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Fall of 2011 is Not the Fall of 2008

Highlights:

- A repeat of 2008 is unlikely for property stocks.
- Property stocks are well positioned despite recession fears and anemic GDP growth.
- Fundamentals are stable and valuations are attractive.
- European financial crisis seeing some easing, caution is warranted as policy develops.
- The debt markets are not bouncing like equities.

In October 2008's *Commercial Real Estate Outlook—Look Out Below* we suggested that REITs had 40% share price declines ahead. At that time, the US was in the midst of the worst financial crisis since the Great Depression, commercial real estate declines of 25% appeared likely, and the weakening property fundamentals had not yet fully been realized. On October 1, 2008 REIT shares were flat on the year, the S&P 500 was down 21% and non-US property stocks were down 33%. It was clear that more downside than upside was likely.

Fall of 2011 is not the Fall of 2008

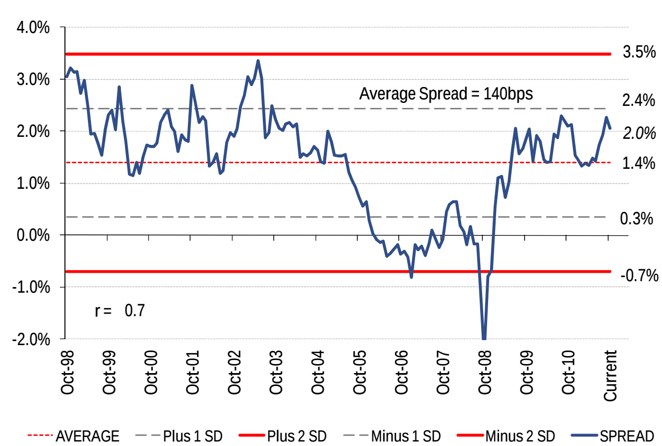
Today, while the capital markets are acting on fear of a repeat of the Fall of 2008 due to concerns surrounding a European financial crisis, and despite the gut-wrenching feeling over the past two months, the current backdrop is quite different than three years ago.

In all likelihood, there will be an interim resolution to the immediate solvency concerns of European countries and banks. Although the austerity measures exacted from European countries will likely result in a European recession and little lending, our base case scenario is that the financial crisis fears fade while a recession-like GDP (+/- 1%) in developed markets remains.

Given our base case scenario, a repeat of the Fall of 2008 is unlikely for REIT shares, but more likely to resemble the 2000-2002 period when real estate stocks outperformed. Specifically, REITs are well positioned given:

- **Valuations are attractive today**. Both on an implied cap rate basis and spread to bonds, real estate valuations are attractive.
  - Underlying property valuations are attractive at 6.1% implied cap rates, up nearly 100 basis points from July and likely 50 basis points higher than private market pricing.

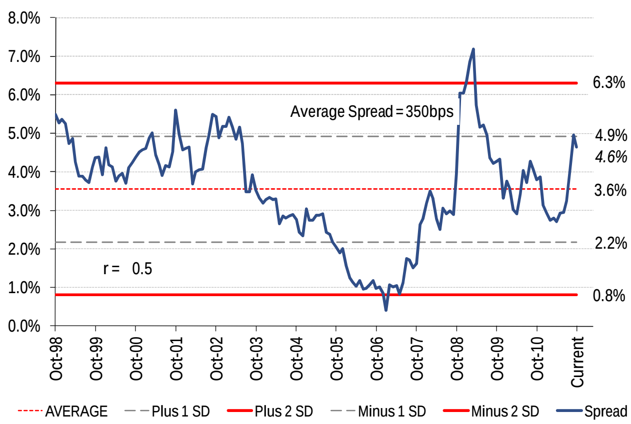
Figure 1: Wide Implied Cap Rate to BBB Spread Historically an Attractive Entry Point



Source: Citi

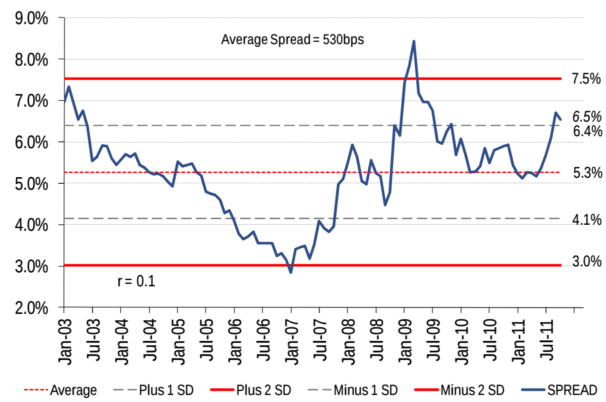
- Cap rates today are near historical wide spreads when compared to bonds which have generally indicated an attractive entry point into REIT shares:
  - 210 basis points higher than BBB corporate bonds versus historical average of 140 basis points. (Figure 1)
  - 470 basis points higher than 10 year treasury bonds compared to 350 bps historically. (Figure 2)
  - 660 bps higher than TIPS compared to 530 bps historically. (Figure 3)

Figure 2: Wide Implied Cap Rate to 10-Year Treasury Spread Attractive Entry Point



Source: Citi

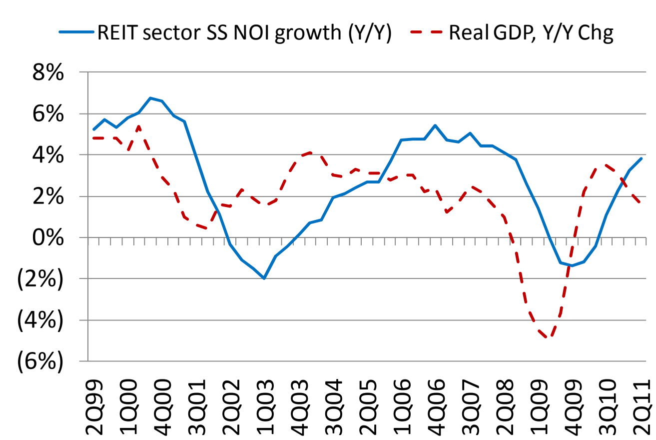
Figure 3: Wide Implied Cap Rate to TIPS Spread Attractive Entry Point



Source: Citi

- **Fundamental outlook is stable.** Today, with virtually no new supply added over the past 4 years and continued population, household and modest job growth, underlying supply/demand dynamics remain stable for most property types. On the ground during the past 6 weeks there have been very few signs of a slowdown for real estate companies, although some management teams have suggested 2012 could be slower.
  - New construction is 390 million square feet a year today, down from 1 billion square feet a year for the 10-plus year prior to the GFC.
  - REIT same-store NOI enjoys a more muted impact from the business cycles than the S&P 500. (Figure 4) During the 2001-2002 period, REIT earnings were up 4% compared to the S&P 500 earnings down 14%.

Figure 4: REITs Enjoy A More Muted Impact from Business Cycles Than The S&P 500



Source: ISI Group

- **Balance sheets stronger**. Real estate values going into the GFC were at bubble levels when looked at on an absolute basis, with implied cap rates at the peak of 5.1% and lower than BBB corporate bonds and 10 year treasury yields, making the balance sheets of public and private real estate companies more susceptible to a decline in real estate values. With real estate now trading cheaper than historical levels (20-25% below peak) on these metrics, balance sheets are better positioned to withstand the impact of a cyclical downturn.

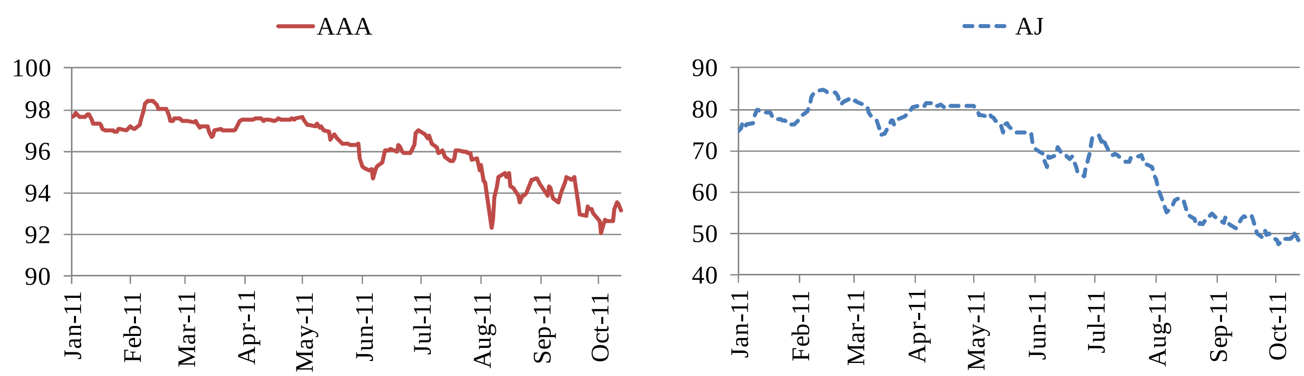
- **Yields appear favorable**. Attractive 4.0% dividend yield and low payout ratios at 73% set companies up for favorable comparisons as investors seek yield alternatives.

Risks To Base Case

The risks to our base case for property shares center around three factors: 1) European Financial Crisis deteriorates causing a further tightening of debt availability, 2) a severe economic downturn which causes demand to fall sharply, and 3) commercial banks who hold the majority of the debt maturing in the next few years forced to liquidate properties at fire sale prices.

At the moment, risk aversion is limiting the availability of new debt to real estate from the levels just three months ago. As the debt crisis in Europe abates, it is likely that financing will start to flow again.

Figure 5: AAA CMBX Down Marginally Compared to AJ CMBX For the Year



Source: JP Morgan, Bloomberg

While the equity markets have rallied on European rhetoric, the debt markets and CDS of the banks and European sovereigns have improved only marginally. Debt markets typically bottom before equities so it will be key to see improvements in the debt markets to determine if the crisis has truly abated. AAA CMBX is up 0.1% month whereas the AJ CMBX is down 1.5% for the month. (Figure 5)

GDP Growth Likely Recessionary (+/-1%)

Our base case scenario assumes that GDP growth in developed markets will likely be anemic given austerity measures and continued deleveraging. In this environment, a more defensive portfolio positioning is warranted.

Typically, companies with the following characteristics should outperform due to better operating results and better access to the capital markets:

- High quality assets in high barrier to entry markets.
- Best management teams who have proved to be good allocators of capital.

- Conservative balance sheets with low leverage and well staggered debt maturities.
- Underlying demand that is more resilient in the face of a slowdown.
- Dividend yields that are well covered by cash flow.

Property sectors with less economically sensitive demand and demand that are less impacted by the focal point of current of the economic weakness (e.g. financials and government exposure) should outperform. Apartments, factory outlets, triple net lease, west coast office, datacenters and towers should generate strong returns. The pullbacks in the stocks over the past few months more than reflect any potential weakness in fundamentals and asset values that these sectors will likely experience.

More economically sensitive sectors will likely continue to lag despite their recent underperformance. These sectors will likely experience the brunt of downward earnings estimate revisions over the next year. A combination of slowing or negative earnings growth should put downward pressure on valuations as weaker growth prospects are priced in. Lodging, low end retail, commercial real estate brokers and office in the Washington D.C. metro and markets with significant financial services exposure will likely be under the most pressure.

Modest Impact to Real Estate Demand on the Ground Thus Far

Real time data points for demand for real estate are showing some pockets of weakness as tenants re-assess their plans, but activity has not fallen off a cliff as it did in the Fall of 2008. National office leasing volumes according to Cushman & Wakefield were up 23% year-over-year in the third quarter, but decelerated from a 44% increase year-over-year during the second quarter. Rents have not been impacted by recent events. Demand for high quality assets has been more resilient as some tenants take the opportunity to trade up to better space. Manhattan and Washington D.C. have experienced a more significant slowdown in activity, while West Coast markets, particularly West Los Angeles and San Francisco, have seen continued strong activity. The transaction market has slowed over the past few months as the CMBS market locked up. The lending market for high quality assets remains wide open, unlike the Fall of 2008.

Earnings Estimates For Cyclical Names Likely to Come Down During Earnings Season

Reported earnings and operating trends for the property companies should largely be in line to modestly ahead of expectations and earnings guidance for the balance of the year should be left intact. However, 2012 earnings estimates are more at risk, as consensus expectations for occupancy gains and rent increases for the more economically sensitive sectors will likely be moved down some.

Consensus earnings estimates for 2012 have risen by 1.5% year to date and are only down 60 basis points from its high despite lower GDP forecasts; it appears that estimates need to be adjusted downward to reflect a slower pace of economic activity. For companies issuing initial 2012 earnings guidance, the economic backdrop the companies assume will significantly impact whether the ranges meet current expectations. Companies will likely set the bar low given the cloudy outlook, but are unlikely to go as far as assuming GDP growth at or near recession levels.

LANDandBUILDINGS Background:

Jonathan Litt is the Founder and CEO of LANDandBUILDINGS, a long/short investment firm that actively invests in securities of global real estate and real estate related companies. Prior to LANDandBUILDINGS, Jonathan Litt was Managing Director and Senior Global Real Estate Strategist at Citigroup where he was responsible for Global Property Investment Strategy from 2000 to March 2008. Jonathan Litt led the #1 Institutional Investor All American Real Estate Research Team for 8 years and was top ranked for 13 years while at Citigroup, PaineWebber and Salomon Brothers. Craig Melcher, Co-Founder and Principal at LANDandBUILDINGS, was a key member of the Citigroup team. LANDandBUILDINGS was seeded by funds advised by Citi Alternative Investments in the summer of 2008, now SkyBridge Capital. Land & Buildings Investment Management is a Registered Investment Adviser with the SEC.

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