate of marked-to-market liabilities.
- Compute NAV by subtracting liabilities from assets.

Step Two - Determine the Appropriate Premium/Discount to Asset Value

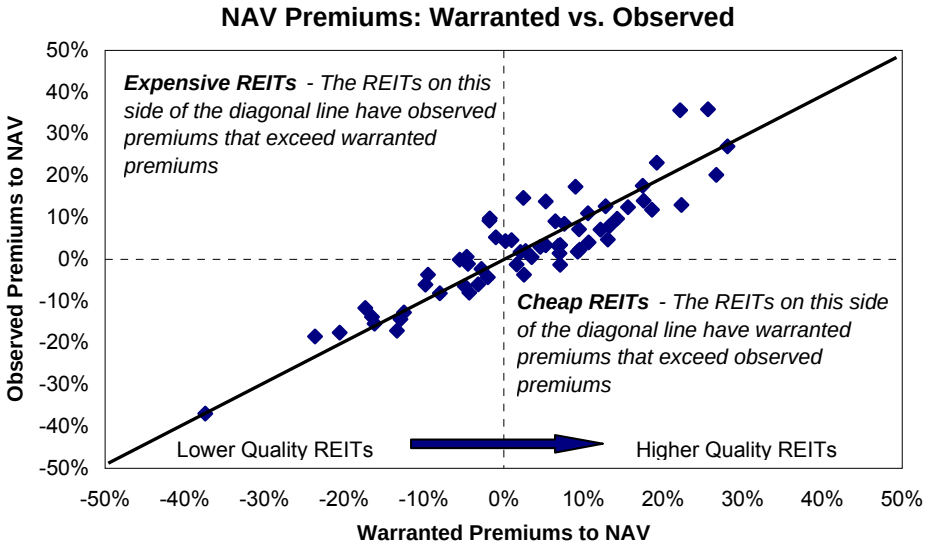
Step 2A - Observe the magntitude of premiums in the marketplace

- Observe current share pricing of all REITs.
- Back into observed premiums to asset value for each REIT.
- Company-specific observations are aggregated to derive average observed premium for each property sector, as well as the dispersion of premiums around that average. A basic assumption of the model is that these aggregated premiums are appropriate at any given point in time, thus making the model both REIT-market neutral and sector-neutral.
- Use observed distribution (i.e. standard deviation) of premiums to ascribe REIT-specific warranted premiums in Step 2B.

Step 2B - Derive Company Specific Warranted Premiums to Asset Value

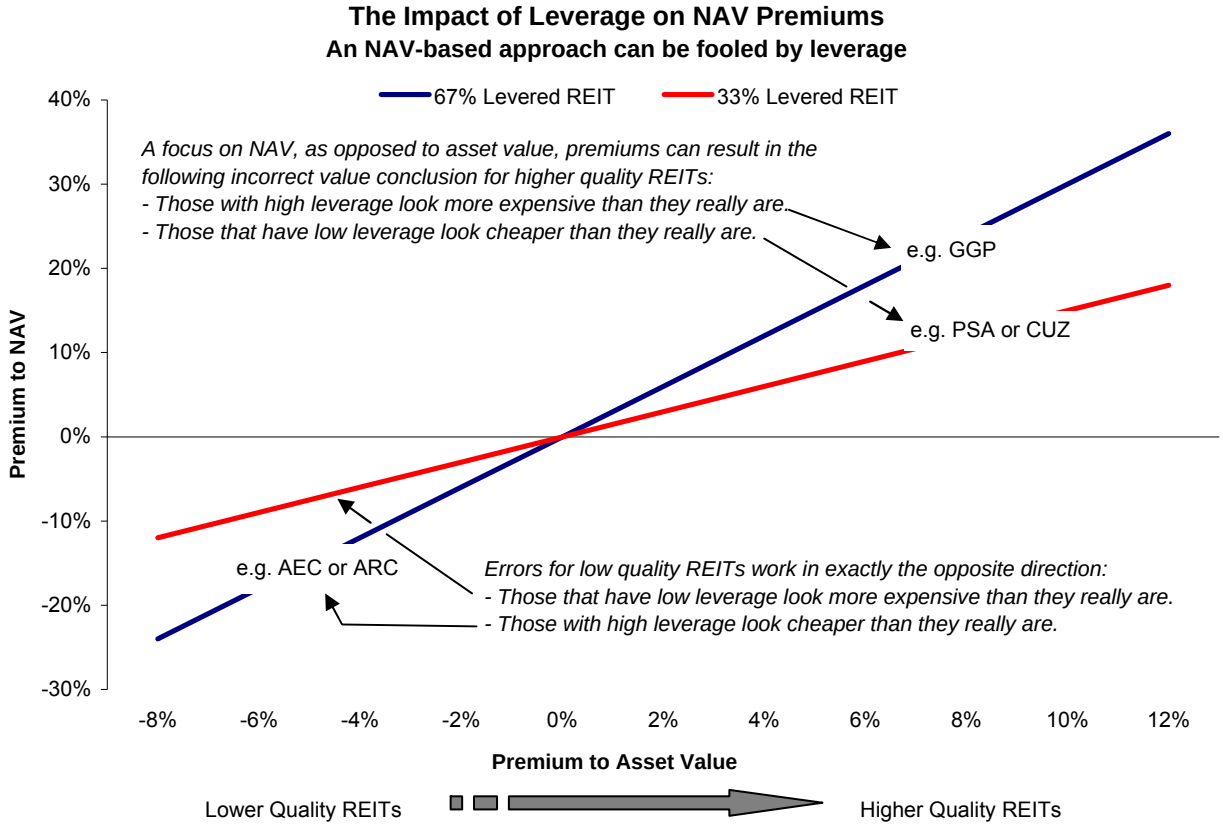
- Rank each company relative to peers with regard to variables that impact premiums to asset value. These variables include Franchise Value, Corporate Governance, Share Liquidity, Overhead & Leverage. Rankings are scored on a 100-point scale.
- Translate company-specific scores into warranted % premiums to asset value. High-scoring REITs are ascribed premiums approximating the largest observed premiums, while the inverse is true for low-scoring REITs.
- Convert warranted % premium to asset value into a $-based Premium, and add to marked-to-market equity valuation. Convert to warranted share price.

Step Three - Compare Warranted Share Prices with Observed Share Prices



Section One - Overview
The Model is Based on Asset Value, not NAV

For most intents and purposes, leverage shouldn't impact value. The value of investment opportunities varies according to the talent of a given management team and the environment in which it finds itself operating. The value of those opportunities is generally not impacted by leverage. However, as is highlighted below, premiums to NAV are materially imacted by leverage, creating the potential to be misled when focused solely on NAV premiums.



Focusing on premiums to asset value, instead of premiums to NAV is consistent with Modigliani and Miller's Proposition I: A firm's overall value is independent of capital structure.

Implications for REITs:

1) The biggest "real world" limitation to M&M's thesis involves the tax shelter associated with debt. Since REITs aren't subject to corporate tax, they're not impacted by this limitation. M&M's thesis on capital structue should be particularly relevant in the REIT sector.
2) The size of the premium to asset value should equate to investors' expectations of the present value of future investment opportunities. This present value is contingent on the volume of investments to be made in the future (i.e. a bigger dollar premium is possible where large external investments are being made) and the extent to which the returns on these investments exceed the appropriate cost of capital. Leverage has no impact.

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Section Two
NAV

Section Two - NAV
Calculating NAV - A Simplified Example

Balance Sheet for REIT XYZ (X's $1,000)

	Book Value	***Analyze Market Value and Replace***	***Current Value***
Real Estate Assets			
Operating Real Estate	$8,500,000	A	$9,350,000
			$2,250,000
Construction in Progress	$500,000	B	$650,000
Land	$200,000	C	$170,000
Equity in Unconsolidated JVs	$1,000,000	D	$0
Value of Fee Businesses	$0	D E	$800,000
Other Assets	$100,000	F	$70,000
Total Assets	$10,300,000		$13,290,000
Liabilities	$5,000,000	G	$5,250,000
			$1,500,000
Preferred Stock	$500,000		$500,000
Shareholders Equity	$4,800,000		$6,040,000
Fully Diluted Shares	200,000	H	204,750
NAV	$24.00		$29.50

The Adjustments:

A. **Operating Real Estate:** Usually the most important part of an NAV analysis. A 12-month look-forward estimate of NOI is calculated, the magnitude of an appropriate cap-ex reserve is determined, and an appropriate cap rate is applied to economic NOI (NOI less cap-ex). The quality of the analysis rests on an in-depth knowledge of prevailing cap rates, the approriate cap-ex treatment for each REIT, and other required industry- and company-specific adjustments (e.g. seasonality, one-time items, etc.).

B. **Construction in Progress:** CIP can be worth well in excess of book value if projects underway appear headed for success. The inverse can also be true.

C. **Land:** Land values can be much higher or lower than book.

D. **JV Accounting is a Mess:** Because of that, we present a pro-rata allocation of assets and liabilities. There is no reliable way to otherwise value JV interests, as leverage within the JV typically renders more simplified approaches useless. A pro-rata allocation also does a much better job of showing leverage that may be embedded, but otherwise hidden, in JV investments.

E. **Fee Income:** REITs are increasingly generating asset management/property management fees associated with JV structures. This fee income can be lucrative, and the range of appropriate multiples to apply is dependent on the quality of the fee stream. This value is not reflected on GAAP balance sheets.

F. **Other Assets:** REITs often have a material amount of intangible assets, which are deducted for this exercise.

G. **Liabilities:** Mark to market adjustments are necessary where: subsidized financing is present, or market interest rates are materially higher or lower than contract rates on the REIT's debt.

H. **Fully Diluted Shares:** Ensure that all in-the-money options, converts, etc. are included in the share count.

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Section Two - NAV
Issues in Deriving NAV

Valuing the Real Estate Portfolios
The success of an NAV-based valuation approach is contingent on the quality of the estimate of the value of the real estate portfolio. Our approach involves a large amount of due diligence - both in the field and at our desks.

Capitalization of Real Estate NOI - the most common approach toward valuing real estate. This valuation approach applies a cap rate to the estimated 12-month forward property-level net operating income (NOI) generated by a REIT's portfolio. There are numerous adjustments that need to be made to numbers pulled from both the income statement and balance sheet when utilizing this approach, but they're generally straight forward. There are, however, two areas where extreme caution is warranted.

1) **Cap Rates: Where do they come from?**
Cap rates are the most critical input in an NAV analysis and the most subjective one. The quality of an NAV analysis is only as good as the quality of this input, and a substantial amount of work is involved in getting the cap rate call right. A broad sense of appropriate cap rates can be obtained by talking to market participants (e.g. brokers, real estate execs), but a detailed understanding of submarkets is important. Property visits are critical. Just as important is an understanding of existing lease structures. Unique lease structures can result in the use of very different cap rates for otherwise identical properties.

2) **The Cap-Ex Landmine - Don't let it blow up your NAV analysis**
Because many of the true costs of owning a portfolio of real estate are capitalized, not expensed, reported real estate NOI almost always dramatically overstates the true operating profit generated by that portfolio. A thorough understanding of the magnitude of those costs is necessary. Otherwise, an incorrect estimate of NOI will translate into an incorrrect assessment of value. The problem is made worse by the fact that cap-ex reserves are far from generic, even among companies in the same property sectors. Accounting policies can vary hugely by company, and they must be well understood in order to derive a good estimate of NAV. In addition, cap-ex requirements can vary hugely due to differences in property quality, age, location, etc. Shortcuts on cap-ex will result in NAV estimates full of errors.

Other Approaches Toward Valuation Should be Considered. We use them when appropriate.
1) Value per square foot (especially interesting for office and industrial properties)
2) Replacement Cost
3) Discounted Cash Flow/Internal Rate of Return
4) Building-by-building Analysis

Marking to Market Liabilities
An oft-overlooked, but important, aspect of computing NAV is marking to market the right hand side of the balance sheet. Two REITs that are otherwise identical except for the fact that the debt of one is all at market rates, while the debt of the other is substantially above market, should trade at very different share prices.

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Section Three
Applying the Model

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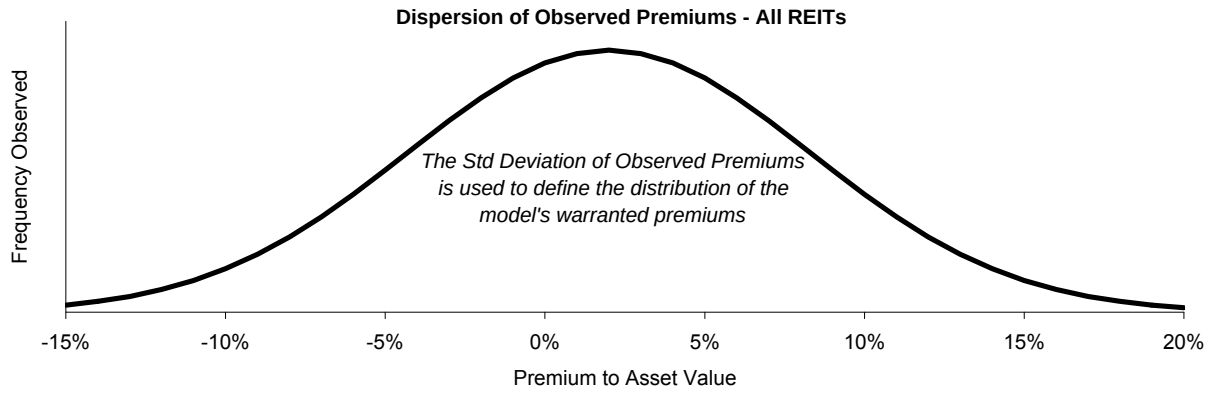
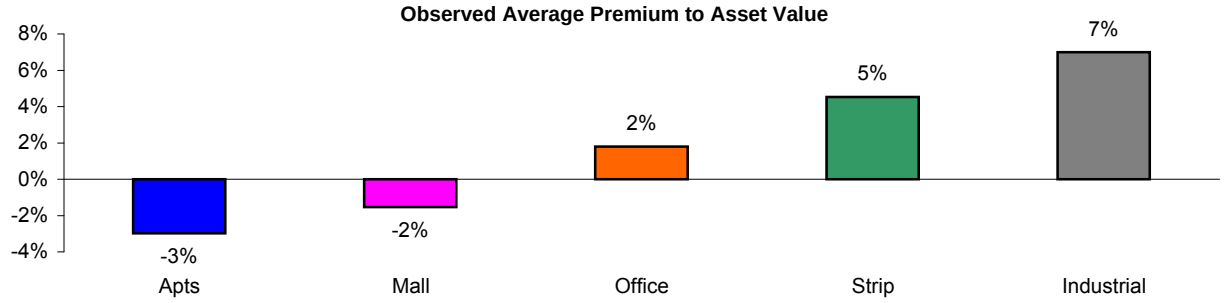
Section Three - Applying the Model
Observe Prevailing Premiums

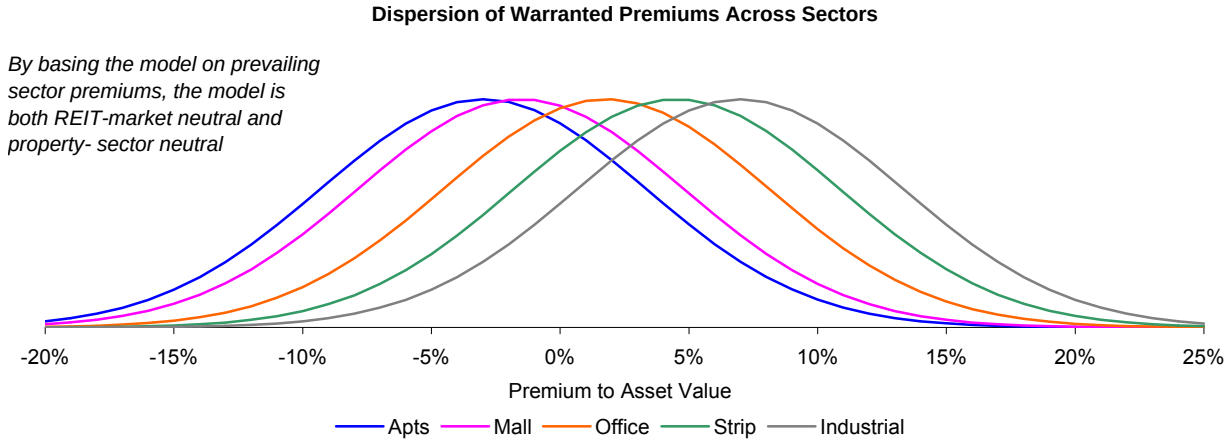
Observed premiums to asset value tend to be patterned along a normal distribution for a large universe of REITs in a variety of property sectors. We assume that both the average premium accorded by the market, and the degree of dispersion in observed premiums are appropriate.



Property sector influences tend to be strong - each major sector has its own unique distribution of observed premiums. Variances in average premiums across sectors are explicitly addressed in our model by using the sector-average premium as the base for calculating warranted premiums of companies in a given sector. In the example below, an average industrial REIT would warrant a higher premium to asset value than an average residential REIT because that is the way those sectors are currently priced in the market.



The dispersion of prevailing premiums for all REITs is combined with the average premium for each sector to generate warranted premiums for companies within each sector.



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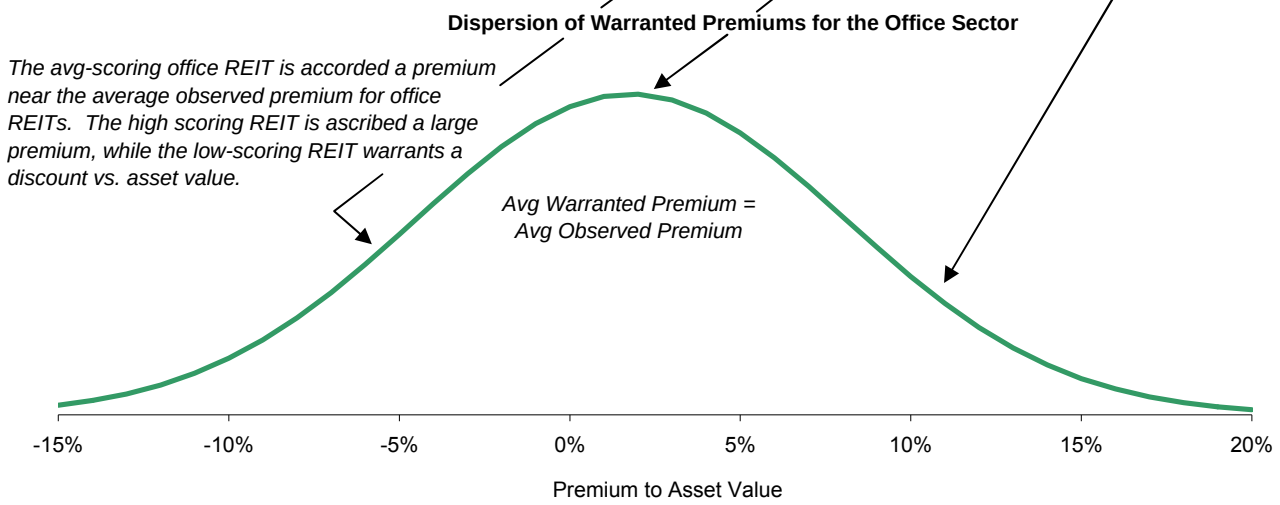
Section Three - Applying the Model
Assess the Ability to Create Shareholder Value

Some REITs are deserving of bigger than average premiums to asset value (or smaller discounts), while others deserve relatively small premiums (or bigger discounts). The size of warranted premiums that are the output of our Pricing Model are dependent on the sum of the scores on each of the variables shown below. Franchise Value, defined as the ability of a management team to create value, comprises 60 of the 100 available points. The variables that comprise the remainder of the scoring system are: Corporate Governance; Share Liquidity, Overhead; and Leverage (more detail is available on each of these inputs on page 16). The example below shows how several office REITs stack up as of Sept '05. These rankings are certain to change over time.

Pricing Model Components	Points Available	Office REIT Avg	Small Premium REIT e.g. CEI	Avg Premium REIT e.g. PP	Big Premium REIT e.g. BXP
Franchise Value					
Performance-based Components					
Beginning Premiums	20	10	7	9	16
Total Return Ranking	20	10	5	7	14
Current Value Net Income Ranking	20	10	5	13	17
Adjustments to Objective Ranking	0	0	0	0	0
Objective Franchise Ranking	60	30	17	29	47
Subjective Components of Franch Val	0	0	5	0	0
Franchise Value	60	30	22	29	47
Corporate Governance	10	5	1	6	4
Share Liquidity	10	5	4	3	9
Overhead	10	5	2	8	9
Leverage	10	10	10	10	10
Total Scoring of Model Variables	**100**	**55**	**39**	**56**	**79**

The output of the scoring process is then statistically manipulated to fit the distribution of observed office REIT pricing (see prior page). While we effectively assume that the overall pricing of office REITs is appropriate, we are reascribing the premiums to asset value for each of the companies. Those we feel are best positioned to add value are accorded the highest warranted premiums, and vice versa.



Section Three - Applying the Model
Franchise Value - The Most Important Variable

Managerial talent varies substantially from one REIT to the next. Some management teams have demonstrated a consistent ability to enhance shareholder value; others have weak track records. An assessment of these track records serves as an important step toward determining franchise value ratings. Franchise value is the most important variable in our model, as it comprises 60 of 100 available points. Here is how those points are objectively allocated:

Total Return Track Record - 40 of the 60 Points

Step One: *Compare total returns (share price appreciation + dividends paid) for each REIT with the total returns generated by the company's property sector peers*

	Total Returns				
Time Period	**1 Year**	**3 Year**	**5 Year**		**Score on 20 Scale**
Weighting	20%	30%	50%		
Stellar REIT	17%	12%	15%	Compare w/ peers; translate into 20 point scale	17.1
So-So REIT	10%	8%	9%		10.0
Laggard REIT	13%	2%	2%		3.5
Sector Average	13%	8%	9%		

Step Two: *Take into account NAV premiums at the beginning of those time periods. A company that has generated solid total returns despite starting at a rich premium is arguably more impressive than one that began the period with cheap pricing, and vice versa.*

	Beginning Period Asset Value Premium				
Time Period	**1 Year**	**3 Year**	**5 Year**		**Score on 20 Scale**
Weighting	20%	30%	50%		
Stellar REIT	9%	6%	10%	Compare w/ peers; translate into 20 point scale	15.6
So-So REIT	2%	5%	7%		10.3
Laggard REIT	-2%	1%	3%		4.2
Sector Average	3%	4%	7%		

Current Value Net Income Track Record - 20 of the 60 Points

Current value net income is defined as NAV growth + dividends over any time period. It serves as an excellent measure of performance and value creation. Comparing a REIT's track record in generating current value net income with that of its property sector peers adds insight regarding value enhancing capabilities.

	Current Value Net Income Change				
Time Period	**1 Year**	**3 Year**	**5 Year**		**Score on 20 Scale**
Weighting	20%	30%	50%		
Stellar REIT	15%	13%	17%	Compare w/ peers; translate into 20 point scale	18.0
So-So REIT	9%	7%	8%		9.7
Laggard REIT	14%	0%	3%		4.3
Sector Average	13%	7%	9%		

Compute Objective Franchise Ranking - The sum of the objective components above results in the objectively derived franchise value ranking.

	Scores from Above						Objective Franchise Score
Stellar REIT	17.1	+	15.6	+	18.0	=	50.7
So-So REIT	10.0	+	10.3	+	9.7	=	30.0
Laggard REIT	3.5	+	4.2	+	4.3	=	12.0

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Section Three - Applying the Model
Franchise Value - The Most Important Variable (continued)

Sometimes, a purely objective approach toward ascribing franchise value ratings works well; sometimes it doesn't. If managerial skill were the only thing that impacted performance and if it was always consistent over time, a purely objective approach would work well. However, because historical performance has also been influenced by factors that should not be extrapolated into the future (e.g. luck, a different management team, etc.), subjective inputs are often appropriate. Ascribing franchise values is part art and part science, and the portion that is art is addressed below.

The simplest way to illustrate why subjective inputs are an important part of ascribing franchise values is by way of example. Consider the following hypothetical REITs:

- ***Lucky Gambler REIT:*** *Management believes it knows more about future interest rates than Bill Gross and has correspondingly financed its entire balance sheet w/ variable rate debt. In recent years, this has resulted in outsized returns and NAV growth.*
- ***Right Place at the Right Time REIT:*** *Despite mediocre management, company's long-time holdings of land in Coastal California and Mid-town Manhattan have resulted in extraordinary share price performance.*
- ***Black Sheep REIT:*** *Derelict son has recently taken reigns from brilliant father. Track record still looks good, but what happens next?*
- ***Bad Part of the Cycle REIT:*** *Having just experienced the sweet spot of the development cycle, this REIT has smartly pulled in the reigns as development has become less lucrative.*

The objective scores for each REIT might look something like what is shown below. The direction of appropriate adjustments is shown, though a determination of the appropriate magnitude of those adjustments requires experienced analysts.

	Objective Franchise Score	Direction of Subjective Adjustment
Maximum Score	60	
Right Place at Right Time REIT	55	↓
Black Sheep REIT	45	↓
Bad Part of the Cycle REIT	38	↓
Average Score	30	
Lucky Gambler REIT	26	↓
Wrong Place at Wrong Time REIT	24	↑
Good Part of the Cycle REIT	10	↑

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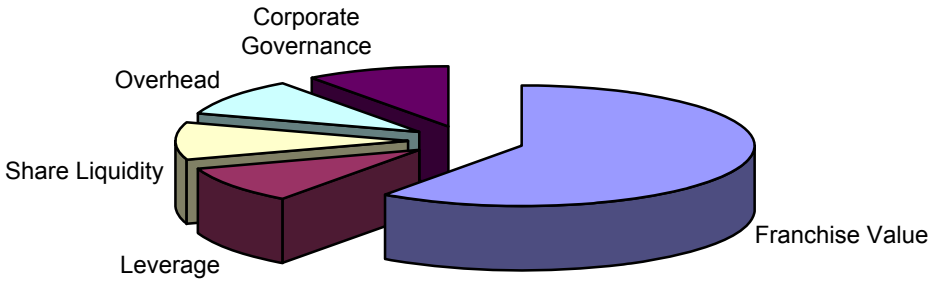
Section Three - Applying the Model
The Other Variables in the Model

Because franchise value is the most important determinant of appropriate NAV premiums, it accounts for 60 of the 100 points in our model. However, other key traits also affect appropriate NAV premiums. The four variables discussed below account for equal shares of the other 40 points in the model.

Weighting the Variables that Impact Premiums



Corporate Governance
The premise that good governance should result in a higher premium to asset value is self evident. The governance scores utilized in our pricing model flow directly from our propietary corporate governance rankings that we have maintained since 2003. Our governance rankings are derived via a methodical review of numerous governance issues for each of the REITs under coverage. These rankings also are impacted by our assessment of past conduct, a critical input that other ranking services are forced to ignore. A brief summary of the variables comprising our governance rankings is shown in Appendix C.

Overhead
Another self-evident premise is that a REIT with high G&A deserves a lower premium to asset value than one with a lean operation. Real estate NOI is an integral input in any NAV calculation, but because this figure comes above the G&A line on an income statement, G&A needs to be dealt with separately. Accounting practices regarding allocation of overhead as either an operating cost or G&A can serve to skew the results of an NAV calculation, but the inclusion of overhead as a separate variable in the model adjusts for that. We focus on G&A as a percent of marked-to-market assets for the sake of measuring overhead, similar to an expense ratio for a mutual fund.

Share Liquidity
All else equal, REITs with liquid markets for their shares should be worth more than those with low liquidity. This view is consistent with academic literature suggesting costs of capital are higher for firms with very small market capitalizations. It is also consistent with observed pricing patterns in the REIT sector, as share liquidity has respectable explanatory power as a determinant of asset value premiums.

Leverage
For most intents and purposes, leverage has no impact on the size of premiums to asset value. There is no compelling reason why a REIT with, say, 30% leverage should trade at a different premium than one with, say, 55% leverage. Leverage can, however, impact appropriate premiums when it is so high that it might constrain managerial flexibility, and our model takes this into account. Most REITs are awarded 10 points on this variable, but fewer points are awarded REITs with debt > 65% of assets and no points are awarded those where this ratio is > 75%.

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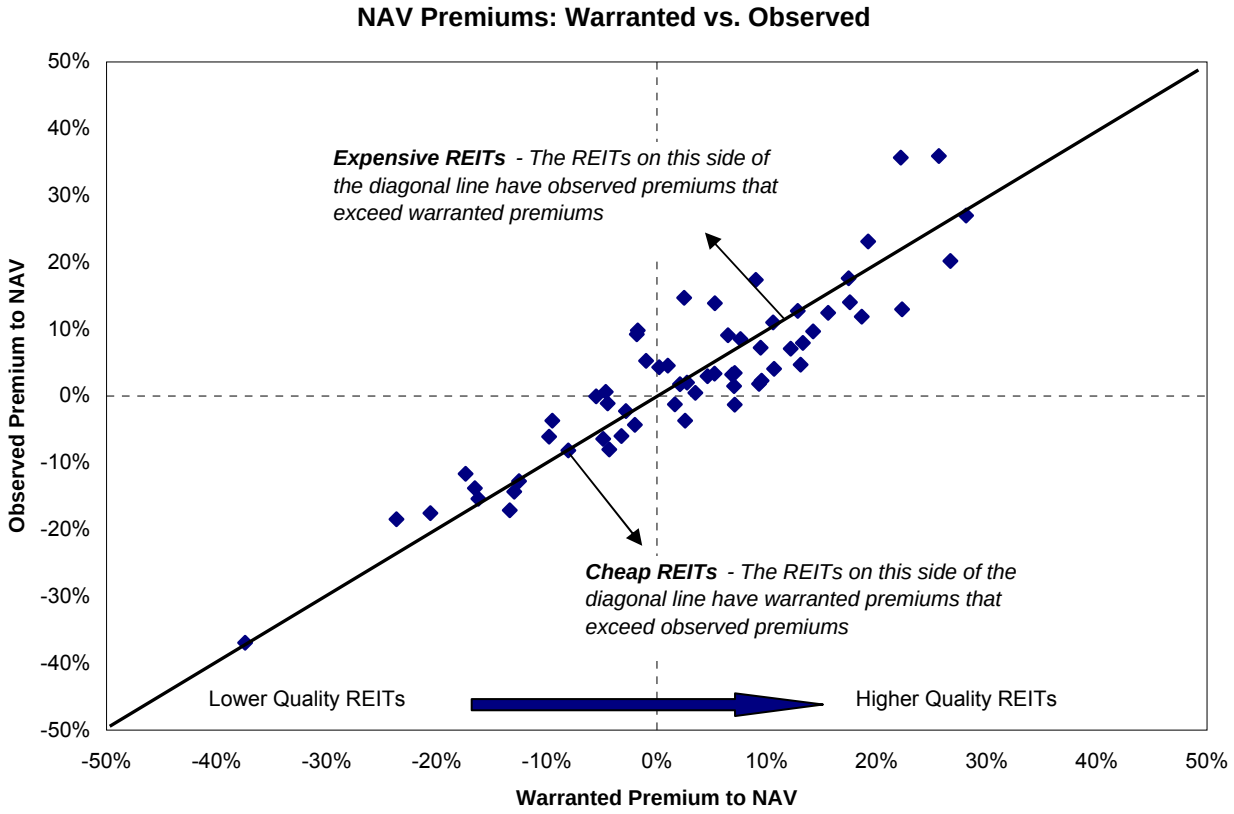
Section Three - Applying the Model
Interpreting the Output of the Model

The warranted premiums to NAV generated by the model can be compared directly to observed premiums to NAV*. Instances where observed premiums substantially exceed warranted premiums are suggestive of an overly rich share valuation. Instances where warranted premiums are much larger than what is observed are indicative of a cheap stock.



*The model actually generates warranted premiums to **asset** value, and these are compared to observed premiums to **asset** value. The directional conclusion - i.e. a REIT is pricey or cheap - is identical whether the comparison is made based on premiums to asset value or premiums to NAV, but the magnitude of any mispricing can be skewed by leverage in an analysis focusing on NAV premiums.

Translating the Output Into Recommendations:

Our method is explicitly REIT-market and sector neutral. Companies in the top 25% of their property sector peers in terms of warranted price > observed price are typically accorded Buy ratings. Those in the bottom 25% are ascribed Sells, and the half in the middle get Holds. We occassionally deviate from this mechanical rating system.

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Appendix A
Answers to Frequently Asked Questions and Criticisms

Q. NAV estimates are far from precise. It's very common to see NAV estimates for a given REIT spanning a very broad range, with some being as much as 30% higher than others. Why base a model on such an imprecise estimate?

A. NAV is admittedly an imprecise estimate of value. It may be better to think of NAV as the midpoint of a reasonable range in which a figure at least 5% higher or lower than the mid-point might be accurate. Reasonable minds can certainly disagree within this range.

However, this lack of precision should not be viewed as a serious shortcoming. After all, every valuation methodology lacks precision, and alternative methodologies are almost certainly less precise than NAV. Where do appropriate P/E multiples come from? EBITDA multiples? An NAV-based approach componentizes the valuation question into discreet pieces and incorporates private-market pricing information, attributes that should yield a higher level of precision than a broad-brush approach to entity valuation.

Finally, the fact that some analyst estimates of NAV fall well outside a reasonable range is probably more a reflection on the quality of the analysis, as opposed to the quality of the metric. NAV calculations require a great deal of time, energy, and expertise to get right, and big errors are likely when shortcuts are taken.

Q. NAV is a backward looking metric.

A. Real estate markets are active and liquid, and when buyers and sellers agree on deal terms (e.g. cap rates, price/sf, etc.), those terms are certainly reflective of their views of future prospects. When prevailing cap rates are applied to a REIT's forward looking NOI estimate, the result is an estimate of value that is as forward looking as any other approach toward valuing stocks.

Q. As the REIT industry continues to mature, analysts and investors will inevitably value these stocks the same way the vast majority of other stocks are valued. Approaches based on P/E multiples, EBITDA multiples, or DCF models will take the place of a REIT-centric concept like NAV. After all, no one tries to figure out the NAV of GM or Microsoft, so why bother to do so with REITs?

The simple answer to this question is that investors in other sectors would use NAV if they could. However, their inability to do so relegates them to using metrics that are generally inferior.

Thoughtfully applied alternative approaches to valuation should result in similar answers to an NAV-based approach, but these other methods have to be used with caution. We utilize a discounted cash flow (DCF) approach as a secondary valuation tool, and it normally provides an answer quite close to the output of our NAV-based approach.

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Q. REITs are more than just a collection of assets. Management matters a lot, and an NAV-based approach can't possibly factor that in.

A. Contrary to a widespread misperception, the use of an NAV-based model is by no means inconsistent with a view that management is important. As long as an NAV-based model provides output with a sizable variance in company-specific warranted premiums/discounts, that model is implicitly acknowledging that management matters a lot.

Q. Many REITs own hundreds of properties spread all across the country, and an asset-by-asset appraisal would take an enormous amount of time. How can an analyst pretend to know the value of any given portfolio?

A. A reasonable NAV estimate can be derived if disclosure at the portfolio level is sufficient to allow for a comparison of the characteristics of a given portfolio with the characteristics of properties that have traded hands. No two portfolios are exactly the same, but plenty of pricing benchmarks exist to allow for adjustments based on portfolio location, quality, lease structure, growth prospects, etc.

Q. An NAV analysis is only as good as the cap rates applied to NOIs. Where does Green Street get its cap rates?

A. The choice of cap rates is the most important input in our model. Our analysts spend a great deal of time talking to market participants (e.g. REIT execs, private real estate participants, brokers, etc.), compiling databases of comparable transactions, reading trade publications, reviewing findings of providers of cap rate information (e.g. Real Capital Analytics), and understanding the extent to which contractual rents are above or below market.

Q. REITs have broad latitude in how they expense many operating costs. Can't an NAV-based approach be fooled if a REIT gooses NOI by moving costs to the G&A line?

A. Yes. This is why an explicit valuation adjustment for G&A expense is included in our model.

Q. An NAV analysis derived from real estate NOI seemingly ignores capital expenditures (cap-ex). How does cap-ex factor into the analysis?

A. One of the easiest ways to make big mistakes in an NAV analysis is to utilize simple rules of thumb with regard to cap-ex. In addition to the fact that most rules of thumb undercount the magnitude of cap-ex, the range of appropriate reserves varies hugely by property sector, property quality, and accounting practices. Each of these factors needs to be addressed before choosing the cap-ex reserve to utilize for a particular portfolio.

The real estate portfolios in any sector that offer the highest quality, best growth, and lowest risk should be accorded the highest valuation multiples (lowest cap rates), and vice versa. It is thus important to rank the portfolios relative to each other, and to then ensure that "economic" cap rates (based on NOI less a cap-ex reserve) line up in this manner. An analysis that does not back out cap-ex costs, and is instead based off of nominal cap rates, will generate misleading relative conclusions.

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